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PART 2
INVESTOR PROTECTION

HEARINGS

BEFORE A

SUBCOMMITTEE OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE HOUSE OF REPRESENTATIVES

EIGHTY-EIGHTH CONGRESS

FIRST AND SECOND SESSIONS

ON

H.R. 6789, H.R. 6793, S. 1642

BILLS TO AMEND THE SECURITIES ACT OF 1933, AS AMENDED, AND THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED, TO EXTEND DISCLOSURE REQUIREMENTS TO THE ISSUERS OF ADDITIONAL PUBLICLY TRADED SECURITIES, TO PROVIDE FOR IMPROVED QUALIFICATIONS AND DISCIPLINARY PROCEDURES FOR REGISTERED BROKERS AND DEALERS, AND FOR OTHER PURPOSES

DECEMBER 3, 4, AND 5, 1963; JANUARY 21, 22, 23; FEBRUARY 4, 5, 18, AND 19, 1964

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Committee on Interstate and Foreign Commerce

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INVESTOR PROTECTION

TUESDAY, DECEMBER 3, 1963

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE OF THE
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to call, in room 1334, Longworth Building, Hon. Harley O. Staggers (chairman of the subcommittee) presiding.

Mr. STAGGERS. The subcommittee will come to order.

When this subcommittee recessed the last time, we had heard certain witnesses in favor of the bill. Today we continue the hearings on H.R. 6789.

Our first witness will be Mr. Amyas Ames. Mr. Ames, welcome to the committee.

STATEMENT OF AMYAS AMES, PRESIDENT, INVESTMENT BANKERS ASSOCIATION OF AMERICA; ACCOMPANIED BY MURRAY HANSON, MANAGING DIRECTOR AND GENERAL COUNSEL; AND WILLIAM WARD FOSHAY, SPECIAL COUNSEL, OF SULLIVAN & CROMWELL, NEW YORK, N.Y.

Mr. AMES. I am Amyas Ames, president of the Investment Bankers Association of America. With me are Murray Hanson, the managing director and general counsel of the association, and our special counsel, William Ward Foshay, of the firm of Sullivan & Cromwell, of New York.

The IBA has a membership of over 750 investment banking firms and securities dealers and brokers. They have offices in every State and every important city in the country, and they employ about 80,000 people. As the name "investment banking" implies, their primary function is raising capital for the American economy. In 1962 they participated in over $15 billion of financing, divided about equally between public and private corporate purposes.

Our annual meeting convened yesterday in Florida. It will continue in session throughout this week, and, as the President for this year, I should be there. The passage of this proposed legislation—H.R. 6789, 6793 and S. 1642—however, is the most important single matter with which our industry has been concerned for a long time. I therefore considered it essential that I leave the meeting and fly here to inform you gentlemen of our endorsement of the bills.

Let me make it clear at the outset that we are not regulators or even self-regulators. We speak as the regulated.

This is not a new experience. In the last 30 years we have become the most extensively and intensively regulated industry. We strive to work under State blue-sky laws, all the Federal laws administered by the SEC, the rules of fair practice, and other dictates of the National Association of Securities Dealers, Inc., and the constitution and regulations of the New York Stock Exchange, the American Stock Exchange, and various regional exchanges. As to whether there should be additional regulation and, if so, what kind, we are experts and in a position to contribute constructively.

Ever since your initiation of the project, the SEC's Special Study has been followed and studied closely by us. Our members have been kept informed and their criticism is being readied. This is not to say, however, that we have not been impressed by the thoroughness of the investigation but also the manner in which it was conducted.

On the contrary, there was an earnestness, an objectivity, and a lack of calculated sensationalism which must be considered exceptional for this type of endeavor. Moreover, the report itself is a model of orderly and clear presentation. Naturally, we are not in agreement with all its findings, but we are gratified with the overall conclusion that our industry is not riddled with abuse, but in the main, conducted according to standards of which we are proud.

The report's recommendations reach a total of 175, but only a relatively small number of these call for amendments of the statutes. The decision last spring to proceed at once toward implementing these legislative recommendations was certainly the correct one. Amendments are needed not only to introduce new requirements, but more importantly, to assure statutory foundation for administrative regulation and self-regulation to follow.

The SEC's approach to the legislative program recognized again, as was true in the 1930's, in 1940–41, and 1954, that Federal legislation in the securities field, if it is to be effective, must have the benefit of government and industry collaboration. The problems are complex, and they cannot be solved from ivory towers. Practicality is an essential ingredient, and that can be supplied only with the help and advice of businessmen. Recently, and from an unlikely quarter, there was heard a voice complaining of the SEC's turning to industry for consultation and warning of dangers of SEC captivity and cooperation becoming appeasement. The gentleman overlooks the lessons of the past, and what is far worse, seems to question the integrity of the conscientious individuals in government and industry who last spring molded a program which merits the approbation of all concerned.

DISCUSSION OF THE BILL

Standards, qualifications, and disciplinary powers: Our review and analysis of the Special Study Report, although not yet complete, has led to one inescapable conclusion. Many, if not most, of the abuses and undesirable practices described in the report could be eliminated to a very great extent by the imposition and enforcement of higher standards of conduct, experience, competency, integrity, and financial responsibility which must be met by persons engaged in the securities business. It is necessary to provide for effective and flexible disciplinary powers which may be used by the Commission and the self-regulatory bodies to bar from the industry those who have failed to

demonstrate their ability or willingness to meet the established standards.

The enactment of the proposed legislation will not, in itself, guarantee the achivement of these objectives, but it will provide the statutory authority which the SEC and the self-regulators need in order to put into effect the necessary reforms in cooperation with responsible leaders of the industry.

A brief analysis of the major provisions of this portion of the bill will illustrate how it will increase the effectiveness of regulation and self-regulation and will permit greatly improved disciplinary procedures.

1. Disciplinary action by the Commission: Under present laws, there is no procedures by which the Commission may take action against an individual associated with a broker-dealer. If it proceeds at all, it must proceed against the firm, even though it is a large organization with a generally good record, and even though only a small number of persons were involved in the alleged violation.

If the Commission takes action against the firm, the only penalties it may impose are revocation of the firm's broker-dealer registration, suspension of the firm from the NASD, or suspension of the firm or its partners or officers from a national securities exchange. There is no provision for taking action against the individual guilty of the violation without taking action against the firm, and there is no provision for suspending, rather than revoking, the firm's registration.

Because of this lack of flexibility, the Commission has sometimes been reluctant to take any action at all in cases involving isolated trangressions by individuals. The bill would make it possible for the Commission to proceed against an individual without making the firm a party to the proceeding and, in appropriate cases, to enter an order temporarily or permanently barring the individual from being associated with a broker or dealer. The bill would also authorize the Commission to censure or suspend the registration of a broker-dealer firm in cases not warranting revocation.

We feel that this broadening of the Commission's disciplinary powers is clearly in the public interest and will make it possible for the Commission to act more effectively in the protection of the public interest by excluding from the industry persons who have failed to live up to their responsibilities.

2. Broadening of SEC jurisdiction: The bill would eliminate the present exemption from registration for broker-dealers whose business is exclusively intrastate, but who use the mails or instrumentalities of interstate commerce. The number of broker-dealers entitled to this exemption is small, and we feel that they should be required to conform to the same rules as those which apply to the great majority of firms in the industry. Many of the State blue-sky authorities have done a good job of regulating broker-dealers, but such regulation is not uniform from State to State, and the State authorities often have no effective means of proceeding against persons who leave their jurisdictions. This provision of the bill recognizes that regulation of individuals in the securities business is a matter of national concern. The bill will not affect the right of each State to impose requirements of its own, in addition to the requirements of Federal law.

Another helpful provision of the bill would eliminate the necessity of proving that the mails or instrumentalities of interstate commerce were used in connection with a violation by a registered broker-dealer. A registered broker-dealer who violates Federal law should be subject to appropriate action by the Commission or the courts regardless of the means employed in the commission of such violation.

3. Increasing the self-regulatory powers of the NASD: It has long been recognized that the Commission cannot reasonably be expected to shoulder the entire responsibility for prescribing and enforcing standards for the securities industry. Self-regulation has played and will continue to play a vital role. The stock exchanges pioneered in self-regulation, even before there were any Federal securities laws. The enactment of the Securities Exchange Act of 1934 and the Maloney amendments of 1938 amounted to an endorsement by Congress of the policy of supporting and encouraging responsible self-regulation of the industry.

At present, broker-dealers may avoid subjecting themselves to the NASD's authority simply by electing not to join the organization. The bill would eliminate this loophole in the self-regulatory structure by requiring that all broker-dealers transacting over-the-counter business be members of the NASD or some other national securities association which meets the standards of the act.

The bill also gives the NASD important new powers to prescribe standards of financial responsibility for members and standards of training, experience, and competence for members and their employees, and also clarifies the NASD's power to regulate quotations. These are matters which can be most effectively dealt with by a self-regulatory organization rather than by the Commission, and the NASD must be given adequate powers to permit it to impose new requirements recommended by the Special Study Report.

Frear-Fulbright proposals: We support strongly the so-called Frear-Fulbright provisions of the bill in the belief that they are essential for the protection of holders of securities of unlisted companies and for the functioning of orderly markets in such securities. Investors in widely held unlisted securities are entitled to the same information and protection as the law presently provides for holders of listed securities.

Although there has been some difference of opinion as to where the line should be drawn in determining which companies are to be subject to the requirements, we support the provision of the present bill making the requirements initially applicable to all companies with more than $1 million in total assets, and 750 or more stockholders with provision for reduction of the stockholder test to 500 after the first 2 years.

We feel that it is not unreasonable to require companies meeting these tests to make available to the public audited financial statements prepared in accordance with standards established by the Commission, and to make public disclosure of other information required by the Commission's reporting forms and proxy rules. Whatever additional burdens which may be placed upon such companies will be far outweighed by the benefits to investors.

It is also proper to subject the officers, directors, and 10-percent stockholders of such companies to the same insider trading provisions as are now imposed with respect to listed companies by sections 16(b) and 16(c) of the act. The present bill recognizes an important need

by exempting from these sections ordinary marketmaking transactions by broker-dealers who might otherwise be subject to such provisions.

This exemptive provision will permit broker dealers to continue to make a market in securities of over-the-counter companies while at the same time providing advice and counsel to the managements of such companies by being represented on their boards of directors.

Broker-dealers who are represented on the boards of companies while making a market in the stocks of such companies perform a valuable function. Such sponsorship, as it is sometimes called, is particularly beneficial for smaller companies which have recently gone public. Their securities are not well known, and the internal management is often not fully aware of the additional obligations imposed upon them as a result of having public stockholders.

The sponsoring broker-dealer has two principal responsiblities: to develop and maintain an orderly market for the stock, and to represent the interests of the public stockholders on the board of directors by counseling the management on business decisions and by pointing out to the management its obligation to make full and fair disclosure of all information of interest to investors. In developing an orderly market, the sponsoring broker-dealer benefits the company by making others aware of its investment potential; by serving as a trusted adviser to management he helps facilitate the difficult transition from a privately held to a publicly held company.

Broker-dealer sponsorship has proved to be of immeasurable benefit to a large number of companies, and we are pleased that the bill makes possible the continuance of this service function of our industry.

Proposed amendment to section 4(1) of the Securities Act of 1933: We endorse this section of the bill, which would change the 40-day prospectus delivery period to 90 days in the case of issues which represent the first registered public offering by the issuer, but would also give the Commission power to shorten either the 40-day or the 90-day period in appropriate cases.

Although we do not think this amendment will solve whatever remains of the "hot issue" problem, it will give the Commission needed flexibility where none exists today to vary prospectus delivery periods according to circumstances. The most important function of the prospectus is to inform prospective investors, and it is reasonable to require prospectus delivery for a longer period in the case of companies going public for the first time which are not well known to investors.

In contrast, little is accomplished by requiring use of the prospectus for any substantial period following the completion of the distribution of senior securities, or additional common stock issues, of companies whose outstanding securities are already widely held and whose reports have been available to the public over a period of time.

In conclusion, may I state that we endorse the bill without qualification and hope that it will be passed by the House of Representatives as soon as possible in substantially the form passed by the Senate. We feel that the Special Study Report has demonstrated the need for this legislation, and we are confident that it will contribute significantly to the protection of the public.

Thank you very much.

Mr. STAGGERS. Thank you, Mr. Ames, for taking the time to come back from Hollywood, Fla., to appear before the committee and give us the benefit of your views.

As I understand it, the bills before us propose to invoke a new disciplinary policy, which is that the Commission may move directly against an employee or individual, whereas, hitherto the firm, itself, was held accountable for the actions of the members, of its members or employees.

Mr. AMES. Yes, sir.

Mr. STAGGERS. I can appreciate why some firms would desire not to be liable for the actions of some of their employees. However I wish you would explain to me why your association, with its high standards of commercial honor and business conduct, wishes now to relieve its member firms from the complete accountability for the actions of its employees.

Mr. AMES. I don't quite understand. Could I have the last part of the question again?

Mr. STAGGERS. Do you endorse in your statements——

Mr. AMES. May I refer the question to Mr. Foshay?

Mr. STAGGERS. Surely.

Mr. FOSHAY. Mr. Staggers, I do not think that the bill would eliminate the right of the Securities and Exchange Commission to proceed against and discipline a firm if it chose to do so. This bill would give them an additional right which would be to go after the individual if it decided that it was not a case in which it should go after the firm. In other words, this does not eliminate any right to go against a firm. It adds a right, if it chooses, to proceed against the individuals, which they do not have now.

Mr. STAGGERS. I understand that it does give that right; but also, there is an implication that the individual can be held accountable and not the firm trading. Of course, it does not eliminate anything, but certainly there is an implication on the individual.

Mr. AMES. May I add to the answer? I didn't quite understand the question in the first instance. If I may speak as one who has been a manager of a major securities firm, the problem of raising standards must go to the individual. It is only by raising the standards, for instance in our own firm, of the individuals that we have with us which permits us to get the whole organization up to the standard which satisfies us. If some individual does something that is not right, the holding of that person up as an example to others, is the most effective means of raising standards.

We, in our firm, can make rules. We do. We have an extensive book of rules and regulations for our internal operation. But those rules don't get through to human beings until those human beings feel the necessity to follow them.

I believe this same principle applies to the Nation's security business just as much as it applies to us in our own firm. Therefore, I believe the right to proceed against the individual is a very important means of raising the standards of the whole securities industry.

Mr. HARRIS. Would the chairman yield?

Mr. STAGGERS. Certainly.

Mr. HARRIS. I don't believe you have answered the question of the chairman in full. I think what you have said is very important, and I have no quarrel with it. The import of the question, as I understand it from the chairman, is How can you explain the fact that you are transferring to the Securities and Exchange Commission the full authority to deal with your employee, relieving your company of that

responsibility, the responsibility of discipline of the employee, himself?

Mr. AMES. I do not think we do transfer that to the Securities and Exchange Commission. I think that remains with us in our own firm. I think our problem is that in a broad country such as this, and with the great diversity of people and firms that there are in this industry, it is necessary for somebody to hold all of the firms up to such standards and all of the individuals within those firms up to such standards. Without this legislation, it cannot be done.

Mr. HARRIS. You are still not getting to the point. In my mind, and I do wish to have a direct statement from you on it, it is this: Do you not feel in the first place that any company rightfully should assume the responsibility of discipline of employees that work for that company if such is necessary?

Mr. AMES. I think that is necessary; yes, sir.

Mr. HARRIS. The question here is that the SEC is given authority to deal with the individual in the company and not the company, itself, for any act that might have occurred; is that right?

Mr. AMES. I think in any act of impropriety.

Mr. HARRIS. Anything to be in violation of the act or the provisions, if these are adopted.

Mr. AMES. That is correct.

Mr. HARRIS. In other words, you would be transferring to the SEC the responsibility of taking such action that might be necessary on a violation of the act instead of your company being held accountable for it.

Mr. AMES. I don't think that would be my interpretation of the meaning.

Mr. HARRIS. That is just what you said in your statement.

Mr. AMES. I may have not stated my position clearly. It does not seem to me that there can be a transference of the responsibility of the individual company for its employees to Government or to the Securities and Exchange Commission. It does not seem to me that this legislation would do so. However, it does seem to me entirely appropriate, if there is malfeasance or if there is a case where the Government finds in its overlook that things are happening which should not happen in the public interest, it seems to me very often to be most effective to go to an individual rather than to have to suspend an entire firm.

Mr. HARRIS. I think it is a matter that deserves a great deal of consideration, Mr. Chairman, because I just do not feel that it would be best insofar as the economy is concerned and the protection of those involved in matters of this kind to relieve the firm, itself, of the responsibility, and the employees of that firm.

I don't say that you would do it, Mr. Ames, and I am not making any accusation, but it would be so easy for any company to single out John Doe and say: "We are going to make him the goat, make him suffer the penalties, and we will be relieved of everything."

Mr. AMES. I think it would be wrong to relieve any individual company of its responsibilities, and I think it is very important that these responsibilities do remain with the security firm itself. I strongly agree with you, Mr. Harris. I am saying ,and I believe our industry has been saying for almost 30 years, that we must have some means—and when I say "We" I mean we as a people, because we in the

business can't control everybody—whereby Government coming into this can look at the whole area.

Mr. HARRIS. It seems to me that you are trying to play both ends Mr. Ames, and I don't mean that with any reflection whatsoever. I recognize it is a tedious and difficult situation to deal with. But you believe in self-regulation.

Mr. AMES. Yes, sir.

Mr. HARRIS. And the whole industry believes in self-regulation.

Mr. AMES. Yes, sir.

Mr. HARRIS. I have given a lot of thought and study to this field of self-regulation, where these acts apply, and I have a strong feeling for the principle, but if you are going to believe in the principle of self-regulation, then the industry is going to have to assume the responsibility of self-regulation. That is going to have to be applicable to not only the company, itself, but the employees of the company.

Thank you, Mr. Chairman.

Mr. STAGGERS. Thank you, Mr. Chairman.

Pursuing this, we were trying to get to the principle of self-regulation and the philosophy behind it. I want to come back in a few moments to some other questions. We also want to pursue something that happened yesterday, briefly, to see where the fault lies in the Williston and Beane group, and leading back to the Allied Crude Oil Vegetable Co., as to the individuals in those instances.

This is something that is current, however, and I do not want to come to it now. Did you want to pursue this further?

Mr. HARRIS. No. I want to thank Mr. Ames for his statement. I am glad to have his statement on behalf of his company, which is very clear and understandable from his viewpoint.

I am sorry that we have inconvenienced you by requiring you to come from the sunny shores of Florida. I guess they are sunny. I know these annual meetings are important. But if there isn't something this week or next week, it is something that comes the following week. We cannot keep on postponing important hearings.

Mr. AMES. If I may say, sir, you have not inconvenienced me. I think this is a matter of such importance that I wouldn't want to have it referred to as an inconvenience. I also might say there are times when perhaps there are even pleasures in appearing before a committee here in Washington as against associating with 1,200 to 1,400 people in a closed hotel.

Mr. HARRIS. I make that statement, Mr. Ames, because this committee was importuned very strongly from the industry to postpone these hearings and giving you and the other groups the chances to attend your meetings, one being held in Las Vegas and one being held in Florida.

I just want you to know that we are sorry if we inconvenienced anybody. We recognize what the situation is, but we simply cannot keep on postponing something to meet the convenience of everybody, because there is always an inconvenience, it seems, when anything like this comes up.

Mr. AMES. We agree. We would not want you to postpone, sir, and we did not press for postponement, but only adjusted our plans to appear. As I say, we do feel this is a matter of prime importance.

Mr. STAGGERS. Mr. Curtin, have you any questions?

Mr. CURTIN. Thank you, Mr. Chairman.

I, too, Mr. Ames, want to congratulate you on a very lucid statement. I think you have handled the subject very well. I also want to congratulate you on your dedication to duty to leave Miami and come to Washington for this hearing.

There are one or two features of your statement on which I would like to have further clarification.

I notice on page 4 of your statement you say that investors in widely held unlisted securities are entitled to the same information and protection as the law presently provides for holders of listed securities.

Mr. AMES. Yes, sir.

Mr. CURTIN. Would you elaborate a bit on that statement?

Mr. AMES. This, of course, deals with the matter of full disclosure about securities, which is something that we in the Investment Bankers Association believe in as one of the essential protections of investors, and, beyond that, one of the necessities for our performing our function on an effective basis.

There is a great difference in the amount of information available about companies which are listed and therefor meet certain standards of disclosure—audited statements and complete information about their operations—and those that are unlisted, perhaps partly privately owned companies, which give no information at all.

Among the unlisted companies, and there are a great many such companies, there are many cases where the information available to the industry and to the investor, or to their own stockholders, is so restricted that it is almost impossible to make a judgment as to value, as to managerial competence.

I think it would be a great step forward if these companies should at least meet certain minimal standards of supplying information so that we and their stockholders would have the ability to judge the value of the stock and the competence of the management.

Mr. CURTIN. Doesn't the individual investor know that there is this distinction in information and protection between different types of securities—listed and unlisted? Hasn't he known that for a great many years and bought accordingly?

Mr. AMES. He has known it, because it has been a fact. But on the other hand, many investors will proceed in their buying or selling of securities on a very small amount of information which sometimes leads them to invest or cease to invest on a wrong premise. If there is information available that either they or the investment fraternity in general can be studying, it will be a major protection to those investors, and I believe it will also be very much in the best interest of the corporations themselves.

Mr. CURTIN. I am not against your position, but I would like to explore it somewhat. For example, over the years, hasn't an investor known, that if he is going to put money in a bank as against a savings and loan association, that his protection for those savings is going to be different?

In regular banks, his savings get a Government guarantee and in building and loan institutions it is merely insured. He makes a choice when he decides which type of institution he will use. Don't you think that is all right?

Mr. AMES. Yes, he knows a great deal about the guarantees and about the deposit desponsibilities of the banks. But he does not know a great deal about the management ability of the men who manage the bank.

There are two separate areas, as I see it. One is the area of the protection of the depositor, or in the insurance company the protection of the insured. But there is another area which is very important to the investor. It is one thing to have him know that the deposits are taken care of and the insurance standards are proper; but the investor either succeeds or fails to succeed in his investment depending upon the quality of the management and the way the managers of that company handle their affairs.

It may be that bank A is well managed and bank B is badly managed. I think the investor should be able to form judgments as to which bank he wants to invest his money in. This is the area where there has been a great lack of information for investors.

Mr. CURTIN. Normally, I believe that the building and loan institutions pay a greater rate of interest than do savings banks.

Don't you think that people are taking into consideration that difference in return when they decide on the type of security they will buy, the same as they make such choice when they decide on their type bank?

Mr. AMES. They are when they are depositing their money, yes, sir; very much. But if I might make the distinction, it is a different thing when you try to judge two institutions as an investor than when you try and judge two institutions as a depositor.

When you judge them as an investor, you want to know how good the manager is. You may be sure that the depositor won't lose his money, but I think the investor wants to know that the manager is of such quality and of such ability that he will do particularly well in the handling of those deposits so that the stockholder will have a chance to have a good investment. This is the area where information, in many cases, does not come forth.

Mr. CURTIN. It seems to me what you are doing is making a distinction without a difference. I would assume that the person who is going to have a certain amount of money to either invest or deposit, is going to look, normally, to where he is going to get the biggest return on that investment or deposit. Don't you feel that is true?

Mr. AMES. No, sir. I think he wants to look to where he can get, as a stockholder, a stock investor, the best management that he can find, because it is the management that determines how the stockholder fares.

Mr. CURTIN. But even the requirements of this pending legislation will not disclose whether or not a particular company has a very good manager or officer as against another company. It is merely going to list the assets and rate of return on the money and how they invest that money.

Mr. AMES. That, but also the more information one has the better qualified or better able one is to judge. I think the whole impact of this so-called Frear-Fulbright part of this legislation is that in the case of a great many corporations, not only banks and insurance companies, but perhaps a much larger number of other small corporations, there is almost no information available and a lot of that information is misleading or it is inadequate.

If certain minimum standards are set forth, this still is not going to tell the investor everything. He still is going to have to take his risk. He will have to make his independent judgment of the character of management. But at least he will have some minimal information

which he will be able to see, and as the years go by, lay it up year after year to see whether the facts come out corresponding with what his managers indicated they were going to do.

Mr. CURTIN. Mr. Ames, isn't it fundamental that the higher the speculation, the higher the rate of return on the money invested should that speculation be successful. In other words, one of the conservative blue-chip stocks doesn't pay as well as some new speculative stock in the way of return on the investment. Isn't that fundamentally true?

Mr. AMES. It is true in the short run. In the long run, very often the company that is the quality company does come out better for the investor.

Mr. CURTIN. If we should provide for such equal protection, aren't you going to make it harder for new companies to get started?

Mr. AMES. No, sir. We are merely giving him a tool whereby he can make a judgment. But, unfortunately, it still remains very difficult to make a final judgment about an investment. There will still be all of the differences between the quality investment and the wild speculation. There will still be the differences between the good manager and the bad manager. But at least the investment industry and the investor himself will have a minimal amount of information so that he has some chance of making a judgment. There is nothing more dangerous in investing and nothing that can more hurt the investor and the public in general than investing in something about which they don't know enough to form a judgment. That is what goes on in this area, and that is what this part of this bill will take a constructive step to solve.

Mr. CURTIN. Thank you.

Thank you, Mr. Chairman.

Mr. STAGGERS. I have a few questions I would like to ask you, Mr. Ames.

I understand that in your ad hoc committee, of which you are the chairman, Mr. Rockefeller is a member, and Mr. Foshay is counsel, has proposed certain policy considerations regarding the SEC's proposals covering the selling practices in the securities industry.

It is my understanding while you support the present legislation insofar as it covers requirements, including examination for the employment of securities salesmen, you deny in that report that they are or should be responsible for the suitability of the purchase which the customers make.

Mr. AMES. Yes, sir.

Mr. STAGGERS. Just how effective, accordingly, can be the suitability rules adopted by the NASD or by the New York Stock Exchange when you feel the salesmen cannot be responsible for suitability of the security for a given customer?

Mr. AMES. This is a most interesting problem in the securities business. The position that we take is that suitability is something that is almost impossible to write into rigid law. We do not say that we do not believe suitability to be important or that we disregard it in our training of salesmen, and that a good salesman we believe should be concerned with suitability.

Our problem on suitability can, perhaps, to some extent be explained by what would have happened in 1926 or 1927 if a security firm had recommended a railroad security to an investor. A few years later with the building of roads and things that might not have been

foreseen, the depression, that security, as history proved, was a great deal lower. It might at that time when looked at in the afteryears be thought to be totally unsuitable.

Suitability is something which changes with time. It changes with the condition of the investor. It is a constantly moving problem. The mistake, I think, that is made in the special report, and perhaps the mistake that is made by those who are unfamiliar with investing and the problems that are involved in it is that by just writing a rule and saying, "You must determine that such is suitable or such is unsuitable, and you must write it down on a piece of paper," that this is a practical rulemaking area. It is not a practical rulemaking area, and if rules are made in this area they can possibly really hurt the entire industry in the performance of its functions.

Mr. STAGGERS. In response to that very briefly, I would say that as I concluded from the proposal in your report, and I would like to make it part of the record, your memorandum on selling practices of the American securities industry, you deny that they are or should be responsible.

According to that statement, I would like to ask whether they perform to the best of their ability—and no one is a prophet except those who look back and say what should have been—under conditions as they are today or tomorrow. For instance, the insurance companies do not go out any more and try to sell an insurance policy which is entirely unacceptable. They have found that it is entirely improper.

I wonder if in securities this is not an improper action, in light of the present situations. Isn't the salesman responsible in trying to do a job for his firm, if the firm is honest and responsible? Is it not the firm's responsibility, also?

Mr. AMES. Please do not misunderstand me, Mr. Staggers. I agree with you. I think suitability is something which a well-run security firm gives a great deal of consideration to. I believe they should give consideration to it.

If I might come over to the position I think Mr. Harris took, I think this is a responsibility of the management of a security firm, and I think once you start to write it into law or into rule, you are going to make it so rigid and so difficult that it will be impossible for the security firm to function.

I think one of the things it is very important to remember is that this country has been developed by the risk of money in new enterprise, and I think it is something very important to remember that there are a tremendous number of companies which no man has the wisdom to judge until events take place. Some of those companies become great companies and some of them go into total collapse and the investors lose all their money.

As soon as we start to overregulate business and to mother-hen it, to a point where everything must be written into a rule, we will stifle the development of our economy.

I will take it one step further, and that it is say that very often the development of a new company results in new jobs in the area in which that company works. If you put any such rule as this on the books, it is going to be impossible to start new companies and that will mean it will be impossible to start the jobs that those companies would provide to the people of the community.

(The memorandum report follows:)

MEMORANDUM ON SELLING PRACTICES OF THE AMERICAN SECURITIES INDUSTRY

A Proposal of Policy

and

An Analysis of Related Recommendations in the SEC Special Study

Ad Hoc Committee

Amyas Ames	Kidder, Peabody & Co.
Francis Kernan	White, Weld & Co.
Albert Pratt	Paine, Webber, Jackson & Curtis
Donald Regan	Merrill Lynch, Pierce, Fenner & Smith, Incorporated
Avery Rockefeller, Jr. ...	Dominick & Dominick
Counsel	William W. Foshay Sullivan & Cromwell

December 2, 1963

FOREWORD

The Report of the Special Study of Securities Markets of the Securities and Exchange Commission raises important questions concerning, among others, "selling practices" of the securities industry. The purpose of the Special Study Report has been described as an attempt to raise the entire securities industry to the best standards which the industry itself proclaims. The Commission has asked the industry to develop preliminary suggestions as to the form and the extent of new rules or guides which will achieve this end and thus we are in a position to work constructively with government in the development of the policies and rules under which we are to do business.

A small ad hoc committee has been appointed to study and to analyze various recommendations in the Special Study Report that deal with "selling practices" and to make a proposal of policy to be considered by the industry. This committee is made up of men whose firms do business in all parts of the country, and are active in most of the areas of the business—listed markets, over-the-counter markets, underwriting and mutual funds.

It is not the function of this committee or the purpose of this memorandum to attempt to speak or set policy for the Investment Bankers Association of America or for the industry in general, but wise policy can only be developed after men qualified by training and experience in each area of the business and each part of the country have focused on the problems involved. The securities industry performs a vital function in this country and it is a matter of important public interest that the economic operating unit of this business—the securities firm itself—actively participate in the advance planning for the policies and rules which are to govern its operations.

Therefore, it is hoped that this memorandum will (i) focus the attention of the industry on the problems involved in future rules or guides on "selling practices" to be adopted by the SEC and the self-regulatory agencies; (ii) develop criticisms and suggestions from securities firms—before the ideas of either business or government become too rigid; and (iii) help us to achieve that goal which we in the industry so heartily endorse, of spreading widely the high standards existing within our industry.

AMYAS AMES, *President*
Investment Bankers Association of America

December 2, 1963

SUMMARY OF CONCLUSIONS

In this memorandum we analyze those recommendations in the Special Study Report which we understand the Commission to regard as of high priority in the area of selling practices. We have also included recommendations of the Special Study regarding minimum capital requirements and qualifications to enter the industry. Although not within the immediate area of selling practices, we believe that proper standards of financial capacity and responsibility, together with adequate supervision of competent personnel, will be by far the most effective methods of eliminating improper selling activities.

While this memorandum is only a preliminary effort, it leads us to propose means by which our industry can work with the regulatory and self-regulatory authorities to achieve a common good.

Recommendations We Support

The Special Study Report was the result of a thorough study of the industry over a two-year period. Many of its recommendations evidence understanding and appreciation of our business and its problems, and we approve them. For example:

(1) We concur that the individual should receive more attention as an appropriate unit for regulatory purposes. The standards of an industry can only be effectively raised by improving the quality and the performance of the people who work in it.

(2) We agree that standards for entry and continuance in the business should be developed and administered by the self-regulatory authorities, and that they should encompass competence of personnel (in the sense of knowledge tested through examinations and appropriate experience) as well as financial capacity and responsibility of firms.

(3) We also agree that training and supervision of sales personnel should be emphasized anew, and that the supervisory methods employed should be improved wherever possible.

(4) We believe that more effective self-regulation can be devised for certain selling practices, including market letters, advertisements and other sales literature. We also think that more

specific standards should be considered by the NASD with respect to "mark-ups" in the over-the-counter markets, and that the dissemination of retail quotations in those markets can be improved.

(5) We support all appropriate steps to stamp out "boiler shop" activities.

Recommendations with respect to subjects such as these can and should be carried out on an industry-wide basis.

Recommendations We Disapprove

The more other recommendations are analyzed, the clearer it becomes that in the course of the Special Study either the problems were not clearly understood or the practical aspects were not given due weight in the formulation of the solutions recommended. To illustrate:

(1) We oppose regulation or self-regulation which would encroach upon prerogatives of responsible management, restrict branch office managers' legitimate sales activities, interfere with management's right to determine what and how emplcyees are paid, or dictate data processing techniques.

(2) While we agree that securities salesmen should be highly qualified to perform their function, we deny that they are or should be responsible for the "suitability" of the purchases their customers make. Adoption of specific "suitability" regulations could so restrict the industry as to preclude performance of its essential function in the American economy.

(3) We deny that abuses can be eliminated by pyramiding regulation and self-regulation, such as, specifically, requirements for marking all orders "solicited" or "unsolicited", for having all customers' cards show investment goals, or for inserting market data in over-the-counter confirmations. Also, we do not believe that improper practices can be eliminated by detailed regulations premised upon the use of mechanical techniques such as initials on documents, names in files, long bibliographies, specific rather than general hedge clauses, and tidy filing of underlying information.

(4) We consider unsound any procedures designed to introduce artificial "deflation" in the after-markets for so-called "hot" first issues, and we oppose the introduction of untried, theoretical

procedures designed to revolutionize the over-the-counter markets such as making "wholesalers" into "primary market makers" for the retail markets.

(5) We condemn investigation and enforcement devices which are novel, theoretical and foreign to our system.

Recommendations such as these encroach unnecessarily on the rights of management and should not be pursued. Their implementation can only result in more harm than good. The objectives of both government and industry can best be realized without resort thereto.

A Proposal for Industry Policy

FIRST: *Support the SEC sponsored legislation now before Congress.* The proposed legislation will provide the basis for the additional regulation and self-regulation which the industry should endorse, thereby enabling the regulatory and self-regulatory agencies to establish and administer effective industry standards. It will also enlarge significantly the volume of available information about issuers of corporate securities.

SECOND: *Urge statesmanship in the SEC's implementation of its recommendations.* The SEC should proceed without haste, with due attention to and regard for practical effects and consequences and with readiness from the outset to consult fully and freely with responsible representatives of the industry.

THIRD: *Urge similar precepts for the self-regulatory agencies.* The NASD and the stock exchanges also should consult in advance with their membership generally before adopting rules or other guidelines relating to practice or conduct in the industry.

FOURTH: *Participate constructively with the SEC and the self-regulatory agencies.* At all stages of the administrative processes, however preliminary, industry representatives should offer their practical advice and assistance, and provide constructive comment and suggestions where the principles are sound, concessions where appropriate,

and firm opposition where necessary. To this end, individual firms should contribute the time of their best people.

FIFTH: *Encourage the SEC and the self-regulatory agencies to reduce and eliminate duplication.* The start which has been made in the unification of tests for competence and of the work of special investigations should be continued and extended. Elimination of duplication by the SEC, the NASD, the stock exchanges and the state commissioners is essential, especially if there is to be any additional regulation, and uniformity must be the keynote. Multiplicity in administration or investigation is costly, time consuming and unreasonable.

ANALYSIS OF SELLING PRACTICE RECOMMENDATIONS

The following are the selling practice recommendations which are analyzed in this memorandum:

	House Document No. 95
Chapter II F.4-8 and 10-12—"Qualifications for Persons in the Industry"	Pt. 1, p. 160-1-2
Chapter III B.1—"Supervision of Selling Activities"	Pt. 1, p. 328
Chapter III B.2—"Surveillance and Enforcement Procedures"	Pt. 1, p. 328
Chapter III B.3—"Certain Selling Practices"	Pt. 1, p. 329
Chapter III B.4—"Suitability"	Pt. 1, p. 329
Chapter III B.5—"Official Data"	Pt. 1, p. 329
Chapter III B.6—"Compensation of Salesmen"	Pt. 1, p. 329-30
Chapter III C.1—"Research and Advisory Services"	Pt. 1, p. 386
Chapter III C.2—"Investment Advice"	Pt. 1, p. 386-7
Chapter III C.3—"Market Letter Surveillance"	Pt. 1, p. 387
Chapter III C.4—"Reckless Investment Advice"	Pt. 1, p. 387
Chapter III C.5—"Organization of Investment Advisers"	Pt. 1, p. 387
Chapter IV B.1—"First-hot Issues"	Pt. 1, p. 557
Chapter IV B.2—"First Issue Rules"	Pt. 1, p. 557-8
Chapter IV B.3—"Acceleration of First Issues"	Pt. 1, p. 558
Chapter IV B.4—"Prospectus Deliveries"	Pt. 1, p. 558
Chapter IV B.5—"Free-riding and Withholding"	Pt. 1, p. 558-9
Chapter IV B.8—"Rule 10b-6"	Pt. 1, p. 559
Chapter VII F.13 (a) and (c)—"Disclosures in Certain Retail Transactions"	Pt. 2, p. 677-8

In order that this memorandum may be a self-contained document we have set forth in italics prior to our analysis the full text of the Special Study recommendation. Since Chapter II F.4-8 and 10-12 contains recommendations that, to a large extent, are the subject of the legislation introduced in the Congress on June 4th, we thought it preferable to comment on these latter recommendations at the end, rather than at the beginning, of this section of the memorandum.

CHAPTER III B. 1
("Supervision of Selling Activities")

The Special Study concludes and recommends:

1. The supervision by broker-dealers of the selling activities of their personnel, particularly in branch offices, should be generally strengthened by the adoption of appropriate procedures including, but not necessarily limited to: the designation of one home office senior

executive responsible for internal supervision and regulatory and self-regulatory matters generally; increasing the branch manager's supervisory role while deemphasizing his selling activities in branches having large numbers of salesmen; and in large firms with many branches, the tightening of home office control procedures, with more extensive use of electronic data processing equipment programmed to expose overtrading, undue concentration in speculative securities, and other potential abuses.

We agree that the supervision by each broker-dealer of the selling activities of its personnel should be adequate to permit the conduct of its business in accordance with just and equitable principles of trade and in compliance with applicable statutes and regulations. Whether and to what extent further action in this area by any particular broker-dealer is required depends upon the procedures which it is already following. Also, the appropriateness of the procedures followed by any particular firm depends upon a wide variety of factors, such as the number, character and training of its personnel, its size, the number of its offices, and the nature of its activities and of its clientele. The proper procedures for any particular firm is a matter of managerial responsibility.

We do not believe that it is the function of the Commission or the self-regulatory agencies to specify, by regulations of general application, specific procedures for supervision which must be followed by all the many diverse firms in the industry. The release by the Commission and self-regulatory agencies from time to time of information showing the efficacy of particular procedures might, however, be of significant help to members of the industry. The self-regulatory agencies (in a fashion which will avoid duplication) should provide member firms with better-organized and more effective material for the development on a voluntary basis of internal operating and supervisory procedures. Some firms have found that an internally prepared operating manual is very useful, and model manuals might perhaps be developed which firms could modify to meet their own particular requirements.

For a number of reasons (including the Report of the Special Study) the respective members of the industry who have high standards are well aware of the problems in the area of supervision and have

developed and are continuing to develop appropriate procedures. The existing rules of the Commission and the self-regulatory agencies are sufficient to permit appropriate action against the other members.

We consider entirely impractical any regulation which would restrict branch office managers from legitimate sales activities or which would require the use of electronic data processing equipment.

CHAPTER III B. 2
("Surveillance and Enforcement Procedures")

The Special Study concludes and recommends:

2. The self-regulatory agencies should establish clearer standards and stronger surveillance and enforcement procedures to assure more effective supervision by their member firms. While the recent publication of the New York Stock Exchange's guide to supervision and management of registered representatives and customer accounts represents a significant step in this direction, the implementation of the standards there set forth will call for strengthening of surveillance. The NASD control procedures in respect of selling practices are also in need of substantial strengthening. More regular and frequent examinations of branch offices are called for, and examinations should include interviewing salesmen and in appropriate cases customers, when accounts show heavy trading or concentration in speculative issues.

To the extent practical and economic, we endorse the concept that "self-regulatory agencies should establish clearer standards and stronger surveillance and enforcement procedures to assure more effective supervision".

As the Special Study recognizes, the principal focal point in this area is the salesman who has direct contact with the customer. It is obviously impractical for either the broker-dealer or the regulatory or self-regulatory agencies to examine every action by every salesman and consequently the most productive approach would seem to be to improve the standards of the salesmen. Steps already taken and those in contemplation should do much to correct abuses which may have existed in the area of selling practices.

Care must be taken, however, in adopting stronger procedures for detection and enforcement to avoid unnecessary duplication of activity. For example, even under present procedures, in one case involving the conduct of two employees of a broker-dealer which resulted in civil litigation for a relatively small amount of money, there are at least 24 persons (including lawyers, investigators and executives from the NASD, two state commissions, two securities exchanges, an insurance company and the broker-dealer) devoting a significant amount of their time to the investigation. We urge that any steps taken in this area be designed not only to improve the effectiveness of detection and enforcement facilities but also to eliminate much of the duplication of activity by the regulatory and self-regulatory agencies that already exist.

The effectiveness of expanded detection and enforcement machinery, particularly in relation to selling practices, must be weighed against the cost of such expansion. A substantial increase in the number and comprehensiveness of examinations by the regulatory and the self-regulatory agencies, additional manpower, and the diversion of personnel from their present supervisory functions to participate in such examinations might well result in excessive costs. Consequently, careful consideration should be given to synchronizing such examinations by the regulatory and the self-regulatory agencies so as to avoid unnecessary duplication and thus permit more effective examination of a greater number of broker-dealers with less increase in expensive manpower.

CHAPTER III B. 3
("Certain Selling Practices")

The Special Study concludes and recommends:

3. The Commission should adopt rules to facilitate and reinforce controls by firms, the self-regulatory bodies and the Commission over selling practices. Such rules should, for example, require: that every retail transaction be designated "solicited" or "unsolicited" in the permanent records of a broker-dealer; that all customer complaints be

kept in a single file and available for inspection and examination by the Commission, the NASD, and the exchanges; and that customer account cards or similar records include such information as investment goals, occupation and type of service desired.

These recommendations involve such diversity that we will discuss them under separate headings.

Solicited or Unsolicited

A number of firms have their own practices regarding the marking of retail transactions as "solicited" or "unsolicited". In some cases all such transactions are involved, in others only underwritings or other particular types, and in still others only certain securities. Basic to all is the belief that a record of whether a transaction is "solicited" or "unsolicited" may prove useful for business or legal reasons.

There is a wide gulf, however, between a voluntary practice and an SEC rule having the force of law. A practice can be adjusted at will to accord with developing circumstances and excusable omissions can be forgiven. An administrative rule would be rigid and difficult to amend and enforce, and any infraction could entail criminal and civil liabilities as well as disciplinary action.

A busy securities man in the course of an active day cannot be expected to solve the dilemma of "solicited" vs. "unsolicited",—an area where even lawyers flounder. Obviously there are many clear cases of orders that are unsolicited. The size of the field for doubt, however, is enormous.

We are satisfied that a workable general rule is not a practical possibility and that any policy of marking transactions "solicited" or "unsolicited" should remain a matter of management discretion.

Customer Complaint Files

An SEC rule requiring all customers' complaints to be placed in one file would be unnecessary and undesirable.

The SEC, the NASD, the stock exchanges and State authorities can get at the complaints wherever they are. Everyone in the industry

already is required to keep customer complaints on file, and they are available to anyone with authority to see them.

In keeping with good management, correspondence of this as well as other types usually will be in the individual customers' files. To order that copies be lodged in another file would go too far. There would be the problem of deciding what are or are not "complaints" for this purpose. Sometimes it is difficult to distinguish between inquiry and complaint, and certainly plain "beefs" should not be included. Also, what of the "complaint" which is answered fully and to the satisfaction of the customer in a single reply?

Customers with legitimate complaints have many adequate ways to pursue them. If their complaints are not handled in what appears to them to be a satisfactory manner, they can go to the stock exchange, the NASD, the SEC, State authorities, or place the matter in the hands of counsel for civil action. Under our system, there need be no more.

Investment Goals

Some firms in the business use records which purport to show investment goals and type of service desired. Many equally conscientious firms, after consideration, do not. This is again something which should be left to the discretion of the particular firm; it is not a subject for a rule with the force of law.

Many customers simply would not furnish the information. Others would furnish it in such broad or ambiguous form that it would serve no useful purpose. Still others, and this might be the largest segment, would not admit, or would be unable to express, what they really have in mind. Few investors, no matter what their intention, would be willing to identify themselves on the record as "speculators".

Investment goals change; and no firm could, as a practical matter, comply with a rule requiring it to keep records abreast with the changing subjective attitudes of its individual customers.

CHAPTER III B. 4
("Suitability")

The Special Study concludes and recommends:

4. Greater emphasis should be given by the Commission and the self-regulatory bodies to the concept of "suitability" of particular se-

curities for particular customers. The NASD, which has taken leadership in this respect by adopting a general suitability rule, should provide further definition of content and more effective surveillance and enforcement. The NYSE, which has less clearly recognized suitability as a standard of conduct, should make greater efforts to define its content and undertake necessary surveillance and enforcement. This area would seem to be a particularly appropriate one to be dealt with through Statements of Policy (similar to that now applicable to investment company selling literature), which can provide the necessary balance between generality and specificity of standards. Such Statements of Policy should cover such matters as: possible guidelines as to categories or amounts of securities deemed clearly unsuitable in specified circumstances; practices deemed incompatible with standards of suitability, such as indiscriminate recommending or selling of specific securities to other than known customers; and approved and disapproved practices in the handling of discretionary accounts.

The Special Study notes that the NASD has taken leadership in the "suitability" area by adoption of Article III, Section 2, of the Rules of Fair Practice:

> "*Section 2* In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."

Of all the problems noted in the Special Study, "suitability" may well be the most difficult. All are agreed upon the necessity to rid the industry of those at its fringe who practice "boiler room" tactics, but in cutting out this cancer the utmost in surgical skill is required lest the patient be maimed.

All are agreed further that not every security is appropriate for every customer. We deal in our business with an infinite variety of securities and an infinite variety of customers. In a sense, the function of the salesman is to help match the right customer with the right security at the right time. We should not adopt a "cure" for the

"suitability" problem which shackles the salesman's ability to perform that function.

Presumably it was for reasons such as this that the Special Study does not recommend new regulation by the SEC in the "suitability" area. The SEC armory is already well stocked and there can be little doubt that the SEC, armed with the weapons already at hand, can drive out of business any "boiler room" and any firm or individual taking unfair advantage of customers.

Rather than SEC regulation, the SEC proposes:

> "This area would seem to be a particularly appropriate one to be dealt with through Statements of Policy (similar to that now applicable to investment company selling literature), which can provide the necessary balance between generality and specificity of standards. * * *."

For the very same reasons that the Special Study did not recommend SEC regulation with respect to "suitability", we do not believe that specific "guidelines as to categories or amounts of securities" can be formulated. A balance between "generality" and "specificity" is more than a matter of delicacy. "Specificity" necessarily involves prediction of the future, and who in 1925 would have challenged the "obvious fact" that railroad common stocks were "investment grade" stocks? The wide ranging differences between securities,—both over the short term and the long term,—and the significant differences as among customers make "specificity" impossible.

We now have generality, and anything more specific could have crippling side effects. It does not follow, however, that the industry should pursue a course of inaction in the suitability area. Much has been done already and more can be done. The problem deserves continued thoughtful analysis in the light of industry experience.

Analysis of the problem necessarily begins with the salesman, for he is the point of contact with the customer and he is ordinarily the person within the firm who best knows the customer. The limited role of the salesman must be recognized. He need not and should not be regarded as a professional who can be expected in every case to ad-

minister generally to the financial needs of his customer, as the physician does to his patient.

The salesman may be a mere conduit for the execution of unsolicited transactions, in which case he plays no part in the selection of the securities to be bought or sold. At the other extreme, he may be the holder of broad discretionary authority with respect to the customer's entire account. Then he is truly an investment counselor with responsibilities under existing law in some respects not unlike those of a fiduciary. Between the extremes there is infinite variety, but, generally speaking, the salesman's role is determined by the extent to which his recommendations are requested by the customer.

Perhaps the present NASD Rule of Fair Practice should be studied to see whether it can be redrafted and refined in a practical manner to sharpen its focus upon the salesman as the point of contact with the customer and to reflect the varying role of the salesman in varying circumstances. Basically, the solution is in personnel standards,—both at the salesman and at the supervisory levels.

CHAPTER III B. 5

("Official Data")

The Special Study concludes and recommends:

The importance of disclosure for the protection of investors has long been recognized in securities regulation, and it is of particular value in connection with selling practices. The present mandatory, officially filed disclosures by issuers (reports and proxy statements), extended and improved as recommended in Chapter IX, should have wider and more prominent use in selling activities, and the obligations of broker-dealers in this regard should be appropriately defined by the self-regulatory agencies and the Commission. These obligations might include such matters as: actually consulting available officially filed data prior to recommending or selling specific securities; furnishing copies to customers in appropriate cases; and advising customers whether officially filed information is available with respect to any security recommended for purchase.

Full and fair disclosure is the cornerstone of our securities distribution system. If these recommendations would contribute to that significantly and on a practical basis, they should have our wholehearted support. Unfortunately, the obligations they contemplate would not meet either test.

The officially filed reports mentioned are principally Forms 10K and 8K and proxy statements. Form 10K is a periodic report called for once a year and furnishes a brief running account of some management affairs and contains detailed financial statements and schedules. Form 8K is a current report required to cover non-routine developments shortly after their occurrence. Proxy statements are required to inform stockholders in advance concerning matters to be acted upon at their meetings. Proxy statements serve well their intended purpose but (except for the limited number which relate to mergers or other non-routine corporate activities) their value for investment disclosure purposes escapes us.

The reports are filed and are matters of public record at the SEC in Washington and at the stock exchanges on which the particular securities are listed. Anyone wishing to study them must either visit one of those places, or obtain photostatic copies from the SEC at a cost of either 23¢ per page or 11¢ per page (where 8½″ by 14″ or less), and with a time lag which even now is from 3 to 8 days. We would guess that very few 10K reports would cost less than $5, that many would cost much more, and that proxy statements for mergers would involve comparable costs. Proxy statements go to all the stockholders of the particular corporation, but are obtainable by others only at the SEC or the stock exchanges.

We recognize fully the responsibilities the industry has with respect to the accuracy and completeness of information used in selling activities. The means available for obtaining and checking the necessary data are many. Official documents are only one of them and they are not the only sources even for the information they contain. Others include annual and interim reports published by the corporations themselves, statistical services, discussions with company officials and others in the same industry, trade and governmental publications, and press

reports. Any important information in an officially filed report will invariably be picked up by the financial services and reprinted or abstracted in current statistical publications. The industry does not need to be told what sources to use. It is competent to select among them and it uses the official data when and to the extent appropriate and practical.

The first two recommendations appear to contemplate regulation by the SEC or self-regulatory bodies requiring that officially filed data be consulted prior to recommending or selling specific securities, and that copies of such data be furnished to customers. Such a regulation would not have to go very far before it would fall by its own weight. Perhaps large firms in the principal metropolitan areas could comply, but even that becomes doubtful when time and expense are considered. Other firms throughout the country could not begin to comply. Finally, the SEC and the stock exchanges themselves would have budgetary problems meeting demands for photostating and public record inspection far beyond their present capacities. Clearly, these practical objections outweigh any theoretical benefit which might be expected.

The third recommendation would call for advice to customers whether officially filed information is available with respect to securities recommended for purchase. Here, too, something would depend on scope. Certainly no one could dream of attempting to require every salesman every time he talks to a customer to tell the customer whether or not something is on file in Washington. Even if he did, what possible value would it be to the ordinary customer?

These recommendations may have theoretical appeal, but on analysis they fail completely to meet the tests of practicality and utility.

CHAPTER III B. 6

("Compensation of Salesmen")

The Special Study concludes and recommends:

6. The almost universal industry practice of compensating salesmen in proportion to the volume of business produced may be assumed to be inherent in the nature of the business, but certain of its particular

aspects may tend to introduce undue pressures or biases into the selling process. This would appear to be another appropriate area for continuing attention of the self-regulatory agencies, with the view to evolving rules and standards, in line with the best existing practices, that might eliminate or reduce the more extreme forms of pressure or bias in selling. Among possible measures in this direction that should be considered by broker-dealer firms and the self-regulatory agencies would be: making monthly compensation less specifically dependent on each month's production; eliminating a step-up of commission rates for transactions in a given month on reaching a stated volume for the month; discouraging undue compensation differentials for sales of different categories of securities where advisory bias may result from the compensation differential; and requiring disclosure of extra compensation in respect of particular types of transactions.

We agree that it is appropriate for each broker-dealer to review its compensation practices to eliminate (if they exist) any "extreme forms of pressure or bias in selling".

We strongly oppose, however, any procedure which will bring the self-regulatory agencies into the area of compensation of personnel. This is a matter which should be the responsibility of management in this industry. In fact, we know of no industry (whether or not regulated) in which it is not such a responsibility. It is unrealistic to attempt to bring about by regulation the elimination of higher compensation for effective production or where more selling effort is required. This practice is accepted throughout American business and has been responsible for the development of many industries which make important contributions to our economy.

We consider that a required disclosure to customers that part of the compensation paid to a firm which is then allocated to its personnel (whether "extra" or otherwise) would be unwarranted and of no benefit to customers.

Chapter III C. 1
("Research and Advisory Services")

The Special Study concludes and recommends:

1. Investment advice furnished by broker-dealers, though an integral part of their business of merchandising securities, is incidental

to that business and, for the small investor particularly, their facilities for providing advice are quite varied in quantity and quality. This being the case, a minimum protection for such investors is that firms should not be permitted to represent that they perform research or advisory services which they are not reasonably equipped to perform. The New York Stock Exchange, instead of indiscriminately encouraging its members to advertise their research and advisory facilities, should adopt standards governing the representations its members may make in this regard, and the NASD should provide similarly for its membership.

The necessity for supplying information about securities to investors and potential investors has long been recognized by members of our industry and the quality of the information which is supplied to the investing public by our members is generally good. The study points out, however, that in a few cases there have been firms whose advertisements have promised more than the organization was able to supply. We believe that such practices are reprehensible and, in general, we favor the recommendation that our self-regulatory organizations have rules prohibiting false or misleading claims regarding research or advisory services.

CHAPTER III C. 2

("Investment Advice")

The Special Study concludes and recommends:

2. Specific practices with respect to investment advice, whether expressed in market letters, advertisements or otherwise, should receive more positive and effective attention from the self-regulatory agencies. Such agencies obviously cannot assume responsibility for the staffing of their member firms or the quality or validity of specific recommendations, but they should assume responsibility for eliminating irresponsible or deceptive practices by their member firms. This area also lends itself to establishment of standards through statements of policy, covering such matters as (a) required disclosures in printed material of sources of information, research techniques used, and/or other bases of recommendation, rather than general disclaimers as to sources and

reliability of data in market letters; (b) required disclosures in written advice of existing positions, intended dispositions, and market-making activities, rather than general "hedge" clauses as to possible present conflicting positions or transactions; (c) required indication of the name of the person responsible for the preparation of market letters, and dating of such materials; (d) in printed investment advice which purports to analyze issuers, required references to most recently filed official disclosures by issuers, and representations that such filed information has been examined, with specific identification of issuers for which no officially filed information is available; (e) prohibition of specific practices in connection with written or oral recommendations, such as predicting specific future price levels of particular securities, claiming "inside" information by reason of a directorship, and trading against recommendations or other self-dealing; and (f) required disclaimers in connection with salesmen's written or oral recommendations not emanating from a firm's research department or otherwise sponsored by the firm.

Many of the suggestions in this recommendation are too extensive for general use in the industry or are unnecessarily burdensome. For example, the techniques of modern securities research are constantly changing. The use of electronic machinery, the increasing amount of information available to analysts, the subjective reactions of the authors, new concepts, etc., make it nearly impossible to describe all of the techniques used in preparing a particular piece of research material. Yet item (a) would require this.

Under item (b) a dealer would always be faced with the practical question of at what instant of time does he disclose his position and for how long does he abide by his written intended disposition of a position, regardless of market action.

Item (c) gives unnecessary publicity to a single person in an organization when, in fact, in many organizations the communication may be the work of many people rather than just one person. The firm issuing the letter is and should be responsible for its contents.

Item (d) involves "recently filed official disclosures". We have already commented on the use and efficacy of these disclosures.

Item (e) involves practices which we thought had long been proscribed by the general "anti-fraud" provisions of federal and state securities statutes and regulations.

Item (f) could well be a boon to the casual, disingenuous salesman who would skillfully interject a specific hedge clause into each letter and telephone conversation, and a trap for the well-trained analyst seriously concerned with research and evaluation but forgetful of the niceties of "required disclaimers".

We feel that this entire recommendation does not meet the practical touchstone of sensible practice, and that proper policing of general regulations would better accomplish the desired end.

CHAPTER III C. 3
("Market Letter Surveillance")

The Special Study concludes and recommends:

3. The market letter surveillance program of the New York Stock Exchange should be strengthened and redirected toward achieving greater responsibility and restraint in the use and contents of such letters. More effective market letter surveillance should also be undertaken by the NASD and the other exchanges, or a coordinated program of self-regulatory agencies should be evolved.

We agree that market letters should reflect responsibility and restraint and should be subjected to effective surveillance by the self-regulatory agencies.

Surveillance should be handled through an intelligent, coordinated program, and the letters of each broker-dealer should be handled by one agency without duplication. This would also tend to keep regulatory costs within reasonable limits. Obviously every communication to the public issued by a broker-dealer cannot be reviewed by a self-regulatory agency. Intelligent coordinated programs must necessarily rely extensively on test checking on a selective basis.

CHAPTER III C. 4

("Reckless Investment Advice")

The Special Study concludes and recommends:

4. Reckless dissemination of written investment advice by broker-dealers, whether or not for a separate fee, or by registered investment advisers, should be expressly prohibited by statute or by rules of the Commission and the self-regulatory agencies and should be made expressly subject to civil liability in favor of customers reasonably relying thereon to their detriment. Without limiting the general principle, written investment advice which purports to analyze issuers but fails to consider most recently filed official disclosures of issuers should be one of the factors to be considered in determining whether such advice is recklessly disseminated.

Reckless dissemination of "misleading" written investment advice should obviously be prohibited; and existing statutes and regulations do provide civil remedies to customers who rely thereon to their detriment. But let us not try to define terms to mean what is not generally comprehended by them. "Reckless", "dissemination", "reasonably relying" must mean what they say to the layman so that he can conduct his business on a day to day basis. It is not the "dissemination" which causes the problem, but rather the content of the "written investment advice".

We have already commented upon the use and efficacy of "recently filed official disclosures".

CHAPTER III C. 5

("Organization of Investment Advisers")

The Special Study concludes and recommends:

5. As recommended in Chapter II, registered investment advisers other than broker-dealers, should be organized into an official self-regulatory association or associations, which should then adopt and enforce substantive rules corresponding to those recommended above

in respect of advisory activities by broker-dealers. Alternatively, the Commission should extend and strengthen its own direct regulation of advisers to accomplish the purposes indicated.

We do not object to an association of investment advisers so long as membership is not required of those who are members of the NASD. Otherwise, there would be an unjustified pyramiding of cost for NASD members.

CHAPTER IV B. 1

("First-hot Issues")

The Special Study concludes and recommends:

1. The Commission's administration of the registration provisions and related exemption provisions of the Securities Act has been one of its most outstanding achievements, and the statute itself has proved generally adequate and workable. Nevertheless, there are limited respects in which provisions of that statute and the administration thereof or of related provisions of the Exchange Act should be modified in order to adapt them more closely to experienced needs. The troublesome and sometimes dangerous phenomenon of "hot" issues is primarily associated with "first" issues, i.e., first public offerings of securities of a particular issuer. Accordingly, such "first" issues, whether fully registered or exempt under Regulation A, should receive particular attention, with a view to preventing certain practices that appear to have contributed unnecessarily to "hotness," while not interfering with normal and legitimate practices in connection with underwriting of "first" or any other issues or the flow of venture capital into new business.

We would endorse any procedure which would eliminate any practices which contribute unnecessarily or artifically to "hotness" and would not interfere with normal practices in connection with the distribution of securities to the public for the first time. As noted below, for the most part the specific Special Study suggestions do not meet this test.

Chapter IV. B. 2
("First Issue Rules")

The Special Study concludes and recommends:

2. Appropriate rules should be adopted by the NASD and/or the Commission, applicable to "first" issues of common stock generally, designed to eliminate or temper certain factors which, either independently or in interaction with each other, appear to have produced artificially high but ephemeral premiums in many instances. Among the types of rules that would appear appropriate for consideration and adoption would be rules (a) requiring that, with respect to allotments resulting from solicitations or indications of interest prior to the effective date, notices of allotment (in the form of confirmations or otherwise) be given to purchasers as promptly as reasonably possible, any delay of more than (say) 24 hours after the effective date to be deemed prima facie unreasonable; (b) requiring that, again with respect to allotments resulting from solicitations or indications of interest prior to the effective date, certificates of stock be delivered or made available for delivery to purchasers as promptly as reasonably possible, any delay of more than (say) two weeks after the effective date or more than (say) one week after the underwriting closing to be deemed prima facie unreasonable; (c) prohibiting all broker-dealers from initiating a trading market for a limited period of (say) 72 hours after the effective date, except for stabilizing activities in conformance with Rule 10b-7 and such other exceptions as may be provided by rule or in specific circumstances; (d) clarifying or defining restrictions on soliciting, holding or transmitting, prior to the effective date, indications of interest or orders to purchase in the open market after the effective date; and (e) prohibiting all participants in the public offering, until the distribution is completed or for a period of (say) 40 days after the effective date, whichever is later, from soliciting or recommending purchases of the stock (including placing stock in discretionary accounts) at a price in excess of (say) 120% of the public offering price.

We would presume that any new regulation in this area would differentiate between the types of issuers coming to market for the

first time, and also would be restricted exclusively to common stocks and securities convertible into common stock.

These recommendations involve such diversity that they are discussed under separate sections. Sections (c), (d) and (e) do have in common, however, the concept of creating artificial "deflation" in the after markets of new issues.

(a) *Notices of allotment (in the form of confirmations or otherwise) be given to purchasers as promptly as reasonably possible.*

We would support a rule which would require that written confirmations of sales resulting from solicitations or indications of interest prior to the effective date be sent or given as soon as reasonably possible under the circumstances. We assume, however, that any such rule or any rule adopted in accordance with section (b) below would be considered in the light of already existing rules relating to confirmations and deliveries which are to be found in the Uniform Practice Code of the NASD and related interpretation, Regulation T, the rules of the various exchanges and applicable state laws. Further, we would regard it unreasonable to specify any particular period such as "24 hours after the effective date". Any such specification would subject an underwriter to unreasonable risk of civil liability. For example, the underwriter might be unable to comply within the specified period because it could not obtain from the printer the necessary statutory prospectus which must be sent or given to the customer prior to or at the same time as the confirmation; or it might be unable to comply because of a breakdown in its electronic data processing equipment. Underwriter self-interest will normally produce the necessary speed.

(b) *Requiring certificates of stock to be delivered or made available for delivery as promptly as reasonably possible.*

Again, we support this recommendation in principle. But any rule would have to take into account the mechanical problems involved in delivering and transferring securities, particularly where relatively unskilled transfer agents are involved. At the closing, the stock certificates are normally delivered in the names of the several underwriters. Before delivery is made to a retail customer, however, the normal pro-

cedure is to put the certificate through for transfer into the name of that customer or as otherwise directed by him. Any specified period of time for delivery, such as "one week after the underwriting closing", would be unfair and impractical.

(c) *Prohibiting the initiation of a trading market for a limited period after the effective date.*

We disagree with this recommendation and believe it would seriously interfere with the raising of capital and, further, would not solve anything. First, raising capital and the distribution process implies liquidity or marketability. The free flow of capital into new public offerings would be seriously impaired by anything that would interfere with the marketability of the new security even for a short period of time. Second, this recommendation would not solve anything, for the problem of excessive demand versus limited supply as it affects the market price would still be with us. Simply put, it would be merely postponed for three days.

The so-called "cooling down" period might well exaggerate, rather than diminish, the demand. Also, in our opinion, this recommendation could create "black market" problems. Trading markets should be available as they are now. Rules 10b-6, 7 and 8 are adequate in this area.

(d) *Soliciting, holding or transmitting, prior to the effective date, of indications of interest or orders to purchase in the open market after that date.*

The scope of this recommendation is not clear. To the extent it recommends restrictions beyond those contained in Rule 10b-6 and the existing laws and regulations prohibiting "manipulative" activities, it seems to contemplate artificial "deflation" of security prices. During the "hot" issue market of the recent past, the ordinary pattern was heavy over-subscription with an initial sharp increase in price above the initial offering price. Artificial "deflation" should not, however, be considered a sound solution to the problem. On balance, we believe that the public interest is best served by having, to the greatest possible extent, free markets in securities, with prices determined upon the

bases of intrinsic and comparative values and current conditions in the markets, including supply and demand. We do not believe that this additional interference with the after market for original distributions is necessary or appropriate.

(e) *Prohibiting solicitations or recommending purchases in the after market.*

We cannot support this recommendation. During the 40 days following the first public offering of securities of a company (or for that matter the tenth public offering by a company) the general securities markets can be and have been such as to make the stock attractively priced even though at a premium of 20% (or more) above the initial offering price. The price at which a stock is recommended involves a value judgment. These judgments differ widely, from time to time, as among firms and within particular firms. It is not unusual for one firm to determine after careful research and analysis that oil stocks should not be held, while another firm reviewing precisely the same material will reach a diametrically opposite result. Some may consider that a price of 20 times earnings in a particular industry is "cheap". Others might determine it to be "fully" or "over" priced. This proposal designed to achieve artificial price "deflation" would, we believe, do more harm than good.

CHAPTER IV B. 3

("Acceleration of First Issues")

The Special Study concludes and recommends:

3. Acceleration by the Commission of the effective date of a registration statement or permitting clearance of a Regulation A filing, with respect to any "first" issue of common stock, should normally be conditioned on delivery of a prospectus or offering circular in substantially final form to each person to whom any participant in the distribution expects to make original allotments at least (say) 48 hours before any sales are made.

This recommendation should be rejected. It would require changes in established methods of distribution by responsible underwriters

which are not warranted on any balance of theoretical benefit against practical detriment. It is based on the theory that a prospective purchaser should have in hand a prospectus for some period of time before the security can legally be sold to him. This theory is no more valid now than when, after careful consideration, it was rejected in the enactment of the Securities Act of 1933 and the 1954 amendments to that Act.

It is not possible to make prospectuses available to all prospective buyers of an issue of common stock (whether the issue be the "first" or "tenth"). Each "first" issue of common stock is not "hot" from the date of the filing of the registration statement. In any issue, shortly before the effective date demand may suddenly occur, increase or decrease. Allotments generally are not made any substantial time prior to the effective date and the selling group of dealers may not be formed until just before the effective date. Simply put, 48 hours before a public offering it is not known "to whom any participant in the distribution expects to make original allotments".

Indiscriminate dissemination of prospectuses to possible buyers has important disadvantages when an issue does turn out to be "hot". Many of those who receive the prospectus, but do not receive allotments, are the customers whose complaints to that effect clutter the files of the underwriters.

Chapter IV B. 4

("Prospectus Deliveries")

The Special Study concludes and recommends:

4. The 40-day period during which all dealers are required to deliver prospectuses should be extended to 90 days in the case of "first" issues of common stock, except as may be otherwise permitted by rule or in specific circumstances. The same provisions should apply to offering circulars under Regulation A exemptions. (It is recommended below that the 40-day requirement be eliminated in connection with offerings of securities of issuers subject to the continuous reporting requirements of Sections 13, 14 and 16 of the Exchange Act.)

This recommendation is properly reflected in the SEC sponsored legislation now before the Congress, and we actively support it.

CHAPTER IV B. 5
("Free-riding and Withholding")

The Special Study concludes and recommends:

5. The NASD should strengthen its enforcement of the prohibitions against "free-riding and withholding" by requiring, in the case of any "first" issue of common stock for which a price in excess of (say) 120% of the public offering price is reached within (say) 40 days after the effective date, a report of the managing underwriter showing all stock allotted to any participant in the distribution (other than stock resold at or below the public offering price) or its principals or members of their immediate families or to any broker-dealer other than a participant, and the disposition thereof, if any. In general, since those violating the "free-riding and withholding" prohibitions may be in a position to realize profits greatly surpassing the fines customarily imposed by the NASD, substantially severer penalties should be imposed in flagrant cases so as to provide an adequate deterrent.

We support the NASD's interpretation as to "free-riding and withholding", agree that it should be appropriately enforced, and understand that the NASD has made numerous investigations in this area and has continued to increase the severity of its penalties for violations. Rigid formulas (such as 120% premiums in 40-day periods) are generally not useful in enforcement. The NASD should, as a routine matter, consider the market prices of common stocks following their public offering (whether or not they are "first" issues) and investigate (in such manner as it deems appropriate in the particular case) any unusual or significant price rise which follows an offering.

CHAPTER IV B. 8
("Rule 10b-6")

The Special Study concludes and recommends:

8. In light of widespread misunderstandings or uncertainties among broker-dealers, as discussed in this and other portions of the report, the Commission should take appropriate steps to clarify the

application of rule 10b-6 (a) during a period when stock is being held "for investment" by a broker-dealer, (b) in connection with various forms of "shelf" registration, (c) in connection with a planned reduction of inventory or "workout," and (d) in connection with unregistered distributions generally.

The "appropriate steps" to be taken should include the adoption of more regulations only where it is essential to do so. Proliferation of regulations in this area, particularly with technical and formalistic definitions, is unsound.

Rule 10b-6 was the result of long and cooperative study between the SEC staff and industry representatives. During this period innumerable drafts were prepared and discussed; the effect of the impediments upon issuers and distributors and the benefits to investors were carefully analyzed and balanced; and the keynote was a practical approach to the problems where the restrictions were developed on a pragmatic basis and stated in terms that could be understood and followed by businessmen. Under no circumstances should there be any departure from this practical approach.

The conclusion and recommendation that "the Commission should take appropriate steps to clarify the application of rule 10b-6 (a) during a period when stock is being held 'for investment' by a broker-dealer" presumably has two aspects.

The first aspect is whether it is proper for the broker-dealer to trade during the period he holds the stock for investment. We feel that no clarification is required in this area. Paragraph (c) (3) of rule 10b-6 provides that, in determining when a person "has completed his participation in a particular distribution", he shall be deemed to have "distributed securities acquired by him for investment." Underwriters and dealers who read and seek to comply with SEC rules know that "investment" means "*bona fide* investment", and hence no further clarification is needed for them. For the others, the Commission need only enforce the existing rule.

The second aspect of such conclusion and recommendation relates to the sale by the broker-dealer of the investment stock. Investment

stock registered under "shelf" registration statements should be handled on a case-by-case basis as indicated below. Where the investment stock is not so registered, it should be exempt from rule 10b-6 unless the amount and method of sale are sufficient to constitute a "distribution" as set forth below with respect to a "planned reduction of inventory or 'workout' ".

With respect to the conclusion and recommendation that "the Commission should take appropriate steps to clarify the application of rule 10b-6 * * * (d) in connection with unregistered distributions generally", it seems clear that lack of knowledge by any person that rule 10b-6 applies to "unregistered distributions" can only be caused by a failure to know the contents of the rule itself or the pronouncements of the Commission. The basic clarification recommended by the Special Study, therefore, must be a suggestion that a definition of "distribution" be adopted. Reference is made to this below.

We believe that the Commission should implement on a case-by-case basis the conclusion and recommendation that "the Commission should take appropriate steps to clarify the application of rule 10b-6 * * * (b) in connection with various forms of 'shelf' registration", and should not attempt to adopt any regulation of general application. The words "proposed to be offered", as used in the last sentence of Section 6 of the Securities Act of 1933, were construed for more than two decades to mean "presently" proposed to be offered. "Shelf" registration normally represents a departure from this construction and, in general, may be said to be a peculiar phenomenon developed by the SEC to compel registration where it wished to do so during the active speculative markets of the recent past. With "shelf" registration required by the SEC in many cases where the securities involved had been offered in violation of the Securities Act of 1933, the acuteness of the problem necessarily varied directly with the number of individuals treated as "underwriters" of the securities registered for the "shelf". We believe, therefore, that any problem in this area not covered by rule 10b-6 in its present form can best be handled by the SEC staff through undertakings required in, or in connection with, the "shelf" registration statement to meet the particular facts involved.

If a regulation can be developed which will be simple of application and represent a practical solution of the problems in the area, we believe that it would be feasible to clarify "the application of rule 10b-6 * * * (c) in connection with a planned reduction of inventory or 'workout' ".

Only under most unusual circumstances should such a planned "reduction" or "workout" involve a "distribution". All offerings of inventory acquired for or in the course of trading transactions should be deemed *prima facie* to be trading and not distributions.

It is quite impracticable to attempt to draft a general regulation defining "distribution" for all classes of securities in terms of dollar amounts. The dollar volumes of normal trading activity in over-the-counter debt securities and preferred stocks make such an approach quite unrealistic.

It is also impractical to attempt to define "distribution" in terms of "normal compensation" to salesmen. It is not simple to determine the "normal compensation" paid by a particular broker-dealer to its salesmen in transactions on securities exchanges at fixed commission rates. For the over-the-counter markets, we do not believe it possible to adopt a regulation of general application to all broker-dealers where as among firms there are significant variations in factors relating to "normal compensation" such as mark-up policies, credits to salesmen for different types of customers and the extent to which transactions are effected on a brokerage rather than a principal basis.

If the Commission determines that regulation in this area is essential, we believe that the definition of "distribution" should be limited to common stocks traded over-the-counter and that it should cover public offerings at an aggregate price exceeding $500,000 or 1% of the market value of all the issuer's outstanding common stock, whichever is greater, and in which there is an organized selling group of broker-dealers who are allowed selling concessions.

If such a regulation is adopted, care should be taken not to cast doubt on the fact that the existing rule 10b-6 does not prohibit purchases or bids by a broker-dealer prior to the time that such broker-dealer determines to effect a "distribution" out of "inventory" or of

"investment stock" nor purchases or bids by a broker-dealer prior to the time that such broker-dealer is offered the opportunity to participate in a "distribution" by another person. If such a regulation is adopted, therefore, it should contain a specific exemption to that effect.

CHAPTER VII F. 13
("Disclosures in Certain Retail Transactions")

The Special Study concludes and recommends:

*13. The NASD and/or the Commission should re-examine present requirements with a view to improving disclosures, at the time of soliciting a retail purchase or in confirmations, of essential information relevant to particular types of retail transactions. Among other possibilities that should receive early consideration in this connection would be rules of the following kinds: (a) A broker-dealer soliciting a customer's purchase of any security for which there is no independent market other than its own, or any security out of its own inventory, or any security in which there is a spread of, say, 20 percent or more in prevailing inter-dealer bids and offers, should be required to disclose such fact or facts at the time of solicitation, * * * and (c) The confirmation of a customer's purchase (but not sale), whether handled on a principal or agency basis, should provide an indication of the prevailing spread between inter-dealer bids and offers by showing a representative bid quotation.*

This recommendation seeks to "police" over-the-counter prices through disclosure in solicitations of and confirmations to customers. Whether such disclosure would be understood by the average customer is highly doubtful. But, in any event, this is not a proper approach to any problem encountered in connection with over-the-counter security prices.

Neither the Commission nor the NASD has or should have the power to fix prices in or otherwise to revolutionize the over-the-counter markets, whether by specifying commissions or selling prices, by designating "wholesalers" of securities as "primary market makers", or by

requiring broker-dealers to effect transactions on an agency (rather than a principal) basis.

Selective improvements in this general area can be made by the NASD. The NASD should attempt to make more specific the guidelines contemplated by its "5% mark-up policy". Attempt should be made by it to develop feasible procedures for dissemination of realistic, current over-the-counter retail prices, including dissemination of "narrow" or "wide" market spreads, as may be the actual case for the particular security. The NASD should review its current requirements to ascertain whether they in fact require a broker-dealer to make reasonable efforts under the circumstances to ascertain realistic inter-dealer quotations before executing a customer's order. If not, attempt should be made to formulate a workable requirement to that effect.

CHAPTER II F. 4-8 and 10-12

("Qualifications for Persons in the Industry")

The Special Study concludes and recommends:

4. The individual rather than the firm is the appropriate "unit" for many regulatory purposes, in the interest of fairness as well as efficiency. The present statutory registration scheme does not reach individuals at all, and the self-regulatory concept of "registered representatives" of particular firms does so only partially and indirectly. Without limiting the responsibility of firms for the personnel they employ or the right of firms to select their own employees, there should be established a system of licensing and registering individual salesmen, supervisors and other specified categories of personnel. Each such individual should be required to file a single basic registration form containing necessary data as to his present and prior employment, disciplinary matters, and eligibility under statutory disqualifications, together with a certificate as to his good character and, for applicants without adequate prior experience, as to his successful completion of any required examination. Copies of the basic registration form would be made available to affected regulatory and self-regulatory agencies. Subsequent changes in employment and disciplinary actions should be required to be reported and recorded in the individual file. Duly

licensed persons would be, for regulatory purposes, eligible for employment by any firm.

5. Under such a system of licensing and registering individuals, disciplinary actions could, in appropriate cases, relate to individuals without necessarily involving current or future employers, as is now the case. The present system, under which the Commission may proceed only against a broker-dealer firm, often operates inefficiently or unfairly in that the Commission must move against an employee's firm or not at all. The Commission's powers in this respect should therefore be made more flexible even apart from the recommendation in paragraph 4, so that it will have the power to bring administrative proceedings directly against individuals involved in violations of the securities laws.

6. Apart from statutory disqualifications and requirements for filing of basic data by firms and individuals, standards for entry into the securities business should encompass (a) competence, in the sense of knowledge and experience, (b) character and integrity, and (c) financial capacity and responsibility—the first two applying essentially to individuals and the third essentially to firms. In all three areas there have been significant accomplishments but there are serious gaps and deficiencies that need to be remedied promptly, as set forth in the following paragraphs.

7. The basic regulatory control in respect of competence is the examination. Present examinations and examination programs can and should be considerably improved, refined and coordinated. The standard examination should cover a core of basic subjects for salesmen, supervisors and principals, with appropriate supplemental questions for supervisors and principals, and with such further supplementation as any particular agency may desire for its own purposes. For certain recognized specialties, special supplementary questions should be provided; individuals whose activity (and license to act) is to be limited to any such specialty may be permitted to qualify through appropriately limited examinations. To achieve maximum results with minimum burdens, a National Board of Securities Examiners should be established by and for the various regulatory and self-regulatory agencies, to administer existing programs and foster improved pro-

grams. Through the same or a similar agency, the various existing training programs should be coordinated, extended and improved.

8. Quite apart from knowledge as tested through examination procedures, appropriate experience in the securities business should be a requirement for individuals in certain crucial roles. The individuals for whom there should be an experience requirement include at least one principal in each registered firm and, if other than such principal, the individual designated as being in charge of regulatory and self-regulatory matters, the supervisor of selling activities, the supervisor or manager of each branch office, and the supervisor of research activities. Appropriate periods and types of prior experience are left for future definition.

10. Of all the types of qualifications needed for the securities business, perhaps the most important, but also the most difficult to assure by formal regulation, is that of character and integrity. As rapidly as possible a system involving local "character and fitness" committees, as in the legal profession, should be established. More immediately, the responsibility for maintaining a proper level of character and integrity of all personnel must reside in the individual firm, but with effective enforcement of this responsibility by the self-regulatory agencies. In addition, regulatory and ethical standards should receive greater emphasis in training and examination programs of the self-regulatory agencies. If the latter are to fulfill the role for which they are thought to be uniquely suited, they must also, of course, exert leadership in defining and elevating ethical standards for their members, above and beyond legal requirements.

11. A minimum net capital requirement is of high importance as one of the several different approaches to assuring a broker-dealer community of principals and firms reasonably qualified in terms of responsibility and commitment. The requirement need not and should not be a uniform one for all firms but should be appropriately scaled to reflect the type and size of business engaged in. Subject to exceptions and refinements to be worked out in the future (such as special provision for small proprietorships engaged only in sale of open-end invest-

ment company shares), and subject to an appropriate "grandfather" clause or adjustment period, every broker-dealer should be required to have at the commencement of business, and maintain at all times thereafter, net capital of at least $5,000, plus (say) $2,500 for each branch office and (say) $500 for each salesman employed at any time.

12. Since the underwriting of public offerings involves special obligations and responsibilities, any firm engaging or proposing to engage in underwriting securities offered to the public pursuant to the federal securities laws, whether on a "firm commitment" or "best efforts" or any other basis, should be required to have and maintain minimum net capital of $50,000 plus (say) 2 percent of the aggregate amount of underwriting commitments or undertakings in the most recent 12-month period (but not less than the amount required under paragraph 11).

Many of the topics concerning selling practices contained in Chapter II F of the Special Study Report are the subject of legislation introduced in the Congress on June 4th. This new legislation is required in certain areas where the SEC does not now have the necessary authority. During April and May, representatives of the industry worked in close cooperation with the Commission and its staff in arriving at what we feel is fair and beneficial legislation.

In the areas of "qualification" for entry into the securities business, the SEC has strongly endorsed the concept of self-regulation with government oversight. As the self-regulatory agencies accept this authority, they must also bear the responsibility for fair, equitable, and confidential procedures and tests, and should strive at all times to keep their costs at a minimum consistent with effective action. Prior to the issuance of the Study Report, these agencies had devoted a great deal of attention to this particular field and rather than answer separately each conclusion and recommendation in respect of selling practices in Chapter II F, it seems logical to group and summarize the answers as we have done below.

The Special Study recommendations contemplate that, at both the Commission and the self-regulatory level, an appropriate "unit" of regulation should be the individual and that legislative authority should

be granted to the Commission to establish this. The present statutory system is not directed at individuals—the firm being held responsible for the activities of all its personnel. The present system of reaching security firms' employees is often inefficient or unfair, and therefore the Commission and the self-regulatory bodies should be empowered to move against the individual or, in the event the firm is implicated, both the firm and the individual. We assume that if Congress grants this authority to the SEC, similar authority will be vested in the self-regulatory bodies.

We endorse the suggestion that, "without limiting the responsibility of firms for the personnel they employ, or the right of firms to select their own employees", there should be proper qualification examinations to establish entry into the securities business. Furthermore, that "each such individual should be required to file a single basic registration form containing the necessary data as to his present and prior employment, disciplinary matters, and eligibility under statutory disqualifications" is also logical and acceptable. In fact, such information is now supplied to the self-regulatory bodies and we believe that there is no necessity for an additional filing with a government agency.

Qualification examinations by the New York Stock Exchange and the NASD have been greatly strengthened in the recent past and many of the "gaps and deficiencies" that were criticized in these examinations have been resolved as testing experience has been accumulated. Both organizations now have highly experienced staffs in this field and examinations are given in some sixty-odd test centers in the United States and in consulate offices abroad. Further, each group has announced programs of additional testing for individuals who are accepting additional responsibility in places of supervision or as principals of their firms. The concept of a "National Board of Securities" examiners to administer existing programs and foster improved programs would seem a needless duplication of programs already activated. It should also be pointed out that within the past year both the NASD and the NYSE have published new training guides for those new to the business and the IBA, through its Educational Com-

mittee, sponsors, both at the group level and the national level, a number of training programs designed to prepare people already in the business for positions of additional responsibility.

The Special Study recommends appropriate experience requirements for individuals in "crucial roles". "Experience" is a difficult requirement to assess, although we agree that the person or persons in any particular firm who are in charge of regulatory and self-regulatory matters, supervision of selling activities, branch offices, etc. should have appropriate background in the business. But "experience", as defined in terms of "time", is impractical and unfair. However obtained, competence and maturity of judgment are the measures ultimately sought.

A further recommendation is the establishment of local "character and fitness" committees to review candidates for the industry. We disagree. The self-regulatory agencies should enforce appropriate rules to see that at the time of employment the background of the employee is investigated and evaluated. "Character" also should be a consideration, but here again the evaluation of such an indefinable quality should best be left to the judgment of the employer. The individual firm must have the authority of employment and, therefore, the responsibility to see that those employed meet requisite ethical standards.

Capital requirements also have a significant bearing on selling practices. This is an extremely important and sensitive area, and obviously a firm without sufficient capital cannot provide public customers with proper protection. Minimum capital requirements have always been a concern to the industry—not only upon entry but at all times. It is apparent that any firm, in order properly to conduct its business (making recommendations, effecting transactions, etc.), should maintain a minimum amount of capital at all times. Obviously, minimum capital requirements will not weed out all the undesirables, but such requirements will preclude from the business many who are unable to meet even basic obligations. Certainly any "entry" capital should be the basic "maintenance" minimum.

The Special Study recommends two levels of capital,—one for firms handling underwritings and a lower level for broker-dealers who

are not underwriters. The suggested formula for non-underwriters is unrealistic. Rather, a minimum requirement should be established.

The substantial additional obligations of securities firms who also underwrite are such that the capital requirement for underwriters should provide adequate protection, not only to the public, but also to other dealers, who in turn are obligated to the public. Again, the formula approach included in the Special Study recommendation is unworkable and in active securities markets could render inadequate the net capital of many responsible firms who are actively engaged in the underwriting of securities. The minimum net capital requirement should, we believe, be a fixed amount and adequate (when measured together with the required ratio of indebtedness to net capital prescribed by Rule 15c3-1) to permit the satisfaction of the firm's responsibilities and provide the desired protection to the public.

Mr. STAGGERS. Then you come back to the theory that the firm is responsible for the salesman?

Mr. AMES. Yes, sir; and should be, and must be.

Mr. STAGGERS. We are coming to some meeting of the minds, then, on that theory.

On another point, perhaps we have differed a little bit. I am only trying to find out your theories on this. Somebody has to be responsible.

Mr. AMES. If I may take it one step further, I think the firm must be responsible and it is terribly important that they be responsible.

My only point is that where some individual does make a mistake, it should be possible for our self-regulatory organization, our NASD or our stock exchanges, to reach in and make an example of that individual. That is constructive and it will help us and I believe it will help the Government in its overlook on the security business.

Mr. STAGGERS. Then we do agree that suitability should be in the book somewhere, where somebody would be accountable some way or somehow. Maybe not by hard and fast rules, but it ought to be in there.

Mr. AMES. Yes, sir.

Mr. CURTIN. Will the gentleman yield?

Mr. STAGGERS. Yes.

Mr. CURTIN. Is not what you are now saying inconsistent to what you said in answer to my question of a few minutes ago? You are now saying that you do not want to stifle new ventures, and a few moments ago I asked you that very question and I thought your answer was different from what you just stated.

Mr. AMES. I think not. I think there is a difference. I think you and I were discussing depositors and——

Mr. CURTIN. We were discussing full information and protection.

Mr. AMES. The full disclosure, that is right. I think full disclosure does not stifle new enterprise. Full disclosure merely allows the stockholder to know what he is doing. It is a very bad mistake for a man to risk his money in the stock of a company without knowing what that company does. It may not be a mistake for that man to take a risk in backing a new enterprise in his hometown that may do something that will succeed. It may do something that will fail. He may lose all his money.

All we are saying is that that man, when he invests his money, is entitled to a minimal amount of accurate, standardized information, year by year, so that he can judge what is happening. Otherwise, it is a pig in a poke, and it is wrong.

Mr. CURTIN. Thank you.

Mr. STAGGERS. Mr. Ames, in section 8(b) of the bill, it contains an amendment to section 16 of the Exchange Act, which would exempt from the operations of the recapture provision of profits made by officers and directors of the corporation when they engage in transactions in their own stock, the activities of the marketmaker. Why should not, as the Special Study Group recommended, a marketmaker be divorced from the corporation; that is, the dealer not be represented on the corporation's board? In this case, would not this paragraph be unnecessary? I know you went into that in your prepared statement, but I want you to answer these two questions, if you will. You partially answered it in your statement.

Mr. AMES. Yes.

Mr. STAGGERS. Would the inclusion of this amendment get around the *Blau* v. *Lehman* decision?

Mr. AMES. This being a matter of a legal point, could I ask Mr. Foshay?

Mr. STAGGERS. Surely.

Mr. FOSHAY. I forget which corporation was involved, but it was a listed company. This would not affect the corporation whose securities are listed on a stock exchange.

Mr. STAGGERS. I do not believe I heard your answer.

Mr. FOSHAY. The question, as I understand it, was whether this amendment would eliminate the effect of *Blau* v. *Lehman*. In *Blau* v. *Lehman*, as I remember it, the question was whether or not the partnership, Lehman Bros., should be held accountable for the profits in transactions within 6 months in the securities of a corporation, the identity of which I have forgotten, which obviously must have been listed on the stock exchange. Since this proposed legislation does not change the existing law in that respect, so far as listed companies are concerned, I do not think it would eliminate the effect. The exemption for marketmakers would apply only to a relatively small number of unlisted companies.

Mr. STAGGERS. Along the same lines, is there a difference between the activity of a dealer in making a market and the ability to use his inside information from a dealer or investment banker, being in a position where his inside information may not be of advantage to himself but to his other partners?

How did this section happen to get into the bill which is before us?

Mr. AMES. This, of course, was a subject which was discussed in the special report, and it is a point which was discussed in great detail between the industry and the Securities and Exchange Commission before the present legislation was put into its existing form.

The problem is that a great many small companies need the knowledge of an investment banker. They aren't familiar with financial problems, and the existence of an investment banker who is knowledgeable in the area of investing and who can secure funds for the new and struggling corporation that wants to expand its facilities, the representative of that investment banker on the company performs a very important function. It is a possibility that under certain conditions men who are not acting properly might use inside information. There are other ways whereby that problem can be controlled.

But the trouble with depriving the corporation of its ability to have investment bankers on the board and depriving those investment bankers of an ability to actively help the market of the securities is that you hurt the corporation and you make it difficult for the small company in this country to develop.

Mr. STAGGERS. I would like to know how this section got into the bill. As I understand it when the initial draft was circulated by the Commission to the Advisory Committee, and you were a member of that Committee, it was not in that initial draft.

Mr. AMES. That is right.

Mr. STAGGERS. Do you know how it got into it?

Mr. AMES. It got into the bill because there was a surge of conviction on the part of the investment bankers across the country that it

would be really wrong, just on a theory of distrust, to take the investment banking director off the board of a company or, conversely, to deprive that company of the right to have its stock sponsored by an investment banker. All across the county there are small companies that are being sponsored and nursed along and developed.

In the growth of the company, it is very important that more investors learn about the stock. It is important that that company's stock be sponsored. Once you start to put a curtain down around the company in the false idea that you are protecting somebody's morals, you will begin to hurt this operation. I think the logic was such that the bill was put into its present form.

Mr. STAGGERS. I asked Mr. Rockefeller 2 weeks ago a question as to whether any of the recommendations that were made to this committee in 1959 or if any of the original draft that was presented to your committee in April, which your industry opposes, if any of them were contained in the bill. His answer was, "I cannot think of any; no, sir."

In the light of this, I would like to ask you, in view of this market-maker proposal, whether there is any proposal that your Industry and Advisory Committee may have made for adding to or changing the draft legislation circulated last April by the Commission which is not contained in the bill.

Mr. AMES. Yes, sir. In the first place, of course, the 1959 legislation was a matter of the Securities and Exchange Commission, matters which they wished. This did not, as I understand it, stem from the desire of the industry.

Our present concern deals with this problem of the special legislation needed to strengthen the authority to proceed against individuals and to generally strengthen the hand of our self-regulatory organizations.

There were a great many matters brought up in the discussions whereby we thought the original drafting of the legislation would seriously hamper the investment banking business, and would be very much against the public interest because they would interfere with the operation of investors. There are a number of those.

Mr. STAGGERS. My question was of your recommendations that your Advisory Committee had come to a hard-and-fast recommendation upon—are any of those not contained in this bill?

Mr. AMES. No, sir.

Mr. STAGGERS. And I will ask you this again: In 1959, the recommendations as made by the Securities and Exchange Commission—and you say that was not your group, they are the arm of the Congress of the United States to regulate the securities and exchanges, and they are responsible to the Congress and not you and your group. But they are the ones who oversee.

I want to know if there is one recommendation made there that you then opposed that is contained in this bill which you know of.

Mr. AMES. As far as the convictions of our group, we did go before the Securities and Exchange Commission and we did express our opinions very strongly on several points. Each of the points that we expressed a strong opinion upon some change was made. They did not accept our opinion all the way, but they did recognize the validity of our criticism and thoughts.

I think what you have before you is legislation where the best thinking of thoughtful men in industry, and the critical thinking of Government was modified or evolved or melded into a common piece of legislation.

Mr. STAGGERS. That is what I wanted to get at, that your committee had great influence in the molding of this bill.

Mr. AMES. I would not think great influence, sir, but I would think we did have influence, and I think it is very fine and as it should be that we were listened to.

Mr. STAGGERS. It may not be in your exact words, but the proposals as made by your Advisory Committee. I was trying to get at the recommendations which the SEC said they needed so desperately and if they had them in 1959 they could regulate the industry.

I wondered if any of those were in this bill. But, that was the answer that I wanted to get from you.

Mr. Keith, have you any questions?

Mr. KEITH. Thank you, Mr. Chairman.

Mr. Ames, I am sorry that I was not here to have the benefit of your testimony. I have scanned it as best I could. I'm sure that many of the questions that come to my mind have been asked by others so I will not pursue them except in one area.

Is not the device in this bill to regulate purely intrastate transactions an artificial one?

Mr. AMES. Is it not a what?

Mr. KEITH. Is not the device contained in this bill, whereby they hope to regulate purely intrastate transactions, an artificial device?

Mr. AMES. Artificial?

Mr. KEITH. Yes.

Mr. AMES. I think I would say, "No, it is not artificial." I do not think there is essentially a conflict here because I think the intrastate regulation, at least by the State authorities, is not in any way interferred with.

I think one of the things we learn in the investment business is that it is almost impossible to carry on an investment business in a single State without it affecting people outside the State. All distances are being so reduced by jets and electronics that it is very difficult to hold any activity down within a very narrow area.

As I see his bill, it is entirely proper that all the people in the business should be brought under general rules, all in the country should be brought under general rules, and it also seems to me that in doing so there is no necessity to interfere with the State authorities and their control of State investment problems.

Mr. KEITH. It does seem to me that the device is sort of an artificial one.

I might conclude as you have, that the end justifies the means in this instance, but it does seem to me that the means founded in the legislation as proposed is an artificial one.

On page 3, you state at the bottom that a registered broker-dealer who violates Federal law should be subject to appropriate action by the Commission or the courts regardless of the means employed in the Commission of such violation.

Do you mean that at present an intrastate dealer can violate Federal law and not be accountable unless this legislation is passed?

Mr. AMES. Yes, that is correct, because not all dealers are forced to be members of a self-regulatory body, so that it is possible for dealers to operate in this country without being controlled in any way.

Mr. KEITH. You mentioned "forced to be members." Does that not trouble you at all; that people are going to be forced to join something?

Mr. AMES. I think in theory it does trouble me. I think force is something, forcing everybody into a pattern, that we do worry about. You might say it is almost un-American. On the other hand——

Mr. KEITH. Would you say it is unconstitutional?

Mr. AMES. No, sir. But there are so many areas where, in order to do something to protect the public interest, it is necessary to set standards. It isn't.

It is necessary, after all, to set rigid standards on banks who handle deposits of public money. I think if we are to exert a control, if we are to raise standards in this industry to the level, the high level, which exists within the industry, it will not be possible to do so if there are people outside of control who may have no standards, who may have no ethics, who may have no feeling of responsibility, and who are beyond the reach of any discipline if they do wrong.

It will be impossible for us to succeed in raising the standards of an entire industry. It would be sort of a hollow thing to raise the standards of a small group or to submit the good people in an industry to all the rules and regulations that might be wise and effective to good operation, and have another group of people who are subject to no rules.

So I think if the public interest requires that certain standards be set, they have to be set for everybody. The only way to make them set for everybody is to force everybody who is going to take this responsible position to be a member of a self-regulatory organization.

Mr. KEITH. My problem is to justify in my own mind the forced membership in a private association which will then be called upon to enforce public policy. The policy, itself, will be promulgated by the private agency.

I would rather see the SEC have the responsibility for the policing of those who do not care to join such an association, and put sufficient authority in the statute to enable the SEC to reach them. This is my thinking, at this point in this discussion.

Mr. AMES. However it is done, I do think it is necessary to have all the people in an area subject to the same set of rules, if those rules are wise and are promulgated for the purpose of raising standards and protecting the public. However it is done, whether by the self-regulatory or by the SEC, I think it must be done.

One of the things that is inherent in this legislation is that it does, for the first time, make it possible to set these standards on an industry-wide and nationwide basis.

Mr. KEITH. It has been the impression of some of us who have served on this subcommittee for some time, and who have talked with the exchanges and the NASD, that self-policing by the fraternity, itself, is not always as effective as it might be. There is perhaps some politics involved in the operations of these agencies in the same way there is some politics, although perhaps not in the generally accepted sense of the word, in the governmental agencies.

But I think there might be more of an opportunity for politics in the operation of the NASD or the exchanges than there would be in the SEC.

Mr. AMES. I think human beings are human in all areas, but I think there has been remarkably little evidence of politics being played in the self-regulatory bodies. I don't mean by that to say that there haven't been mistakes made in the industry, but I believe, for instance, that there was no charge in the special report of politics being played. That wasn't the problem. It might be that the controls weren't quite adequate, or it might be that some things happened that should not have happened within the industry.

But I think that the self-regulatory operation, the self-regulatory bodies, has functioned well. I think it is well to realize that in this period our customers have fared very well, and for the last 30 years the investment banking and the stock exchanges of this country have performed at a high level. We have raised capital for a terrific expansion both in the cities and in the States, and in corporations, and even financed part of the Western World. This has been done on a high level.

It so stated in the special report. But at the same time, things have happened that have been wrong. This is human; this is inevitable. But in general, in an intricate business like the securities business, it is infinitely better, and I think this has been proven in the record, for the knowledgeable people in the industry to regulate themselves through self-regulation as long as Government is there with a really sharp overlook.

I think this is a procedure which has not worked perhaps as well as it should work, but has worked well.

Mr. KEITH. I am sure that your philosophy is well understood by the committee.

Mr. AMES. Yes, sir.

Mr. KEITH. Thank you.

That is all, Mr. Chairman.

Mr. STAGGERS. Are there any other questions?

Mr. DINGELL. I have no questions, Mr. Chairman.

Mr. STAGGERS. Thank you very kindly, Mr. Ames. As I said earlier, I do consider your organization association as having high standards of commercial honor and business conduct. We appreciate your coming and giving us the benefit of your views. They have been helpful in the consideration of the final outcome of the bill. You can tell your members we appreciate the fact that you as their spokesman would come and give us the views which are helpful in our consideration of the bill. Thank you very kindly.

Mr. AMES. Thank you very much. May I just say that we appreciate very much the courtesy with which the committee and the clerk of the committee have handled our appearance. Thank you very much.

Mr. STAGGERS. Our next witness will be Mr. William M. King.

Mr. King, would you come forward?

STATEMENT OF WILLIAM M. KING, SECURITIES COMMISSIONER OF THE STATE OF TEXAS

Mr. STAGGERS. Mr. King, would you state your name and the position that you hold?

Mr. KING. Mr. Chairman, I am William M. King, the securities commissioner for the State of Texas. I did prepare the written remarks as was requested. I would like to state that due to a shortage of time, and I apologize, I will vary some from these because there are a few errors in the written remarks.

Mr. STAGGERS. If you have any oral statement you would like to make and present for the record, we would be glad to accept that.

Do you wish to have it inserted into the record, or would you proceed with your statement?

Mr. KING. I think what I will say I would rather go into the record, if I can understand your question.

Mr. STAGGERS. We can insert statements into the record and permit you to make any statement you wish to.

Mr. KING. I am going to just talk from this. There will be a little variance.

Mr. STAGGERS. All right.

Mr. KING. As I stated, I am the securities commissioner of the State of Texas and charged with the responsibility, through a staff, of course, of regulating the sale of securities in Texas and the people or corporations who issue and sell them. To my knowledge I have a counterpart in every other State except one.

I am not appearing before this committee as an expert on Federal law or constitutional law, or even as securities commissioner of the State of Texas. I am appearing as a private citizen who believes that two sections of the proposed legislation represent extreme and in my opinion, dangerous precedents and that the means used do not justify the ends sought to be accomplished.

I am in a strange position. I am in favor of the general aims of this bill to strengthen protection to the investing public. I am in the regulating business myself. But I am very concerned over sections 6(a) and 3(c), and I would like to address my remarks to these sections only.

If enacted, these two sections would, in my opinion, set a very far-reaching precedent, that of granting jurisdiction to a Federal agency over a business or industry based upon use of the mails and size. Under this precedent Federal jurisdiction could be obtained by any Federal agency and be imposed upon any business, profession, or industry.

The Midwest Securities Commissioners Association, with 18 member States, has gone on record as being opposed in principle to the portion of the proposed legislation submitted to Congress by the Securities and Exchange Commission, which would require membership in a trade association by a broker-dealer.

Under section 15(c) of the Securities Exchange Act of 1934, which is not being amended in this bill, the Securities and Exchange Commission now has jurisdiction over any broker or dealer who uses the mails to defraud or to deceive (there is no intrastate exemption) so the SEC already has jurisdiction over the crooks, or at least those who would use the mails to defraud or to deceive.

In getting to the portions under discussion: Section 15(a) of the 1934 act now provides in substance that no broker or dealer (* * * other than one whose business is exclusively intrastate) shall make use of the mails or of any means or instrumentality of interstate commerce to effect a securities transaction unless they are registered with the Securities and Exchange Commission.

Section 6(a) of H.R. 6789 would amend section 15(a) so as to delete the parenthetical intrastate exemption and in addition to requiring registration with the SEC would require every dealer to be "* * * a member of a securities association which is registered pursuant to section 15A of this title."

The National Association of Securities Dealers, a nongovernmental self-regulatory industry trade association, is the only such organization so registered.

In the more than 25 years after that other associations could have registered, this has been the only association which has registered.

The effect of the amendment would be to authorize a Federal agency to assume jurisdiction over any broker or dealer, regardless of how localized the transaction, who uses the mails to receive a check or transmit a stock certificate, and to require mandatory membership in a trade association, thus having the effect of a federally imposed closed shop in the securities industry.

Section 6(a) of the bill may be an unconstitutional delegation of governmental licensing authority to a nongovernmental organization. The National Association of Securities Dealers has rules, regulations and sanctions whereby it can and does suspend or revoke membership. Since the wording of the amendment would require registration with both the SEC and membership in the trade association, the broker-dealer might be deprived of due process of law, that is, if his National Association of Securities Dealers membership is revoker for nonpayment of dues or for not paying a fine, and he would be out of business.

The other section to which I refer is section 3(c). This is the Freer-Fulbright amendment. This would authorize a Federal agency to assume jurisdiction over any issuer or corporation which has total assets exceeding $1 million and 750 stockholders (500 stockholders 2 years hence) whose securities are traded by use of the mails (regardless of whether intrastate or not or if its business affects interstate commerce).

It should be noted that in this instance SEC jurisdiction would be conferred upon a corporation based upon size, type of business, or the use of the mails by its stockholders, not the corporation.

I am in favor of as much information as possible being available to the purchasers of securities and securities holders whose proxies are solicited by company management; however, in this instance, I do not think this end justifies the means.

If Congress enacts the amendments proposed in sections 6(a) and 3(c) some of the effects would be:

Federal jurisdiction over an industry, not malum in se, for the mere use of the mails in a purely intrastate transaction not in or even affecting interstate commerce.

Looking at the other side of the coin, you could say that members of the securities industry, which in my opinion is vital to the industrial

development and to the economy of this country, would be denied the use of the mails in their business unless they register with a Federal agency and join an industry trade association.

These restrictions on use of the mails would apply even to transactions completely without fraud or any character of interstate commerce, even though the broker-dealer has been registered for many years and is regulated by the State in which he does business.

Unconstitutional delegation of governmental licensing authority to a nongovernmental industry trade association.

A federally imposed closed shop in the securities industry.

A possible "back-door" enactment by Congress of all the rules, including those providing for fees and the assessment of fines, of a nongovernmental trade association, in effect now and as later amended, without the Congress even seeing such rules.

Possible violation of the individual broker or dealer's rights to due process of law under the Constitution because the amendment requires both registration with SEC and membership in the National Association of Securities Dealers (which has sanctions whereby it may cancel or revoke National Association of Securities Dealers membership for nonpayment of dues or fines or violation of its rules). I am not objecting to the National Association of Securities Dealers as it now is—a voluntary, self-regulating trade association.

I think if this amendment passes, it would no longer be a voluntary trade association.

These extraordinary requirements would affect more than "a relatively small group of broker-dealers." They would affect 1,800 in the State of Texas alone—not including their 3,600 salesmen. The statistics given to the Senate committee as to the group did not take into account the broker-dealers affected by the removal of the intrastate exemption.

The many purely local industrial foundations in all States and small businesses local in character would be denied the right to have their securities sold in purely intrastate transactions by local securities dealers, registered with the State, without the added expense or intervention of a Federal agency or a national securities trade association.

Here we have the problem of the small dealers, with geographical differences or distances between many of our small communities. Many small communities in most of our States cannot support a full-time dealer. This dealer in order to make a living must sell insurance, real estate, and perhaps automobiles as well as securities. But I think he has a right to be in the business and I think the local people have the right to buy from a local man, without him being required to join a trade association at a cost of $500 or $300 a year thereafter to maintain his membership.

The SEC would acquire jurisdiction over a corporation because of its size and use of the mails by its stockholders—thus setting an extreme precedent. A corporation which is successful enough to amass $1 million in assets, and since there are no statements given to liabilities it may have an equal amount of liabilities, and fortunate enough to attract 750 persons who purchased its securities comes under Federal jurisdiction if its stockholders use the U.S. mails to trade those securities.

The stockholders of such a corporation, regardless of who they are, are denied the use of the mails in disposing of their securities by private sale.

The committee has been advised that in the last decade many insurance corporations were created and sold stock to the public and that State regulation of insurance companies is designed to safeguard the policyholders. The committee was not advised that States do regulate insurance securities for the protection of investors.

The information sought to be filed with the Federal Government by insurance corporations is for practical purposes already on file as a public record in the annual reports filed with the State insurance commissions and is readily available, without cost, in Best's and other well-known national insurance manuals, found in almost every city library and almost every broker's office.

In closing, I would suggest that section 6(a) of H.R. 6789 be deleted in its entirety, leaving section 15(a) of the 1934 act as it is.

If the Congress wishes to enact the purposes embodied in section 3(c), then it is suggested that it allow the Securities and Exchange Commission to assume jurisdiction based on some criteria other than use of the mails by the securities holders of a corporation, type of business in which a corporation is engaged, or size. A criterion such as whether the securities have been distributed in interestate commerce would seem more appropriate.

It is also suggested that if the Congress wishes the securities brokers and dealers under the moral sanctions that we have heard about of the NASD, then the Congress, itself, enact those requirements and not delegate that power to a nongovernmental association.

Gentlemen, I wish to thank you very much for allowing me to express my views.

Mr. STAGGERS. That completes your statement?

Mr. KING. Yes, sir.

Mr. STAGGERS. Thank you very kindly, Mr. King, for submitting your views.

Very briefly, I would say this, that the regulations now do not require every broker, in your statement, that uses the mails to be registered with the SEC. Is that correct?

Mr. KING. Referring to the Federal act, no sir; 15(a), as it is now written, says no broker or dealer—except those engaged in exclusively interstate transactions—shall use the mails. So there is an intrastate exemption for use of the mails.

Mr. STAGGERS. It does not say that if they use the mails they are exempt. If they do use the mails to transact business, are they not then under the jurisdiction of the SEC?

Mr. KING. Everyone uses the mails, sir. They would be under the jurisdiction of the SEC where there is fraud or deceit by use of the mails. But where there is no fraud and no deceit or manipulation, then the SEC would not have jurisdiction over purely intrastate transactions, where the broker-dealer uses the mails.

That is one of the main purposes for amending section 15(a), and is included in section 6(a) of the bill, to give SEC jurisdiction over anyone who uses the mails.

Mr. STAGGERS. I understand what it is there for, but I was wondering this, Mr. King, and I have probably misunderstood the thing, that

anyone who uses the mails did have to register with the SEC, even though they were intrastate.

Mr. KING. No, sir. I would guess in our State that it is just almost impossible to be a broker-dealer without using the mails. According to the SEC's last annual report, they had 5,700 broker-dealers registered with the SEC—4,700 of those were members of the NASD. But in the statistics, only 210 broker-dealers in Texas were registered with the SEC.

Our office has 1,800 broker-dealers registered.

Mr. STAGGERS. You do not know how many are not registered with the SEC?

Mr. KING. The difference would be 1,600 in our State alone who are not registered with the SEC.

Mr. STAGGERS. I do not have anyone from the SEC present to get the information from, but I might ask our counsel if he can supply that information as to the requirements of those dealers who use the mails being registered with the SEC.

Dr. STEVENSON. Mr. Chairman, this is exactly the question, the preemption that is involved. The witness has not discussed that at all. This is the question as to whether the proposed amendment overrides section 28. The Commission has contended that it does not and, therefore, that there was this exemption, and that it can move against these people where it proves they do use the mails and instrumentalities of interstate commerce if they deliver the securities afterward or even if the check paying for the securities clears through the mails or through the Federal Reserve clearing system.

So it is a question of proof, so far as the Commission is concerned.

Mr. STAGGERS. In regard to that, I would like to ask you, Mr. King, this question: When Chairman Cary was here, he referred to the fact that section 28(a) still would remain, and to quote him on page 65 of his statement he said it should be perfectly clear that repeal of this exemption interferes in no way with the States' regulation of broker-dealers, section 28(a) of the Exchange Act, it explicitly preserves the State jurisdiction in these areas.

As I read section 28(a), it says nothing in this title shall affect the jurisdiction of the securities commissions of a State over any security or any person insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder.

Mr. KING. I didn't mean to give the idea that I thought that this amendment would in any way alter the jurisdiction of an individual State. I do not think it would. I think that it would impose upon the fine, small broker-dealers in the many States an additional jurisdiction. I don't think it would hamper the States jurisdiction at all. It would bring them under an additional jurisdiction where a county industrial development corporation which perhaps makes the mistake of being formed for profit gets a local man to go out and sell the securities to raise the money with which to attempt to attract industry.

Those securities are not a marketable thing anyplace really except in that county. The securities of an Amarillo corporation of that type will find no market in Oklahoma City or in Houston. So it is purely a localized situation with purely localized interest.

I think it would hurt, particularly in some of the smaller towns, if each individual who happened to go into the securities business and complied with the laws of his State, had to come under Federal jurisdiction. For example, it requires an independently audited financial statement each year, which is somewhat expensive. If he had to join the NASD, this would cost from $300 to $500, which is also expensive, if the man does not earn a great deal of money from this business.

Bearing in mind that these proposed amendments would affect not only the fine, large firms, such as Mr. Ames represents, it would also affect the very small dealers who are solvent but not quite so solvent.

Mr. STAGGERS. But it would not affect the States jurisdiction.

Mr. KING. No, sir; I do not think it would affect the States jurisdiction.

Mr. STAGGERS. Mr. Dingell?

Mr. DINGELL. I have no questions.

Mr. STAGGERS. Mr. Curtin?

Mr. CURTIN. Mr. King, I understand that you are appearing today as an individual and not in any official capacity.

Mr. KING. Yes, sir.

Mr. CURTIN. You are, however, the securities commissioner of the State of Texas?

Mr. KING. Yes, sir.

Mr. CURTIN. In that capacity, are you the chairman or commissioner of some board, or commission, that has jurisdiction in this particular field?

Mr. KING. Yes, sir.

Mr. CURTIN. What is the name of that particular board or commission?

Mr. KING. The name is the State securities board. This board is composed of three board members who are not full-time members. They are all exceedingly busy men, professional men. They set the policy for the board. They appoint a securities commissioner. This is a nonpolitical agency. The commissioner is not appointed by the Governor nor could he be removed by the Governor, nor is he approved by the senate. He is responsible to this board. None of the board members can be in the securities business. We have one securities commissioner in our State who is charged with the responsibility of administering the State Securities Act, which was passed originally in 1913 but which has been amended because of the needs which have arisen, and sometimes the scandal.

Our legislature has attempted to remove a great deal of pressure from the agency.

Mr. CURTIN. There are, then, two other members of the board, together with yourself?

Mr. KING. No, sir; I am not a member of the board. There are three members of the board.

Mr. CURTIN. And those three members pick a commissioner?

Mr. KING. Yes, sir.

Mr. CURTIN. So there are three members of the securities board?

Mr. KING. Yes, sir.

Mr. CURTIN. Have you discussed this pending legislation with the members of that board?

Mr. KING. I have.

Mr. CURTIN. And have they taken any official position in reference to it?

Mr. KING. They have taken no official position in reference to this legislation. They are, as myself, as individuals opposed to these provisions.

Mr. CURTIN. So that the three members of your State securities board are individually opposed to this legislation, although they have taken no official position, is that correct?

Mr. KING. Yes, sir.

Mr. CURTIN. Thank you.

That is all, Mr. Chairman.

Mr. STAGGERS. Mr. Chairman, do you have any questions?

Mr. HARRIS. I want to compliment Mr. King for bringing to the attention of the committee his views and recommendations on this legislation.

There has been a great deal of discussion on these two questions. The Chairman of the Securities and Exchange Commission has given their views as to why they think it would be appropriate and necessary. I am glad to have all the information we can get on the subject. I am not altogether sure of the position of Mr. King.

You apparently do not represent your own commission, is that correct?

Mr. KING. I suppose I am like you, in a certain respect. It is very difficult to take off your official hat when you go some place. You are still Congressman Harris even though you may not go in an official capacity.

I stated I am appearing here as a private citizen because my board has taken no official position on this. We have discussed it, all three board members, and they are of the same opinion, that while the aims of the bill to strengthen protection to the investing public are laudible, that the means being used would set a very dangerous precedent.

If you would give one agency jurisdiction over an industry because it happened to use the mails in its business, then you could give another agency jurisdiction over the doctors, lawyers, engineers, chicken farmers, or just whatever some agency happened to wish to push at that time.

Mr. HARRIS. I do not believe I can agree with you that it could go that far. I think that is stretching it just a little bit.

The major thing is, Why should x number of dollars investment in the State of Arkansas, which ultimately makes its way into the interstate securities field not have to comply with the same disclosures and information at the start as it is with others who deal on the exchange board?

Mr. KING. Mr. Congressman, I am in accord with the aims of the reporting requirements so as to give as much information as possible. I would say I am opposed to the vehicle that is being used. It is such a loosely drawn vehicle, in my opinion, by saying that the stockholders use the mails to sell the securities. They could use the mails from one point in Little Rock to another point in Little Rock and still have jurisdiction.

My suggestion here is to keep this in the interstate thinking, perhaps to base the legislation on the distribution of the securities in two or more States. You could get the same results but you would have an interstate jurisdictional situation.

Mr. HARRIS. It starts out as an intrastate deal. The transaction is, say, in Texas. It may be between Fort Worth and Dallas, though that may not be the appropriate example to use. We probably should use Houston and Dallas. But it could end up in New York, New Orleans, or some other place as those transactions are transferred to somebody else. Is that not true?

Mr. KING. Yes, sir; it certainly could. In that instance, you could have the jurisdiction lying, perhaps, in the wisdom of the Congress, at the moment that the corporation had notice that it had stockholders in two or more States. Just because something might do something in the future I don't think causes as great a need as the committee has been advised.

I have been commissioner for 7 years in our State, and prior to that time I was assistant attorney general, trying the lawsuits which were involved in our well publicized Texas securities scandals. We had scandals with the sale of insurance company stock and trust company stock.

Prior to September of 1955, our State did not have regulations over the sale of insurance and trust company stock. They were specifically exempt from the State act. The attorney general's office took some action against that and these loopholes were closed by the State legislature. Many other State legislatures have assumed the responsibility of closing loopholes, and they do regulate the sale of the securities.

Mr. HARRIS. The State legislature cannot, though, under any circumstances, pass legislation that would extend jurisdiction beyond the border.

Mr. KING. Yes, sir.

Mr. HARRIS. Of course, I guess you understand that I am arguing something here, if it can be considered an argument, which has put me on the other side of the fence than I have been on all this time on the States rights propositions. But I recognize in these regulatory matters that our economy has reached such a stage at this point, and our progress and our expansion and development, that it is pretty difficult in matters of this kind to hue to the State line. We have the same difficulty in the question of electric power and certain of our natural resources. The courts have been construing the matters of the intrastate natural gas lines, where your own State is involved with the flow of that natural resource within the State, and now we have the stretch of the legal opinions that if it gets in a line even though it stays in a State it becomes a part of the interstate transaction.

I am trying to bring to your attention what has been taking place as the courts have been construing them, on the basis that it is very difficult where you have a natural intrastate operation of preventing a loophole if the same exemptions on these continue. The telephone is the same thing.

Mr. KING. I am not an expert on Federal or constitutional law, but if I might express an opinion here—and I have an opinion on most anything—it would seem to me that the instances you have mentioned have been so stated under the interstate commerce clause, and it is maybe one of my contentions as objecting to the vehicle in this proposed legislation that we have taken or the courts have taken the interstate commerce clause to what some people have said to be very extreme situations, such as regulating window washers of the building

under the wage and hour law because some occupant of that building happens to be engaged in interstate commerce.

Perhaps my main objection here, Mr. Harris, is that this could be construed as saying that the use of the mail gives Federal jurisdiction, construing it as being an entirely new horse and there is no telling how far this new horse could be ridden.

Mr. HARRIS. I did not intend to go to the extremes by using the Wage and Hour Act because I have always had a pretty deep feeling that I thought that was stretching things beyond the imagination of an individual. But, nevertheless, it has been done. It is just like the courts construed that anything that happens on a branch somewhere, because the water runs into a river, becomes subject to the Federal jurisdiction.

It seems to me that the question here should be based on whether or not those transactions within that State ought to be left to the jurisdiction of the commissions themselves, as was originally intended in the act, on the basis that the laws locally adequately deal with it, and it would be a matter that should be dealt with on a local basis because of its locality and the effect that it has to be adequately handled and not having to bother the Federal agency in spending the time and money to go do it.

My own personal opinion is, right now, that any decision based on the precept of what should or should not be done, we will not solve the problem as the interstate activities have been construed by the courts.

I do not think there is a constitutional question involved here at all, myself. I think that was decided a long time ago, before you and I appeared on the scene.

The Senate had hearings on this matter. Did you or any one of your organizations come here to testify?

Mr. KING. No, sir; no one appeared to testify on that bill. However, the Midwest Securities Commissioners, which is rather a misnomer—this is really the tough, regulatory State of the Nation—in a meeting in July, in Phoenix, Ariz., passed a resolution opposing the mandatory requirement that broker-dealers join a trade association, that mandatory portion of the act.

This information was relayed to the Federal agency concerned prior to the time the bill came out of the committee of the Senate. It was felt that it was not necessary that anyone appear at that time.

Mr. HARRIS. So many of these things happen in the other body and they make their way over here. Everybody sits idly by and lets them go through and do nothing about it. Then when it gets over here, it hits the fan.

I want to say that I am getting pretty tired of it, myself, with a good many of these things. Another one went through the other day on international aviation rates. They are hollering over here already that they did not have a change to be heard.

But I am getting to the point where I think one of these days I am going to take a position that these things that go through the other body by unanimous consent, with people sitting down and doing nothing about them, we ought to take some shortcut action ourselves.

I just do not think it is right for this committee to be bludgeoned over something about a position that was taken with everybody being unanimous for it, when with but one objection it could have made the whole thing into a different situation.

Going into this requirement for belonging to the Securities Dealers Association, I did not have an opportunity to ask any questions of the representatives of the Securities Association the other day, but you believe they are strong, I suppose, in the principle of self-regulation, do you not?

Mr. KING. I do not think I could answer that in the affirmative, sir. I am charged with administering an act which our legislature wrote.

Mr. HARRIS. You are an administrator and they are not. But the industry has made it manifest here, as they have done all along, that that is the way to do things and that is the way we ought to do it. I have some question about the provision of law requiring anybody to belong to any organization, and I have that same feeling with reference to the union shop. Congress felt differently about it, however. As a matter of principle, I see no difference in this requirement and the provisions of the Railroad Labor Act which provides for mandatory union shop membership. The thing to me is the practical approach to it. You just can't have your cake and eat it, too.

If you are going to believe in the principle of self-regulation, there ought to be some arrangement set up where you can do it and fully realize it.

I have been giving a lot of thought to the broadcasting industry in this field. If you are going to have the principle involved, I suppose there is something in it to giving somebody in the industry authority to set up some kind of uniform standards that all of you would have to comply with. I think the industry better decide, and the Midwest Securities Association, too.

Mr. KING. I am not representing that association either. I happen to be a member of that association. It has passed the resolution.

Mr. HARRIS. I know it has. But I think it should get on one side or the other. I know how it is, though, that nobody wants to be bothered until they just have to submit to it. That is all there is to it.

I suppose it is a pretty good thing in our country, but the time comes when something has to be done.

Mr. KING. I have to take this position, sir, that I administer an act written by the legislature of my State, and I attempt to administer it the way they wrote it. They did not write it with any regard to self-regulation.

Mr. HARRIS. Yours is a State act, though.

Mr. KING. Yes, sir.

Mr. HARRIS. But you are here talking about a Federal act.

Mr. KING. Yes, sir.

Mr. HARRIS. And you are making recommendations on how the interstate Federal regulatory procedures should be taken care of.

Mr. KING. Yes, sir, I am; and I have never done such a thing before. It is perhaps jousting with windmills, but I just feel very strongly about a few principles, and I thought I would state them.

Mr. HARRIS. We are glad to have you state them here, but I wanted to remind you of some of the problems that we have with reference to agreeing to those principles and what the problems are that we have to deal with if we followed some of these suggestions at the outset in 1933 and 1934, which probably never would have happened, but neither would we have had any stability in this business.

That is all, Mr. Chairman. I did not intend to go on so long.

Mr. STAGGERS. Mr. Dingell?

Mr. DINGELL. Very briefly, Mr. King, you recognize that there are people in the securities industry who are very marginal in terms of capital, and who are sometimes, in fact, in terms of the very small and very marginal people, persons who are forced by circumstances to engage in practices occasionally that are not in the best interests of the purchasers of securities, and persons who not infrequently are of limited knowledge and ability to recommend stocks and securities and to serve as financial advisers, do you not?

Mr. KING. Yes, sir; but I don't think it is limited to small dealers.

Mr. DINGELL. There are some who are large. The problem is to eliminate these people, is it not, or to at least impose upon them a measure of responsibility and understanding of their trade and profession; am I correct?

Mr. KING. I don't know whether they should be eliminated. I don't know which people you mean by "these people." I think you have a right to be small and I think you have a right to be wrong.

Mr. DINGELL. When you are dealing with somebody else's money?

Mr. KING. If you met standardized regulations that covers your particular business. But if you are in a local situation, if you are in a town of 2,000 or 4,000 people, that town cannot support a full-time securities dealer who can meet a certain standard.

I think that the people who live in that community have a right, if they wish, to buy from a local man and not be subject to some itinerant peddler from one of the larger cities.

Mr. DINGELL. Let us put it the other way. Do you like the idea of stock being peddled by doorbell pushers with limited knowledge, limited experience, and limited responsibility in terms of capital to respond to the requirements of their office?

Mr. KING. No, sir; but I don't think you have that. For example, our State regulations on dealer requirements are actually much stronger than the SEC requirements.

Mr. DINGELL. There are States which are not so blessed.

Mr. KING. Yes, sir.

Mr. DINGELL. Our problem is how are we going to stay within the philosophy of self-regulation and prevent some of the abuses that I have just been discussing without going to the device which the SEC has recommended, and that is compulsory membership in an organization?

Mr. KING. Is your basic premise that we must go to the self-regulation?

Mr. DINGELL. The SEC has found on the basis of about a million dollars of expenditure, that there are abuses, and on the basis of this they have come up with this as an approach. I do not intend to quarrel with the finding of the SEC that there are certain abuses which require a change. The abuses to which they referred were generally the ones which I discussed with you earlier.

The question is, how do we halt abuses which the SEC found to be not in the public interest without requiring the sort of action that the SEC takes?

Mr. KING. I don't know. I have not made a full study of all of the study, and I have only read a part of it. But the study does not neces-

sarily, in my opinion, agree with the recommendations the Commission made to the Congress. The study found, for example, I think, in chapter 12, at about page 662, as I recall, that there was a resolution or two resolutions that had been passed by the NASD which forbade the local secretaries of the NASD to attempt to enforce Federal law, and forbade the local secretaries of the NASD to attempt to enforce or cooperate with the State securities regulatory officials. They found instances where there were some ill or bad doings in the securities business, but these were being done by NASD members.

So the point I am sort of leading up to is you may require a man to join a church but that does not make him a Christian.

Mr. DINGELL. I understand that. Do you then advocate the retention of the present intrastate exemption?

Mr. KING. Yes, sir; I do.

Mr. DINGELL. Thank you very much.

Mr. STAGGERS. The committee will stand in recess at this time. The chairman will ascertain after he goes to the floor whether we can obtain permission to return this afternoon to hear the remainder of the witnesses. If the situation is such that we cannot, we will have to meet tomorrow morning at 10 o'clock.

If you witnesses will keep in touch with the clerk, he will let you know by 1 or 1:30 whether we intend to reconvene. We hope to, if possible.

Thank you very kindly, Mr. King, for your testimony. We appreciate your coming and having your statement here. We hope you have a safe journey back.

Mr. KING. Thank you, sir.

(Whereupon, at 12:15 p.m. the subcommittee recessed, to reconvene at 10 a.m. Wednesday, December 4, 1963.

INVESTOR PROTECTION

WEDNESDAY, DECEMBER 4, 1963

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE OF THE
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to recess, in room 1334, Longworth Building, Hon. Harley O. Staggers (chairman of the subcommittee) presiding.

Mr. STAGGERS. The subcommittee will come to order.

The chairman would like to make this statement before we begin. The House goes into session at 11 o'clock today, therefore, of necessity this session will be short. It is very doubtful as to whether we can have a meeting this afternoon because of the legislation which is on the floor. There will be quorum calls and I expect several rollcalls.

I will make this statement. We will meet tomorrow at 10 o'clock to continue the hearings. I would say to any of the witnesses who are here, and anyone who wants to testify who cannot possibly stay over, if you wish, you may insert your statements into the record. We will be glad to receive them for the record. We are not trying to rush anyone because I believe this is important legislation and I believe every person who desires to contribute, who has something to contribute, should be heard. Therefore, we will give each group or person the opportunity to appear.

If it would be expedient to place your statements into the record, we will be glad to receive them that way.

We will have as our first witness this morning Mr. Ralph P. Coleman, Jr.

Would you state your name, occupation, and address for the record, Mr. Coleman, and present your statement? If you wish, you may place your statement into the record and give a summary.

STATEMENT OF RALPH P. COLEMAN, JR., PUBLISHER AND EDITOR, OVER-THE-COUNTER SECURITIES REVIEW, AND LISTED SECURITIES JOURNAL, JENKINTOWN, PA.

Mr. COLEMAN. My name is Ralph P. Coleman, Jr., of Jenkintown, Pa., publisher and editor of Over-the-Counter Securities Review, a monthly magazine devoted to unlisted securities, and of Listed Securities Journal, a monthly magazine devoted to listed securities.

I would like to express my sincere appreciation to the members and staff of this committee for their courtesy in allowing me to testify. As a private citizen representing no official organization, I feel most grateful for this opportunity. In both 1955 and 1957 I had the

privilege of testifying before congressional committees in regard to earlier versions of this bill before us now, and in June of this year I expressed my views on the present bill before a Senate committee chaired by Senator Willis Robertson, of Virginia.

At the outset, I would like to state that I am in general agreement with a number of proposals made by the SEC in regard to strengthening the ethical and financial standards of the securities industry, especially in the area of broker-dealer relationships. I feel that there is considerable merit in a number of these proposals, and I am sure that this committee will view them in that light.

As a financial publisher for the last 12 years, I have had an intimate interest in seeing that over-the-counter companies provide full information to their stockholders. And, going back to 1951, I believe I can safely say that most over-the-counter corporations have made giant strides—voluntarily and on their own—in providing stockholders and the financial community with meaningful, accurate reports on their operations and finances.

Because of this fact, and the succeeding reasons which I will discuss, I must state my opposition to the SEC's proposals to bring several thousand additional over-the-counter companies under its regulatory purview. I am not in agreement with the methods the SEC has proposed for accomplishing full disclosure, although philosophically I am in favor of the objectives of full disclosure. On balance, I feel that the additional time, expense, and administrative and legal difficulties inherent in the Commission's proposals outweigh any advantages that could flow from these proposals.

Corporations are the creatures of individual States. The full disclosure requirements suggested by the SEC should be the province of the various States where the over-the-counter companies are incorporated, since there is no Federal law of incorporation. There is much talk and little action about States rights. Investment industry representatives, legislators, and administrators can make the concept of States rights work in an effective, economical manner by developing in the individual States full disclosure requirements for the publicly held companies incorporated therein, in much the same fashion as the SEC is attempting to do with its proposed legislation.

In this connection, it would appear pertinent to comment on what Senator Javits observed at the Senate hearings in a dialog with SEC Chairman Cary. The Senator, discussing regulation of insurance companies, stated:

> Is there anything, therefore, to the possibility of delegating administration (of the over-the-counter insurance companies) to the State regulatory agencies; in other words, to follow in some fashion—although it does seem to be a somewhat less clear road—the pattern which you propose to establish for the banks?

It is conceivable that the SEC could be challenged on legal grounds for extending its control to those over-the-counter companies, which in themselves have never offered securities for sale on an interstate basis.

I think we had a possible example of that yesterday when the Texas securities commissioner testified. You could see from his viewpoint that this might well be possible.

In such a case, a contesting corporation might very well be joined by a State jealous of its corporate and legal prerogatives. It is per-

haps significant to observe that even before the SEC had submitted its proposals to Congress that another official of the Federal Government—Comptroller of the Currency Saxon—was challenging the authority of the Commission to extend its regulations to over-the-counter bank stocks.

The SEC presently has authority over approximately 4,000 companies—2,500 listed companies and almost 1,500 over-the-counter companies which have issued new securities. The new proposals submitted by the SEC would bring an additional minimum of 1,200 over-the-counter companies and perhaps over 1,600 companies under Federal control. I believe these are minimums—basic minimums.

In his statement before the Senate subcommittee considering this bill, Chairman Cary of the SEC commented: "costs of the program for that year (fiscal 1965) are estimated at approximately $600,000." I think I can state with accuracy that this figure is an administrative rockbottom minimum. In addition, this sum applies only to the 1,200 over-the-counter companies that would come under SEC control on the basis of the 750-shareholder standard, and presumably does not include the 400 banks that would be subject to the appropriate Federal banking regulatory agency.

If the 500-shareholder standard is adopted, the number of over-the-counter companies reporting to the SEC would be increased by at least 33 percent, which would mean at least an equivalent increase in the SEC estimate to $800,000 of additional annual expenses. And with the continued growth of the over-the-counter market, it is not difficult to project the SEC budget for just this one phase of the proposed legislation running to well over $1 million a year, ignoring the fact that several hundred thousand dollars would also be required by the appropriate Federal banking regulatory agency to administer the over-the-counter reporting requirement for the up to 600 banks that would be brought under its jurisdiction.

I just learned this morning from an agency person that would be charged with this that this 600-company-bank figure is not a firm figure. They are not sure whether it is going to be 600 or many more.

At this time I think all of us here should give consideration to the open-end and long-term nature of the legislation that is being proposed here. If the Congress passes this bill, it should clearly keep in mind that in this one part of it alone it is increasing the annual budget of the SEC by a minimum of $600,000 each year at the outset, and probably by at least $1 million each year shortly thereafter.

In the relatively short span of 10 years, this could accumulate into a total expenditure of well over $10 million by the SEC to fulfill the reporting requirement alone, excluding the substantial sums that would be required by the designated agency supervising the banks in this regard. Certainly this question should be asked, "Is this the best possible way that the SEC can spend $10 million or more to protect the investors of this Nation?" I am not here to propose a solution, but I think this is a question that is worth pondering.

I would ask this question of those proposing this legislation: "How can the SEC be certain that there are only 3,900 companies with 500 or more stockholders in view of the fact that there are over 1.1 million active U.S. corporations that filed income tax returns in 1960–61?" Simply because a company's stock is not listed in the NQB or NASD

quote sheets is no guarantee that is has less than 500 stockholders. This is particularly true of companies which require employees to sell stock back to the company when they sever their connection with it.

Much support for the SEC proposals is based on the belief that "full disclosure" will help to "protect" the investor. Certainly there should be considerable cause for reflection on this concept in the fact that one of the most flagrant and widespread cases of stock manipulation in the past decade took place in a company which was listed on an exchange and was subject to SEC full disclosure and reporting requirements. This victim of management machination was United Dye & Chemical Corp., formerly listed on the New York Stock Exchange.

In its testimony before the Senate, I think it is highly significant that the SEC itself describes nine seletced fraud cases before the Commission involving companies which have securities listed on a national securities exchange or are subject to reporting requirements of the Securities Exchange Act of 1934. Certainly these examples, which in the aggregate cost investors many more millions of dollars than the selected fraud cases involving nonreporting companies, are proof positive that if management has fraud in its heart, reporting requirements are not going to protect the unwary investor from getting fleeced.

In setting limits of 750 and 500 stockholders and $1 million in assets, the SEC excludes from its full disclosure concept of protection many of the very companies which have failed to furnish stockholders with reports and which have caused them the most grief, investmentwise in the last few years. These are the over-the-counter companies with less than 500 stockholders and less than $1 million in assets, often unflatteringly referred to as "junk" or "penny" stocks.

It is precisely this type of company, on the low end of the quality spectrum in the over-the-counter market, which is often the violator of the principle of full disclosure to stockholders, rather than the host of legitimate, reporting over-the-counter companies which would be affected by the SEC's proposals.

There is a distinct possibility that if a minimum stockholder limit is established above which SEC control is exercised, the managements of numerous OTC companies with stockholder families in this general area will legally do all they can to keep the number of shareholders below the SEC limit and thereby avoid SEC regulation. They could do this through stock offers to minority holders and/or grouping blocks of stock in the names of nominees. In either case, the effect would be to contract and concentrate stock ownership—certainly a condition that neither the SEC, the Congress, or the investment industry favors.

In S. 1642 passed by the Senate, the following provision appears:

> Registration of any class of security pursuant to this subjection shall be terminated 90 days, or such shorter period as the Commission may determine, after the issuer files a certification with the Commission that the number of holders of record of such class of security is reduced to less than 300 persons.

As I interpret this provision, if company A has over 750 stockholders and assets of $1 million, it is subject to SEC reporting requirements at that time and in the future, even if the number of stockholders drops to as low as 300. On the other hand, company B, with, say, never more than 749 stockholders, is not subject to SEC requirements, al-

though it may actually have 2½ times as many stockholders as company A when the latter is down to 300 stockholders.

I submit that this is a flagrant double standard which treats a company that at one time had over 750 stockholders in an entirely different manner than a company that did not have that magic number of stockholders. In effect, S. 1642 seems to be saying this to managements of OTC corporations:

> The stockholders minimum doesn't really mean anything once you get over the 750 figure. If you go over that amount, that's just too bad, because you won't be able to get out from under SEC regulation ever again unless you lose some 450 stockholders. On the other hand, if you can just keep your number of stockholders below 750, you don't have to worry at all.

Such a situation does not reflect the elemental, evenhanded justice which every governmental regulatory body should, of necessity, have as its ultimate guide and goal.

Another provision of S. 1642 which gives me concern states that the Commission may, by rules and regulations, or upon application of an interested person, by order, after notice and opportunity for hearing, exempt in whole or in part any company from the reporting requirements of the bill. It should be quite apparent that such a provision opens up a Pandora's box for all sorts of favoritism, private pressures, backdoor deals, et cetera—the very type of personal, subjective arrangements which are the bane of any regulatory body's existence.

In dealing with listed securities, the SEC has an open-and-shut case—either the stock is listed on an exchange or it isn't, and it is or it isn't subject to SEC control. Now, if this exemption provision is applied to OTC companies, some of which would be SEC regulated and some of which would be SEC exempt, a whole vast no man's land of regulatory discretion would be opened up, with the attendant dangers and difficulties which such a situation would entail.

Along the lines of administrative discretion, I believe the SEC is setting a dangerous precedent in allowing the reporting requirements for banks to be administered by another Federal agency. If banks are thus exempt from the SEC, would it not be equally logical for insurance companies to make their reports only to State authorities as they do now, for public utilities to report only to the Federal Power Commission, for transportation companies to report only to the Interstate Commerce Commission, for communication companies to report only to the Federal Communications Commission, and so on down the line?

I think if the SEC lets the banks "off the hook," so to speak, it can hardly protest if other industries would prefer to report to their own regulatory bodies rather than to the SEC. In denying them this right, the Commission would be practicing deliberate regulatory, discrimination.

I think it is generally agreed that the majority of corporations which will come under SEC surveillance as the result of this proposed legislation are, in the main, much smaller and less affluent corporations than the larger, listed corporations which presently constitute the bulk of companies under SEC control. I would like to know if there are any hard facts and figures as to the amount of time, effort, and money that would be required by the typical over-the-counter company to comply with the new rules and regulations which the SEC is promulgating.

It seems to me that it would be very worthwhile for the SEC to confer with a panel of executives of representative OTC corporations that would be subject to this bill, tell them exactly what is expected from them in the way of filings and forms, and have these executives develop estimates of just how much additional time and money it would take for these companies to comply with SEC reporting requirements. I understand that, to date, this has not been done.

In his transmittal letter to Congress SEC Chairman William L. Cary stated:

> I should also like to acknowledge the substantial and beneficial cooperation offered the Commission by representatives of the securities industry in connection with our legislative proposals.

I believe the SEC is to be congratulated in developing this liaison with the industry in evolving its legislative proposals.

This is the type of joint cooperation which goes a long way in avoiding misunderstandings at a later date. However, I understand that the Commission did not contact the chief executives of the organizations who would be most affected by its full disclosure proposals—the heads of the over-the-counter corporations whose firms would be subject to SEC rules and regulations if this legislation is passed. Certainly these gentlemen have a much more pertinent interest in these proposals than, for example, officers of national exchanges who would not be directly affected by these proposals and who, quite frankly, would probably be the beneficiaries through additional listings of OTC companies should these laws come into being.

I feel it is most important that committee members carefully recognize the self-interest which is reflected in the statements of various witnesses before it. An honest admission of such self-interest was made by both Mr. Etherington, president of the American Stock Exchange, and Mr. Day, president of the Midwest Stock Exchange, before this committee when they conceded that a side effect of S. 1642 probably would be an increase in listings on their exchanges.

In this regard, I do not think it would be beyond the purview of this committee to investigate the unremitting programs and pressures of the major exchanges upon prominent over-the-counter corporations to have them list their stocks on their exchange. An over-the-counter market totally decimated of its "blue chips" might be all right with the exchanges, but it hardly makes for the quality leadership which investors have a right to expect from a major security medium.

In my own mind, I'm quite convinced that even if this bill does not pass, it already has had the effect of driving more and more fine OTC companies to the various exchanges with a consequent diminution in the quality of the over-the-counter mart. Certainly this trend, if continued, argues poorly for the future of the unlisted market and those who invest therein.

I would suggest that the committee very carefully consider the proposed legislation that would require all brokers or dealers registered with the Commission to become members of a registered securities association. While I can see the practical reasons for this proposal, I would ask this question: Does this legislation mean, in effect, that the Federal Government, through its laws, is applying the concept of the "closed shop" to the securities industry, making it requisite that an individual join a particular group before he can engage in the securities business? Is not this possibility an abridgement of a basic

freedom of the individual to practice in a profession as the result of Government fiat which effectively bars him from entering that profession?

Finally, I think each committee member should carefully consider this proposed legislation in this light: The basic thrust of this bill is more Government regulation and more conformance in yet another area of economic activity. Can I, as a legislator, honestly say that the circumstances are such that there is an overwhelming necessity that this legislation be passed?

Do I hear requests from my constituents for such laws as are being proposed in this bill? Am I convinced in my own mind that this bill represents the most effective and economical way of protecting investors and at the same time assuring traditional patterns of economic freedom? And can I truthfully say that the various parts of this bill are completely fair to all concerned and are free of discrimination as regards various companies and industries?

If you, as conscientious Congressmen, can answer "Yes" to all of these questions, then I say, "Pass this bill and pass it immediately." But if you cannot answer these questions positively, then I would suggest that you exercise your legislative judgment and act accordingly in modifying the bill to eliminate the inequities and shortcomings you find in it.

Regarding the proposed legislation on OTC companies, I would summarize my ideas as follows:

1. Incorporation is a State rather than a Federal function. Why not let the States where the companies are incorporated enforce full disclosure rules on publicly held OTC companies incorporated therein?

2. Although security dealers and the exchanges were consulted on the new bill, there was no attempt made to contact executives of OTC companies who would be most affected by legislation.

3. Arbitrary minimum of 750 stockholders—500 later on—and $1 million in assets won't bring under SEC supervision most of the "junk" and "penny" stocks which have caused the most grief to stockholders and which have most often violated the concept of full disclosure.

4. There is pause for reflection in the fact that one of the biggest cases of stock manipulation and investor loss in the past decade was in a New York Stock Exchange-listed company—United Dye & Chemical Corp.—subject to SEC "full disclosure" requirements.

5. Some companies with approximately 750 or 500 stockholders might very well try to "freeze" the number of stockholders in the company at a figure below the minimum in order to avoid SEC regulation. This would result in contraction and concentration of stock ownership—hardly a healthy trend.

6. The Congress should be fully aware of the long-range implications of this legislation and the probability that administrative costs will probably be well over $1 million each year for the reporting requirements alone when the program is in full swing. And this is an "open end," escalating type of expenditure with no ceiling on expenditures or a "cutoff" time for the program.

7. The section for exempting companies from provisions of the act could conceivably open a "Pandora's box" for all sorts of favoritism, private pressures, back-door deals, et cetera, and, in effect, could undo much of the expected benefits of the bill.

8. In proposing to transfer administration of the reporting provision for banks to an appropriate Federal banking agency, the SEC is setting a dangerous precedent under which other industries could, with equal logic and justice, ask to be regulated in this regard by their appropriate Government agencies such as Interstate Commerce Commission, Federal Communications Commission, Federal Power Commission, and the various State insurance agencies.

Thank you very much for the opportunity of testifying and for your cooperation in listening to my remarks.

Mr. STAGGERS. Mr. Coleman, we thank you for coming and giving us the benefit of your views. I have tried to listen very carefully to your testimony. You talk about what this would do if we brought the people under it.

Would you be in favor of doing away with the Securities and Exchange Commission and permitting everybody to be free?

Mr. COLEMAN. No.

Mr. STAGGERS. Why not regulate all of them, then? You say that it is discriminatory and unfair, but state the worst offenders are in the under-750 stockholders category. I believe you made that statement.

Mr. COLEMAN. I believe that is quite possibly true.

Mr. STAGGERS. Would you be willing, then, if we say not to do away with all of it, but to bring everybody under it?

Mr. COLEMAN. I would say that theoretically that would be the fairest way to do it. But I think there are definite administrative difficulties in that.

Mr. STAGGERS. We know that. I want to say this about your statement: I noticed that nearly all of it was against the provisions of the bill. You didn't propose anything positive in any way to correct. You go back to the opposition that we should have States rights.

Mr. COLEMAN. I do have some ideas.

Mr. STAGGERS. Of a positive nature?

Mr. COLEMAN. I think so.

Mr. STAGGERS. I don't believe you put them into your statement.

Mr. COLEMAN. I thought in this case I was to criticize rather than to propose. I thought that was the function of the witness. I do have some ideas.

Mr. STAGGERS. We do want ideas. We don't want just those against. It is easy to be against. We are trying to write a bill. We are going to write a bill, I believe, which will be helpful. We will not just abandon this.

You mention our constituents. We may not have in our districts one constituent that this would affect, but we are a committee legislating for America, and not for just one district. We have to face the overall picture. That is a different proposition and I don't want to go into the theory of government when we vote.

You mentioned the fact that since the banks are excluded, that we should let other groups out from under it. Do you think that we should go down the line and either let banks in or let others out?

Mr. COLEMAN. I am saying when a precedent of this type is set, the other groups that are to be regulated could very well ask for the same treatment. I am not saying that that should happen. Perhaps it probably won't, but I think in the case of the banks, pressure could be brought by certain individuals within the agency to make this part of the bill. I just don't feel that that is an even-handed situation.

Mr. STAGGERS. Then your suggestion to us, I conclude, is that it is a positive thing; we either include them or let others out?

Mr. COLEMAN. Yes. I think really the SEC should have the authority on bank stocks, if they are going to have it on one industry, as well as on all industry.

Mr. STAGGERS. You mentioned the fact that because United Dye & Chemical and perhaps nine others had failed and had caused much grief and loss to others, that maybe the SEC had failed completely because they were under regulation. You cite this as an example that they had not regulated the ones which were under the SEC. That, to me, is another indication that maybe we should do away with the SEC. Would that be correct?

Mr. COLEMAN. Well, I would say this: that as the facts of the case were proven out, the SEC was not effective in preventing losses. I don't say that the SEC is at fault, but the facts of the matter are thusly, that this did occur with a listed company.

Mr. STAGGERS. We had two that occurred just recently. In fact, one yesterday was disclosed.

Mr. COLEMAN. Which one was that, sir?

Mr. STAGGERS. It has to do with the Allied Crude Oil & Vegetable.

Mr. COLEMAN. As I understand, that is a privately held company.

Mr. STAGGERS. That is a privately held company, but the other two companies were on the New York Stock Exchange and were members.

Mr. COLEMAN. You are speaking of the brokers; yes.

Mr. STAGGERS. Yes. Just because one or two fail. Because we have a crime committed in the community, we don't do away with all the police, and because the firemen don't save one building from burning we don't do away with the fire companies, do we?

Mr. COLEMAN. That is true.

Mr. STAGGERS. If this SEC does any good, we want to amend it and make it stronger for all America; is that right?

Mr. COLEMAN. Yes.

Mr. STAGGERS. That is all of the questioning I have.

Mr. Curtin?

Mr. CURTIN. Thank you, Mr. Chairman. I have no questions, but Mr. Coleman is a neighbor of mine from an adjoining county in Pennsylvania, and I want to welcome him to Washington.

I also want to say that I have listened to your statement with much interest, and I think it is a very good statement.

Mr. STAGGERS. I agree with the gentleman. It certainly serves its purpose very well.

We thank you for coming before us.

Mr. COLEMAN. Thank you very much.

(The following material was received for the record:)

HARRISON & CO.,
Philadelphia, Pa., December 10, 1963.

Mr. RALPH P. COLEMAN, Jr.,
Over-the-Counter Securities Review,
Jenkintown, Pa.

DEAR MR. COLEMAN: Following our telephone conversation yesterday, I have given some further thought to the things we discussed.

I think your idea of including in the application for an "A" filing, certain reporting requirements on the part of the issuer, is an excellent one. In the last 5 years we have had quite a bit of experience with "A" filings and fortunately have had rather good luck in convincing the issuer that it was to his advantage

to keep his stockholders advised of the company's progress. I feel that the company should supply the stockholders with at least a semiannual unaudited statement and an audited annual report.

We have, however, had some experience with companies who take the attitude that inasmuch as management controlled the company, they had little obligation to their public stockholders. We have been able to prevail on these people and insist that they issue at least an annual report, which they did with some reluctance.

We are in complete accord with your feelings pertaining to keeping stockholders informed of the progress of their company, whether the news is good or bad.

Very sincerely,

ROBERT E. DAFFRON, JR.

ADDITIONAL TESTIMONY OF RALPH P. COLEMAN, JR., PUBLISHER AND EDITOR, OVER-THE-COUNTER SECURITIES REVIEW, LISTED SECURITIES JOURNAL

After testifying before Messrs. Staggers, Harris, and Curtin on December 4 concerning proposed over-the-counter legislation, Mr. Staggers asked me if I had any constructive suggestions concerning the problems before the committee. I am pleased to submit herewith my recommendations in this regard.

In my testimony, I made this statement: "In setting limits of 750 and 500 stockholders and $1 million in assets, the SEC excludes from its full disclosure concept of protection many of the very companies which have failed to furnish stockholders with reports and which have caused them the most grief, investmentwise, in the last few years. These are the OTC companies with less than 500 stockholders and less than $1 million in assets, often unflatteringly referred to as 'junk' or 'penny' stocks. It is precisely this type of company, on the low end of the quality spectrum in the OTC market, which is often the violator of the principle of full disclosure to stockholders rather than the host of legitimate, reporting OTC companies which would be affected by the SEC's proposals."

Since testifying, I have made an intensive study of this situation, in cooperation with governmental and industry sources, and as a result of this I developed some ideas which I think can be most helpful in illuminating this "blind spot" that would be almost completely untouched by the proposed SEC legislation already passed by the Senate. Investment dealers and impartial authorities in the OTC field, both in and out of the regulatory agencies, are generally agreed that the vast majority of OTC companies which do not supply adequate investment information to their stockholders are the small and speculative companies which offered securities to the public under the SEC's regulation A exemption, which generally provides exemption from full registration for companies raising up to $300,000. From the time regulation A went into effect as the result of the Securities Act of 1933 through June 1963, a total of 24,693 filings had been made with the SEC under provisions of regulation A.

In the period 1952 through 1963 (fiscal year June 30) registration A filings totaled 13,481 filings with a dollar amount of over $2.4 billion. In the peak year of 1955—the year of the uranium boom—1,628 filings were made to raise over $296 million. In the fiscal year ended June 30, 1963, total filings had dropped to 517 for a dollar amount of $101 million. This drop is, of course, a reflection of the drying up of speculative new offerings as the result of the market "break" of mid-1962.

It has been my experience as a financial publisher that it is the company which files under regulation A which gives stockholders the "hardest time" in the way of getting adequate financial information about the corporation. Especially is this so if the company runs into financial troubles, a not unfrequent situation with this type of issue. Obviously, there are hundreds of "regulation A" companies which supply proper investment data to their owners, but it is principally among the less enlightened companies in this area that shareholders experience the greatest difficulty in obtaining annual reports and similar investment information.

At the present time, although these companies come into close contact with the SEC through regulation A, they have no obligation whatsoever to supply annual reports or any other data to the SEC once they have completed sale of the stock offered under regulation A. My recommendation is a simple one that

should be administratively feasible to enforce and should be free of any legal entanglements concerning "States rights" and the like. My thought is this: In the future, require that all companies which make use of the SEC's regulation A be required to send annual reports, certified by independent accountants, to the Commission thereafter. Such reports should include balance sheet, income statement, and analysis of the capital account. From discussions I have had with Government officials I believe the SEC already has the legal authority to make this requirement a permanent part of regulation A. If not, then I think the Congress should act to see that the SEC is armed with this authority. I would seem tragic if the SEC did have this potential power of requiring annual reports from regulation A companies and it did not begin to exercise it many years ago to protect investor interests in this very important area. I have not learned of any specific reasons why the SEC has not used its power in this regard heretofore.

It would appear to me that the Congress might give some consideration to the idea that all companies which filed under regulation A within, for example, the past 10 years be required to file with the SEC annual reports—starting possibly in calendar 1964 or 1965. I recognize the element of retroactivity in this proposal but I believe that law passed by Congress along these lines would be most helpful to many stockholders who already have despaired of getting financial information from companies which have filed under regulation A in the past few years.

The efficacy of the preceding proposals as I view them is that all of these companies already have had contact with the SEC and in a sense conducted their public offerings with the aid of SEC machinery. It seems to me that there is an element of legal or at least moral obligation for such privileged companies to cooperate with the SEC in seeing that adequate financial standards are met toward their shareholders.

My ideas in regard to the SEC's regulation A have not changed my basic opposition to the bill before the House subcommittee which would regulate many hundreds of OTC companies which have had no contact whatsoever with the SEC and have done nothing at all to bring them under SEC purview. As I have said before, I believe these provisions of the bill are aimed entirely in the wrong direction, are of dubious legal validity, and would be fantastically expensive to enforce. However, I do hope that the suggestions I have made in regard to regulation A will be accepted in the constructive light in which they are made.

As a final suggestion, I would recommend that serious consideration be given to increasing the maximum amount to be raised under regulation A from the present $300,000 to $500,000. The strong inflationary trend which has plagued the Nation since the maximum was advanced from $100,000 to $300,000 in 1945 certainly makes such an upward adjustment long overdue and completely in order.

AMERICAN INSULATOR CORP.,
New Freedom, Pa., January 22, 1964.

Mr. RALPH P. COLEMAN, Jr.,
Editor, Over-the-Counter Securities Review,
Jenkintown, Pa.

DEAR MR. COLEMAN: As the president of American Insulator Corp., a fabricator of custom molded plastic products whose shares has been traded in the over-the-counter market for over 40 years, I would like to give you my thoughts in regard to the proposed SEC legislation which would bring several thousand over-the-counter companies under supervision of the Securities and Exchange Commission for the first time. As the executive head of one of the corporations which would be so regulated I would like to first state that it is my belief that the SEC would be on extremely tenuous grounds in extending its authority to our company and similar corporations. American Insulator Corp., in business since 1916, has never availed itself of SEC machinery to raise money from the public. We have never listed our stock on a stock exchange and do not intend to do so. We keep all our stockholders fully informed by comprehensive semiannual and certified annual reports. Our operations are conducted in complete conformity with the various governmental laws including taxes that apply to our business. If this proposed legislation is passed it will place an undue and wholly unnecessary burden of cost upon this company and others in our category by a governmental body with which we have had no contact and of which we have never requested any ruling.

permission, authority, or advice. We think that this arbitrary action, which permits some unlisted companies to be relieved from SEC regulation because they do not have as many stockholders or lack certain maximum assets, is basically discriminatory and most unfair and appears to me that the SEC are endeavoring to regulate the wrong corporations.

Also it is my understanding that this proposed legislation would require a corporation to report its annual sales. Until about 22 years ago American Insulator Corp. reported its yearly sales. However, we learned the hard way that when this information which yielded our exact profit margin became public knowledge it was most helpful to our many competitors and most damaging to the competitive position of our company. Believing that it is more vital to protect the competitive condition of our corporation than to provide the most complete financial information possible, we have not published our sales figures since about 1941. To do so, would, in our opinion, have a most adverse affect on the competitive situation of our company since we are 100 percent in the custom molded business and many of our competitors, who are in some cases our customers, have other manufacturing lines and report to their shareholders on a consolidated income basis. Others are family or privately owned and do not publish any reports in most cases not even to Dun & Bradstreet, Inc., so it should be very easy to understand how this sales figure provision would work against our company with harmful effects to the financial investment of our stockholders.

As indicated earlier in my letter, American Insulator Corp. has never had a public offering of its stock. Should the time come when such an offering would be required then we would quite naturally register with the Securities and Exchange Commission and be fully subject to the rules and regulations such registration entails. Until then, I do not believe that our corporation or any other over-the-counter corporation which has not filed for a public issue with the SEC should be subject to SEC surveillance.

Yours very truly,

EDWARD J. CAUGHLIN, *President.*

Mr. STAGGERS. The next witness will be Mr. Leonard Spacek.

Would you give your name, address, and occupation, please, to the committee, and proceed with your statement?

Mr. SPACEK. Thank you, Mr. Chairman.

Mr. STAGGERS. Mr. Spacek, your full statement will be included in the record. You may summarize it or present it, as you wish.

STATEMENT OF LEONARD SPACEK, ARTHUR ANDERSEN & CO., WASHINGTON, D.C.

Mr. SPACEK. Thank You, Mr. Chairman. I think that since it is short, I will present it, to be more accurate.

Mr. STAGGERS. Very well.

Mr. SPACEK. My name is Leonard Spacek. I am chairman of the partnership of Arthur Andersen & Co., a firm of independent public accountants. Arthur Andersen & Co. has 279 partners and approximately 4,500 total personnel. Our firm, which is one integrated organization on an international basis, has a total of 60 offices, of which 33 are located in the principal cities of the United States, while the remaining 27 offices are located in 20 countries in Europe, South America, Australia, and Japan. Our firm gives opinions on the financial statements of several hundred companies which are required to file reports with the Securities and Exchange Commission. I may mention, as an aside, that we have some 20,000 clients.

One of the purposes of H.R. 6789, as I understand it, is to provide better protection for the investors by requiring the dissemination of more adequate information with respect to securities. While I do favor the passage of this proposed legislation, and while such legis-

lation might provide more work for public accountants, my reason for appearing here today is to comment briefly on two aspects of this bill relating to the protection of the American investor. Such protection is of primary concern to your committee.

The first matter relates to the coverage of insurance companies by this bill. There apparently has been considerable discussion, controversy, and confusion on this point. I agree with the conclusions of both Chairman Cary of the SEC and President Funston of the New York Stock Exchange that the coverage of insurance companies by this bill is desirable, and that this would not impose an additional burden of any significance on those companies.

I say that in the light of having many clients who will be covered by this bill.

Chairman Cary indicated that the reports ordinarily filed with the State insurance regulatory authorities, plus some relatively minor supplemental information, is all that would be required by the SEC. In this regard, it must be recognized that the State regulatory authorities are interested almost entirely in the protection of policyholders, while the purpose of the proposed legislation and the general responsibility of the SEC is to protect the investors.

Mr. Cary, in his prepared statement presented to you on November 19, 1963, quoted from a 1960 report by a subcommittee within the National Federation of Financial Analyst Societies, which stated:

> It is our conclusion that annual reports (to stockholders) of the life insurance industry are the poorest of any major industry in the United States.

This is a well-known fact, and this situation arises in part from the fact that the accounting practices as prescribed by the States are designed for the protection of policyholders, and not for investors. In some major respects, insurance companies do not keep their accounts and report to their stockholders in accordance with practices that conform with generally accepted accounting principles followed by almost all other industries. The resulting financial statements of stock insurance companies can be very misleading to investors.

This bill, H.R. 6789, requires only a filing of minimum financial data. Therefore, I raise the question—is anyone looking out for the interests of the investors who are buying and selling the capital stocks of these companies, insofar as the financial statements are concerned?

I further ask: Who are those complaining about the burden of proper accounting to the investors? Are they not the managements who are hired by the stockholders, and are not the managements the persons whose stewardship is to be accounted for?

You might ask yourselves whether the objection to disclosure, as required by this bill, is by the very individuals whose accountability is involved. Is State regulatory accounting for the benefit of policyholders a proper basis for preventing a proper accounting for investors' interests? An accounting designed to protect policyholders in no way needs to conflict with a proper accounting for investors, and one does not serve or is not dependent upon the other.

Finally, is not the cost of such an accounting borne by the very investors that the accounting will serve?

When these questions are answered, the question of merit is clear: There is no reason whatsoever why insurance companies should not make the same careful accountability to investors as that prescribed

for other regulated industries, such as gas, electric, pipelines, and telephone companies.

The second matter I would like to discuss briefly relates to the financial statements (1) that are being filed under the Securities Act of 1933; (2) that are being filed under the Securities Exchange Act of 1934; and (3) that would be filed if H.R. 6789 is passed.

Pursuant to the broad rulemaking powers conferred upon the Securities and Exchange Commission under the several acts which it administers, the Commission has adopted various rules and regulations with respect to the preparation and presentation of financial statements. In addition to special rules applicable to holding companies and securities brokers and dealers, the Commission has promulgated rules contained in a single comprehensive regulation, identified as regulation S–X, which governs the form and content of financial statements filed in compliance with the several acts. That regulation is supplemented by the Commission's accounting series releases, of which 98 have so far been issued. Such rules and regulations generally have not prescribed accounting principles or practices on any broad scale.

The Commission recognizes the limited applicability of such rules and regulations, and this is evident in the following comments contained in the Commission's 28th annual report to Congress, page 149:

> * * * The rules and regulations thus established, except for the uniform systems of accounts which are regulatory reports, prescribe accounting principles to be followed only in certain limited areas. In the large area of financial reporting not covered by such rules, the Commission's principal means of providing investors protection from inadequate financial reporting, fraudulent practices, and overreaching by management is by requiring a certificate of an independent public accountant based on an audit performed in accordance with generally accepted auditing standards which expresses an opinion as to whether the financial statements are presented fairly in conformity with accounting principles and practices which are recognized as sound and which have attained general acceptance.

I respectfully suggest that the broad standards of disclosure which the Securities and Exchange Commission has stated on various occasions that it is relying upon in the general area of financial reporting should be formally recognized as the standards of protection available to all investors who rely on financial statements.

The accounting profession should be held responsible for the determination of accounting principles that best serve the needs of investors and other elements of our society relying upon such financial statements. Yet, that profession really has not assumed this responsibility in any effective manner; and there appears to be great reliance by Congress, by the Securities and Exchange Commission, and by the public on "generally accepted accounting principles." But at the same time, no one has assumed the responsibility of saying what those principles actually are, so that investors can hold responsible those who prepare financial statements or give opinions on them, even under their own definition.

The need for uniform standards of financial information, which I endorse, for the benefit of investors was brought out by Chairman Cary of the SEC in a statement before the Subcommittee on Securities of the Committee on Banking and Currency, U.S. Senate, on June

18, 1963, concerning the legislation presently before this committee. He stated:

> * * * The purpose of disclosure is to place the investor in a position to make an informed judgment on the merits of a security, and to provide a basis for comparing that security with others issued by companies in the same or different industries. Essentially this purpose is achieved through the furnishing of financial information which provides a uniform pattern of reporting based on understood and generally accepted accounting practices.

While Chairman Cary in making these comments was referring to banks, his comments are equally applicable to all companies filing financial information with the Commission. His comments indicate that the Commission considers uniform standards and principles for financial reporting to be imperative and that H.R. 6789 will achieve these results. However, as this bill is drawn, he is wrong in this assumption. His objectives will not be achieved even though they are extremely meritorious.

Independent public accountants have just as great a responsibility in the area of their opinions on financial statements given to the public as does the Securities and Exchange Commission in determining that proper financial information is prepared and disclosed. In fact, independent public accountants have a greater responsibility in that they must sign their opinions on the financial statements, and they are personally liable for false and misleading financial statements upon which they give their opinions, or for lack of disclosure of significant financial information in connection therewith.

Furthermore, while SEC has the power to prescribe accounting principles, it has generally delegated, and properly so, this responsibility to the managements of the companies under its jurisdiction and to the accounting profession. The Chairman of the Commission recently publicly stated the Commission did not desire to undertake this responsibility in the following words from a speech by William L. Cary before the Financial Executives Institute, Boston, Mass., on October 8, 1963:

> Writing in the Harvard Business Review, my friend and former colleague, Prof. Robert N. Anthony, says we [SEC] should set the [accounting] rules. We have the power, and perhaps should lend more concrete rulemaking support to decisions reached by a body such as the Accounting Principles Board. But Government should not be called on to do everything, and actually we do not want to. (Some of us in Government are conservative about the use of our powers.) We are, therefore, not prepared to accept the mantle which Professor Anthony has cast over us. At the same time, you should bear this in mind: You can help in preventing the encroachment of Government by participating directly in steps toward agreement upon accounting principles.

The Congress, in carrying out its responsibility to the public of protecting the investors, should carefully consider the need to establish guidelines spelling out the responsibilities of the accounting profession and of independent public accountants in giving opinions on financial statements, so that the informal reliance being placed upon the accounting profession today by the SEC is clearly understood by everyone concerned.

Therefore, I propose that the Securities Exchange Act of 1934 be amended to incorporate the language of Chairman Cary before the Senate committee as I previously quoted it. This is particularly important if supervisory duties under the act are delegated to other agen-

cies as it is proposed under new paragraph (i) in section 12 (lines 1 to 9 on page 11 of draft of proposed H.R. 6789). The exact wording is indicated on the following page. Also, the Securities Act of 1933 should be amended, as indicated, to make the two acts consistent in this respect.

The wording is on the last page of my statement and reads as follows:

Section 12(b) of the Securities Exchange Act of 1934, as amended, is amended by adding the following subparagraph under (1):

"(M) The accounting and reporting practices followed in the preparation of the financial statements referred to above in this subsection (b)(1) shall be based on uniform accounting standards and principles as determined by the accounting profession so that the investor is placed in the position of being able to make an informed judgment on the merits of a security and to provide a basis for comparing that security with others issued by companies in the same or different industries. The Commission has the responsibility of determining whether the accounting profession has taken appropriate action in this regard."

The second section is the same amendment that would be made to the Securities Act of 1933.

Schedule A under section 7 of the Securities Act of 1933, as amended, is amended by adding the following paragraph at the end of that schedule:

"The accounting and reporting practices followed in the preparation of the financial statements included in the registration statement in accordance with paragraphs (25) to (27), inclusive, shall be based on uniform accounting standards and principles as determined by the accounting profession so that the investor is placed in the position of being able to make an informed judgment on the merits of a security and to provide a basis for comparing that security with others issued by companies in the same or different industries. The Commission has the responsibility of determining whether the accounting profession has taken appropriate action in this regard."

Mr. Chairman, I do appreciate your giving me the opportunity to testify before you have to go to the floor.

Mr. STAGGERS. We appreciate your coming, as we do every witness who comes before the committee, because each one contributes to our decision when the bill is written.

I was interested in your statement, and also in the fact that Mr. Coleman said witnesses appearing before this committee are here in their own self-interest or in the interest of those whom they represent. I notice you are an accountant and represent the accountants.

Mr. SPACEK. That is right, the accounting profession.

Mr. STAGGERS. And you are testifying as to a principle of accounting that should be written into the law.

Mr. SPACEK. I state that the standards of accounting which Mr. Cary said where the bases of this disclosure should be written into the law, that it is the accounting profession's responsibility to determine this. He relies on the accounting profession to do it, the Congress relies on the accounting profession to do it. The accounting profession is not carrying the responsibility. I have urged Mr. Cary to state what the accounting profession's responsibility is. I agree with what Mr. Cary has testified to before this committee so far as it applies to disclosure.

Mr. STAGGERS. Whether I agree or disagree with you, I think you have made a fine statement and certainly you have made a concrete proposal that will be before us for consideration at the proper time. Again, on the point of self-interest, I believe if all of us could recognize we don't really testify against ourselves or our own self-interests.

When we get a composite of the different groups then it is our duty to write into law what we think is for the best interest of the Nation.

Mr. SPACEK. Yes, sir. Let me say one thing about my own self-interest. Undoubtedly there might be some small amount of work involved in further disclosures before the Commission. In general, there is no additional work proposed by the Securities and Exchange Commission on the insurance companies so far as accounting is concerned. He does not require those financial statements to be certified as other independent industries are required to be certified.

With respect to other industries, we are all right, in most part, examining those accounts, our profession is. All I say is what Chairman Cary wants to do is very much needed, and the only thing I suggest is that the very principles and standards that he says will be achieved by this legislation be made a part of the law itself.

Mr. STAGGERS. Pursuing the interest of the State's rights, you in your statement said that the State insurance agencies or supervisory groups protect the policyholders in the State.

Mr. SPACEK. They are primarily, through their accounting, to protect the policyholders on what I would call a liquidating basis, yes, sir.

Mr. STAGGERS. And your proposal is to protect the investors who invest in the insurance companies?

Mr. SPACEK. Yes, sir, without detracting one iota from the other protection to the policyholders.

Mr. STAGGERS. And you are not taking any power or supervision away from the State agencies?

Mr. SPACEK. That is right. And this legislation does not injure the policyholder regulations.

Mr. STAGGERS. Thank you very much.

Mr. Chairman?

Mr. HARRIS. No questions.

Mr. STAGGERS. Mr. Curtin?

Mr. CURTIN. No questions.

Mr. STAGGERS. Thank you very much.

Mr. SPACEK. Thank you.

Mr. STAGGERS. Mr. Paul Holenstein will be the next witness.

STATEMENT OF PAUL L. HOLENSTEIN, PRESIDENT, PRUDENTIAL DIVERSIFIED SERVICES, HELENA, MONT.

Mr. HOLENSTEIN. Thank you, Mr. Chairman.

Mr. STAGGERS. We see that you are a way from home, too. I was alerted by your Congressman, Mr. Olsen, that you would be in here and would be prepared to speak. We are glad to have you. Perhaps by your appearance today you can return home sooner. Please give your name, address, and what your occupation is, and then proceed with your statement.

Mr. HOLENSTEIN. My name is Paul L. Holenstein. I am president of an investment company in Montana. I came in especially for this hearing as it was arranged. My comments are brief.

I am appearing in opposition to H.R. 6789 and S. 1642 on behalf of my company, Prudential Diversified Services, a Montana corporation, and its over 4,000 men, women, and children who in good faith invested $2,807,000 in its securities.

I sincerely believe the Securities and Exchange Commission should not be granted any further appropriations or powers until a complete top-to-bottom investigation is made by a committee of Congress into its existing activities and powers as it affects American business and enterprise.

Before giving my specific reasons why I am against the above bills, I wish to state that on February 28, 1963, without benefit of a conference or one word of warning, the SEC regional administrator in Seattle, Mr. James E. Newton, filed an action requesting an injunction against my company from further sale of securities. The first word I personally received was the news broadcast on the radio and TV.

The effect of the adverse publicity in the news had the company and its investors who had great confidence in the company in panic. It was no different than the assassin's bullet that killed our beloved President Kennedy. The SEC, supposedly an organization to protect the rights of investors, completely ruined a growing company that provided jobs, industry, and opportunity in an economically distressed part of Montana. (If any of you gentlemen would like to question me further on this after my testimony, I am here at your pleasure.)

I am against the above bills for the following reasons:

(1) They give the SEC new power to regulate the raising of venture capital under the guise of so-called self-regulating stock exchanges. In my opinion, it virtually forces the offering of securities into large associations firmly entrenched in this field at the expense of the little fellow. The person on the outside does not have a chance. My State of Montana was built with speculative capital. Not one railroad, powerplant, or copper mine would be in existence today if our founders would have had to follow today's rules as compiled by the SEC. What good can this do our free enterprise system and the people you represent?

(2) Both bills firmly pound a new nail into the coffins of our State investment commissions who license, regulate, and administer the offering of securities on an intrastate exemption. As it now stands, the SEC takes it on itself to interfere with legitimately licensed concerns on this type of offering in order to justify its existence and taxpayer-paid staff.

(3) The high cost of registering a securities issue with the SEC which runs about $40,000 puts a complete stop on the average person's ability to raise capital or finance a new venture starting with an idea. How many of us here could put up that kind of money just for the right to raise capital? The bills before you further endorse this expense and I ask what good can be done to further the American economy, built from people willing to take risk, under the disguise of "protection."

May I summarize my testimony: (1) No new powers or appropriations be given SEC until a congressional investigation is made of their existing powers and activities. (2) The ability of many of the zealots in the SEC be questioned. Finally, that the efforts of this agency—and here I want to digress from my statement. I am not for the abolition of the SEC, but that part of their efforts be directed to help firms like mine, to help us put together these deals, and come along and give us suggestions, help us raise capital from the public instead of just deliberately going out and destroying us.

I say in the interests of our American system I ask that you give some consideration to my testimony.

Thank you very much, gentlemen.

Mr. STAGGERS. Mr. Holenstein, we appreciate your taking the time. I know it took you some efforts and funds as a separate organization, an independent organization, to come to Washington and give us your views. I certainly am sympathetic with you and your statement. I would like to ask you a question or two about your own company. You say you welcome any questions about it and about the proceedings of the SEC against you. You say the first warning you had was that which came over the TV and radio?

Mr. HOLENSTEIN. That is right.

Mr. STAGGERS. I think that is one of the most despicable habits in Washington, of our agencies doing just that for sensationalism. I hope this committee can write into law for the prohibition of such procedure. I think every agency in Washington should be prohibited from such action, without first consulting and trying to bring about help. I say that as only one member of the committee, of course. Is your company still in operation?

Mr. HOLENSTEIN. It forced us into chapter 10 under the bankruptcy laws. In order to keep the entire corporation from just collapsing, we had to ask for court protection and my company is now in the hands of a court-appointed trustee. I am working now trying to get it out of there. But in the meantime, the mental anguish that was caused these people was just something terrible. It is hard for me to even sit here and to come to Washington and tell you people that because it sounds unbelievable. I would like to add this: I think I have a suggestion that would answer the powers that this organization asks. Tied to any bill should be that they should be bonded up to the asset value of that corporation before they can publicly attack you in the newspaper and destroy your equities overnight. Furthermore, that they be responsible for their acts. I think then you could give them any powers they want. That would be the answer.

Mr. STAGGERS. You say you are president of the company?

Mr. HOLENSTEIN. Yes; I am.

Mr. STAGGERS. Are you willing to make an affidavit that you were never notified of any suggestion that anything was wrong in your company, until you were notified by TV or radio?

Mr. HOLENSTEIN. I might say that we were under investigation for 3 years. The men that came in and investigated us never gave any indication whatsoever that any action like this was to be taken. I will sign an affidavit that I was never warned nor had any word that this injunctive action was going to be taken against me. Further, I have a statement that was sent through Senator Mansfield in which Mr. Cary says that they did not take the time to notify Mr. Holenstein of this action. I have that with me.

Mr. STAGGERS. If you were under investigation for 3 years, you had warning, then, of knowing that something perhaps was, as we shall say, working or "cooking."

Mr. HOLENSTEIN. I have always felt that one conference may have resolved a lot of difficulty. I think they should have called me in and said, "Mr. Holenstein, we don't agree with you on this and that. If

you do not change this forthwith, we are going to do so and so." But don't just drop a bomb in somebody's lap and leave you there to bleed.

Mr. STAGGERS. As I said to one of the previous witnesses, because a company does wrong, if they fail to answer the firebell one time, you would not do away with the fire company. You would probably see something about it being alerted to do the job properly.

Mr. HOLENSTEIN. That is correct. I would like to see this changed accordingly.

Mr. STAGGERS. That is what this committee is here for, to find out any weaknesses, to try to make it a better law if we can, or, if there is something wrong, to try to correct it or perhaps cut or add something.

Mr. Chairman?

Mr. HARRIS. I have no questions, except in view of the fact that this witness has come here with a complaint regarding administration of the act and has given the committee his own ideas and suggestions, together with the implications involved in the case, I think a report should be obtained from the Securities and Exchange Commission on the case so that we can have the benefit of the Commission's report, of its records, on it to go into the record at this point.

I don't think the record ought to be left as it is without an opportunity for the facts from the standpoint of the Commission to be included in the record.

Mr. STAGGERS. I think that is a very fair statement.

Mr. HARRIS. I ask unanimous consent that it be included in the record.

Mr. STAGGERS. Mr. Chairman, we shall request the SEC to forward that. It will be made a part of the record immediately following Mr. Holenstein's testimony.

Mr. Curtin?

Mr. CURTIN. No questions.

Mr. STAGGERS. Thank you, Mr. Holenstein, for taking the time to come and appear before us. Your views will be given every consideration.

Mr. HOLENSTEIN. Thank you.

(The information mentioned follows:)

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., December 18, 1963.

Re Prudential Diversified Services, Paul L. Holenstein

Hon. HARLEY O. STAGGERS,
The House of Representatives,
Washington, D.C.

DEAR MR. STAGGERS: In response to your letter of December 4, 1963, I am enclosing a memorandum prepared by our Division of Trading and Markets.

Please let me know if we may be of any further assistance.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

MEMORANDUM FROM THE DIVISION OF TRADING AND MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION IN RESPONSE TO A LETTER DATED DECEMBER 4, 1963, FROM REPRESENTATIVE HARLEY O. STAGGERS

In his letter, Mr. Staggers makes reference to and transmits a copy of the testimony of Paul L. Holenstein of Butte, Mont., before the Committee on Interstate and Foreign Commerce on December 4, 1963. Mr. Staggers requests that the committee be furnished a statement reflecting the Commission's position in regard to Mr. Holenstein's complaint.

As the committee is no doubt aware, the Commission instituted an injunctive action in the U.S. District Court for the District of Montana on February 28, 1963, against Prudential Diversified Services, its president, Paul L. Holenstein, and other affiliated persons to enjoin them from further violations of the antifraud provisions of the Securities Act of 1933 and to obtain the appointment of a receiver for the protection of investors' interests. This action arose out of the defendants' offer and sale of 6-percent 20-year convertible debentures to residents of Montana.

On March 9, 1963, all named defendants consented to the court's entry of a permanent injunction enjoining each of them from further violations of the antifraud provisions of the Securities Act of 1933 and appointing a conservator to hold, manage, and conserve the assets of Prudential Diversified Services and its affiliate corporations.

Subsequently, the company became the subject of proceedings under chapter X of the Bankruptcy Act. As the committee is aware, chapter X is a reorganization section and is primarily based upon democratic action by security holders in conjunction with a trustee under the jurisdiction of the court, operating for the general purpose of returning a financially distressed corporation to an active and profitable business level. At the present time, the court appointed trustee is operating the affairs and activities of Prudential Diversified Services under supervision of the court.

The circumstances leading to the Commission's enforcement action were as follows:

(*a*) Prudential Diversified Services was organized in 1958 and until the filing of the Commission's action was engaged in selling its 6-percent 20-year convertible debentures to residents of Montana by means of an extensive sales campaign. The proceeds were invested in real estate in Montana and Texas and in various other enterprises. It appears that over $3 million worth of unregistered debentures were sold to approximately 4,000 Montana residents in reliance upon the so-called intrastate exemption from registration afforded by section 3(a)(11) of the Securities Act of 1933.

(*b*) The venture was consistently unprofitable primarily by reason of the expensive sales campaign and high interest expenditures. As of October 31, 1962, the consolidated balance sheet showed a prior-year loss of over $800,000 and total liabilities exceeded total assets by approximately $1 million.

(*c*) The debentures were sold to the public upon the representation that the investors could redeem their debentures at any time, a factor which was of material significance to investors. Notwithstanding these representations, our investigation disclosed that Prudential had frequently refused to redeem its debentures and for this and other reasons, the Commission's staff received during the years 1961 through 1963 a great many complaints from residents of Montana who believed that they had been deceived by the company. Our investigation further disclosed that the company and its salesmen had failed to inform prospective and existing investors of its current and deteriorating financial condition and of the fact that it was unable to generate sufficient income to meet its costs and expenses. It further appeared that the company was only able to keep in operation by selling additional debentures to the public.

(*d*) During the course of the staff's investigation, the foregoing facts were discussed repeatedly with Mr. Holenstein and other officers of the company who promised to make the necessary disclosures to investors. In late 1961 and early 1962, staff members met with and corresponded frequently with Mr. Holenstein and other officers of the company and they agreed upon a program under which specified disclosures would be made to all investors, including disclosure of the firm's financial condition and the fact that it would not redeem debentures upon demand. Mr. Holenstein was clearly advised that this program was the only alternative to the staff recommending legal action against the company and its officers. Notwithstanding this agreement, the company continued to offer and sell its debentures without disclosure of its financial condition. Under such circumstances, the staff concluded that it was necessary and essential for the protection of Montana residents that injunctive proceedings be instituted against the company and its officers to enjoin further violations of the antifraud provisions of the Federal securities laws and that such action seek the appointment of a receiver for the protection of investors' interests. Thereafter, the staff recommendation was forwarded to the Commission who approved the filing of the injunctive action.

It might be noted that at Mr. Holenstein's request, he visited the Commission's offices on December 5, 1963, and discussed the subject case with Mr. Arthur Fleischer, Jr., executive assistant to the Chairman, and Thomas W. Rae, chief enforcement attorney of the Division of Trading and Markets. At such conference, Mr. Holenstein was offered the opportunity but declined to point out any allegation in the Commission's complaint which was untrue. Mr. Holenstein only reiterated his complaint that he was not given prior notice or warning of the Commission's injunctive action against himself and the other defendants. Mr. Holenstein was reminded of specific meetings and correspondence which reflected the numerous warnings and advice given to the company that unless appropriate disclosures were made to investors, the staff would have no alternative but to recommend appropriate enforcement proceedings. Mr. Holenstein did not dispute the fact that the company failed to make such disclosures subsequent to such warnings.

In summary, Mr. Holenstein does not appear to seriously contest the fundamental fact that he was and had been engaged in selling securities to the public in violation of the fraud provisions of the Federal securities laws in that in the sales of these securities he failed to disclose the very material facts that the income of the company was insufficient to meet its expenses, that supposedly redeemable debentures could not in fact be redeemed, and that the proceeds from the debentures which he was selling were being dissipated to pay current expenses.

Mr. Holenstein's primary complaint seems to be that he was not notified or consulted prior to the filing of the Commission's action but learned of it through the news media and that the staff of the Commission should have assisted him in his efforts to raise capital.

With respect to the first point, as indicated above, the staff had repeatedly warned Mr. Holenstein that he was violating the securities laws and that unless he made the required disclosures which were outlined to him, the staff would have no alternative but to recommend that action be taken. The staff could not tell him that an injunctive action would be filed since this could only be done if it was authorized by the Commission.

After the staff was authorized and directed to file the action, a staff attorney traveled to Montana for the purpose of filing the papers. He did not propose to discuss his plans with Mr. Holenstein in advance, since this would have served no useful purpose, but he did endeavor to communicate with Mr. Holenstein on February 28 immediately after filing the complaint but was unable to reach him. The U.S. marshals encountered some difficulty in effecting service on Mr. Holenstein and were not able to do so until some time on March 1, 1963, although, as Mr. Holenstein has stated, he was aware of the filing of the action on February 28.

No press release or other statement to the press was made at the time when the action was filed but interested reporters were referred to the complaint which was on file in the Federal district court and, of course, a matter of public record. It was presumably from this source that the radio and TV statements to which Mr. Holenstein objects originated. A routine litigation release summarizing the allegations of the complaint was issued on March 5, 1963, under date of February 28, 1963. We enclose a copy of that release, together with a copy of a release dated March 9, 1963, reporting the entry of the court's decree. In this connection it may be noted that the staff originally contemplated not making its motion for a temporary restraining order or preliminary injunction until March 25, 1963, in order to allow Mr. Holenstein ample time to prepare his defense. The U.S. district judge, however, felt that the matter was of sufficient public importance so that it should be resolved earlier, and consequently the court's decree was entered by the consent of Mr. Holenstein on March 9, 1963.

With regard to the matter of attempting to assist Mr. Holenstein in raising capital in compliance with the law, it may be noted that the staff developed in conference wih Mr. Holenstein in 1961 a program for disclosure of the material facts which, had it been followed, might have made it possible for Mr. Holenstein to proceed without the necessity for legal action. It was only after Mr. Holenstein failed to follow this program and continued to sell securities under conditions which we believed, and which he does not seriously contest, amounted to a fraud on investors, that the staff determined that it was necessary to file the action.

LITIGATION RELEASE NO. 2549

SECURITIES AND EXCHANGE COMMISSION,
SEATTLE REGIONAL OFFICE,
Seattle Wash., March 9, 1963.

James E. Newton, administrator of the Seattle regional office, announced that the Honorable William D. Murray, judge of the U.S. District Court for the District of Montana, at Butte, entered a decree of permament injunction and order appointing conservator on March 9, 1963, enjoining Prudential Diversified Services, a Montana corporation; Paul L. Holenstein, Continental Underwriters, Inc., a Montana corporation; Prudential Diversified Services, a Texas corporation; and B. F. Froelich from further violations of the antifraud provisions of the Securities Act of 1933, and appointing a conservator for the protection of investors' and creditors' interests. The decree was entered upon consent of the defendants.

The defendants are enjoined from making misrepresentations and material omissions in connection with the offer and sale of their debentures concerning:

(1) The financial ability of Prudential Diversified Services, a Montana corporation, to make redemption of debenture bonds upon demand of investors, and the source of funds for such redemption.

(2) The practice of Prudential Diversified Services, a Montana corporation, in refusing the requests of some investors for withdrawal of their funds, in stalling off like requests of other investors, while at the same time permitting some investors to withdraw their funds.

(3) The financial ability of Prudential Diversified Services, a Montana corporation, and its affiliated companies to pay 6-percent interest on the debenture bonds of Prudential Diversified Services, a Montana corporation, as well as their other expenses, current liabilities, and interest obligations, from their earnings.

(4) Assets, libabilities, income, expenses, profits, losses, and deficits of Prudential Diversified Services, a Montana corporation, and its affiliated companies.

(5) The extent to which investors' funds have been and are being used for the payment of interest on outstanding debenture bonds, to pay off debenture holders seeking withdrawal of their funds, and to pay promotional expenses in connection with the sale of debenture bonds, such as advertising, salaries, commissions, gold bond stamps, dishes, silverware, and other related costs.

(6) Provisions for a sinking fund to provide for redemption of debenture bonds at maturity.

In order to protect the interests of the investors and creditors of the various corporations involved, the court appointed a conservator, Mr. E. R. Blinn, of the CPA firm of Newland & Blinn, Butte, Mont., to hold, manage, and conserve the assets of the corporations involved. The conservator was empowered to take immediate custody and control of all the funds and assets of the named corporations and any other corporations under their control in order to provide orderly administration of the assets and to prevent damage and injury to investors and creditors. The conservator, Mr. Blinn, is required to report to the court within 90 days and recommend what further action should be taken in this matter.

The investigation was conducted by John N. Fegan and Jack H. Bookey, attorneys, and Gordon E. Pedersen and Robert D. Kennedy, financial accountants, under the direction James E. Newton, administrator of the Commission's Seattle regional office.

LITIGATION RELEASE NO. 2524

SECURITIES AND EXCHANGE COMMISSION,
SEATTLE REGIONAL OFFICE,
Seattle, Wash., February 28, 1963.

The Securities and Exchange Commission today announced the filing of a complaint in the U.S. District Court for the District of Montana, in Butte, Mont., seeking to enjoin Prudential Diversified Services, a Montana corporation, and others, from further violations of the antifraud provisions of the Securities Act of 1933, and asking for the appointment of a receiver of Prudential Diversified Services for the protection of investors' interests.

The complaint alleges that the defendants are making untrue statements to investors concerning the availability of their funds for withdrawal, and omitting to state to investors that Prudential Diversified Services has been refusing demands of investors who requested withdrawal of their funds, and that Prudential Diversified Services lacks sufficient liquid assets to meet such withdrawal demands by investors, and that funds for that purpose are being obtained only by selling additional debenture bonds to other investors. The complaint also alleges that the company is omitting to state to investors that it is operating at a substantial loss and is not able to pay its current liabilities, expenses, and interest on its notes and debenture bonds except by raising funds from the public through the sale of debenture bonds. The complaint further charges defendants with not disclosing to investors the various uses of their funds, such as payment of interest on debenture bonds, to pay off withdrawal demands of other investors, as well as promotional costs in the sale of the bonds. The complaint further charges the defendants with failure to disclose that the operation of the New Placer Hotel in Helena, Mont., is a substantial loss.

The investigation leading to the injunctive action was conducted by John N. Fegan and Jack H. Bookey, attorneys, and Gordon E. Pedersen and Robert D. Kennedy, financial accountants, under the direction of James E. Newton, administrator of the Commission's Seattle regional office.

Mr. STAGGERS. Mr. Kellogg, would you come forward.

STATEMENT OF FRANCIS J. HUGHES, GENERAL COUNSEL, ASSOCIATION OF STOCK EXCHANGE FIRMS, NEW YORK, N.Y., ON BEHALF OF JAMES CRANE KELLOGG III, PRESIDENT

Mr. HUGHES. Mr. Chairman, with your kind permission, Mr. Kellogg is en route and will not make it before you adjourn today. He will be unable to wait over until tomorrow. With your permission, I would like to file our statement for the record.

Mr. STAGGERS. Would you state your name and your connection with Mr. Kellogg?

Mr. HUGHES. Yes, sir.

My name is Francis Hughes. I am general counsel for the Association of Stock Exchange Firms, New York City. Mr. Kellogg is the president of the Association of Stock Exchange Firms.

Mr. STAGGERS. What you would like to do is to insert this statement into the record?

Mr. HUGHES. If I may, yes, sir.

(The statement follows:)

STATEMENT BY JAMES CRANE KELLOGG III, PRESIDENT, ASSOCIATION OF STOCK EXCHANGE FIRMS

Mr. Chairman, and members of the Subcommittee on Commerce and Finance, my name is James Crane Kellogg. I am president of the Association of Stock Exchange Firms, 120 Broadway, New York, N.Y., and a general partner of Spear, Leeds & Kellogg, 111 Broadway, New York, N.Y., a member firm of the New York Stock Exchange. I am also a specialist on the floor of the exchange.

With me today is Mr. Francis J. Hughes of New York, general counsel of our association. We welcome this opportunity to appear before you to testify in behalf of H.R. 6789 and H.R. 6793, which are identical bills, and were introduced by Congressman Harris and Staggers, respectively; and S. 1642, the Senate-passed version of the SEC legislative recommendations introduced by Senator Williams.

The Association of Stock Exchange Firms is a voluntary, nonregulatory association, representing member organizations of th New York Stock Exchange, and was created 50 years ago to aid members in dealing with individual and industry problems. We have some 600 members ranging from indi-

viduals to the largest member firms in the United States. Our members have offices in every State of the Union with the exception of Alaska. The association is governed by a board of 38 leaders of the securities industry, at least half of whom represent areas outside of New York, in metropolitan financial centers across the country. Our members have approximately 70,000 employees and are responsible for the vast majority of securities transactions, not only on the New York Stock Exchange but also in the over-the-counter markets, the regional exchanges, the markets for foreign securities—in fact, the customers of our members truly represent the investing public of America.

Inasmuch as the association is a voluntary organization, we perform no regulatory functions. However, since some of our governors are active in connection with the regulatory duties of the exchanges and the National Association of Securities Dealers, which bears the responsibility for regulating the over-the-counter markets, our interest and involvement in the regulatory aspects of the securities industry is continuing and important. Whenever matters important to the securities industry are discussed, whether they involve changes in the securities acts, new implementing Commission rules, or important matters of self-regulation, the association is usually called upon to participate.

As our members' business operations cut across all segments of the securities industry, we really speak for a broad cross section of the industry. To elaborate on this statement, I would like to point out that eight members of our present board of governors have served or are serving on the board of the New York Stock Exchange; we also have four members with services as governors of the National Association of Securities Dealers, Inc.; two with service as governors of the American Stock Exchange; and seven with service as governors of the Investment Bankers Association of America. In large measure, the organizations just mentioned comprise the prime regulatory and policy-making organizations in the securities industry.

Inasmuch as our association is a voluntary one that neither speaks for the self-regulatory bodies nor implements their decisions, my statement today deals broadly with the principles involved in the proposed legislation rather than with the technical aspects of these amendments to the various securities acts. This same point was made during the hearings on S. 1642 before the Subcommittee on Securities of the Committee on Banking and Currency of the U.S. Senate this past June.

With respect to the legislation being considered by this subcommittee, I would like to provide the subcommittee members with some idea of the association's vital interest in the special study report and our continuing participation in the legislative and rulemaking program which grew out of this report. Governors and staff members of the association were represented at all the SEC-industry deliberations which followed the issuance of the report and participated in the decisions which eventually led to the introduction of this SEC omnibus legislative package.

All during the discussions of the special study report and the followup legislative recommendations, we were in constant touch with our board of governors and our members, keeping them advised of developments as they occurred. During the current year we have had three board meetings, in Houston, Tex., Richmond, Va., and recently in Salt Lake City, Utah. At the first two meetings we were fortunate to have Chairman Cary and Commissioner Whitney of the SEC join in open discussions of the special study report and the ensuing legislative proposals. Our regional governors were urged before and after each board meeting to hold discussion meetings in their areas with regional members, with the result that the feelings of our members across the country were brought to the ASEF board's attention.

As a result of all this, I am confident that I am reporting the true opinion of our board and membership.

The association membership strongly favors the legislative proposals before this subcommittee. The Securities Acts of 1933 and 1934 were written almost 30 years ago. Changing conditions in this interval thoroughly warrant corrective legislative procedures at this time. Unfortunately, certain abuses have a way of working into our business and these must be corrected. Our first thought is, and must be, to protect the investing public. We believe, after thorough study, that the legislation as presented to you by the Securities and Exchange Commission is in the public interest. Our meetings with the Commission leads us to expect that they will use the same enlightened judgment in preparing implementing rules and regulations which are not subject to legislative action.

After a review of the SEC Special Study Report, our board adopted the following broad premises with respect to the many recommendations contained therein; therefore, we believe in:

(1) Self-regulation by the enforcement agencies of the industry—with Government oversight;

(2) A liquid securities market to facilitate the free flow of capital;

(3) The elimination of double standards for the various segments of the securities industry.

Certain of the proposals contained in this legislation now before your subcommittee have been espoused by industry leaders for many years. We feel that the proposed reforms are long overdue. Senator Williams, in his remarks to the Senate on June 4 in connection with the introduction of this legislation in the Senate, indicated that the proposals to extend reporting requirements, proxy rules, and insider-trading provisions to those securities traded in the over-the-counter market, had been submitted on numerous occasions over the past 15 years.

Full disclosure by all companies above a certain size is a concept which has been sought by leaders in our industry since the middle 1920's. We can see no reason why domestic corporations which have actively traded securities should be exempted from full disclosure simply because such securities are not listed on a national exchange. We do not believe in double standards. There has, however, been some doubt expressed as to whether the legislation should apply to all companies down to the size presently contemplated. The question is simply whether, in the case of small companies, the anticipated benefits would be commensurate with the cost to the SEC of administering the law. Though the association would suggest a higher minimum as to stockholders—that is, companies with 1,000 or more shareowners, as being a more practical approach, we cannot seriously quarrel with the standards set forth in these bills. I might add that because we do believe in full disclosure, we see no reason why all corporations having less than 1,000 stockholders and down to those with 300, which is the figure recommended in the special report, should not be required by law to make interim reports to their stockholders, and also to send an audited statement at least once a year. As this would not seem to require the filing of registration statements and formal policing by the SEC, it would reduce the cost of government and yet be a valuable gain toward the goal of full disclosure to the public.

We fully approve the proposals in this legislation which are designed to raise standards of entry into the securities business. The New York Stock Exchange has long been a leader in upgrading the qualifications of salesmen in our industry and has continually strengthened the examinations which prospective salesmen are required to take before being permitted to act as registered representatives. At the present time, the exchange requires that candidates for full registration who do not have prior equivalent experience fulfill a 6-months' training program with their employer. We feel that a program for raising the standards and qualifications is an integral part of self-regulation and should be continuously implemented by all segments of the industry.

For many years our members have urged that minimum capital requirements for entry into the securities business are a necessary safeguard for the protection of the public. It was only in 1963, after many years of industry effort, that minimum capital requirements were made part of the New York State law. If such power had been given to the National Association of Securities Dealers at the time it was formed, I feel sure some of the regrettable incidents of the past would not have occurred.

We in the Association of Stock Exchange Firms wholeheartedly recommend the passage of this legislation and respectfully urge the subcommittee to lend its weight toward the enactment of the SEC legislative program at an early date.

I would like to make further reference to S. 1642, which was introduced at the same time as Chairman Harris' bill, and which has since passed the Senate with amendments. These amendments, many of which are of a technical, clarifying, or conforming nature, have the support of the association. The same is true of the amendment which, in effect, vests the powers, functions, and duties of the SEC to administer and enforce certain sections of the Securities Exchange Act directly in the three Federal bank supervisory agencies with respect to banks under their supervision.

I thank the members of this subcommittee for permitting me to appear in support of this legislation. If there are any questions you would like to ask, we will do our best to answer them or supply answers for the record.

Mr. STAGGERS. And you did not want to give an oral statement?

Mr. HUGHES. Not at this point, no, sir.

Mr. STAGGERS. The statement of Mr. Kellogg will be incorporated into the record. We are sorry that Mr. Kellogg could not be with us. It may be possible at a later date, if he desires to give anything additional, for him to appear. I know we are trying to conclude the hearings and hear everybody we can.

Mr. HUGHES. If there are any questions that we can answer for the record, or any information that you would like to have for the Committee, we would be very happy to do so.

Mr. STAGGERS. For the record, would you state whether Mr. Kellogg is for this bill or against it? I just want your statement so far as you know as counsel.

Mr. HUGHES. Mr. Chairman, Mr. Kellogg and the board of governors of the association are completely in favor of the legislation pending before this committee.

Mr. STAGGERS. He has no suggestions for additional areas or anything to delete?

Mr. HUGHES. The only area where we thought there might be some change would be in the area of full disclosure with respect to over-the-counter corporations. We figure that perhaps the share owner floor suggested (750) might be too low. We believe that a floor of 1,000 share owners would be a better one, more practical, because many corporations are closely held, and you are not accomplishing very much by requiring disclosure to the people who own such a corporation. This might also permit the SEC to have fuller disclosure from widely held corporations without going to a great deal of expense. Any new job the SEC undertakes is going to cost money, and, of course, we are hopeful that they are going to get the most results for the least money, where possible.

Mr. STAGGERS. Thank you very kindly.

Are there any questions, Mr. Curtin?

Mr. CURTIN. No questions.

Mr. STAGGERS. Mr. Chairman?

Mr. HARRIS. No questions.

Mr. STAGGERS. Thank you for giving us the views of Mr. Kellogg, Mr. Hughes.

Mr. HUGHES. Thank you, Mr. Chairman.

Mr. STAGGERS. Is Mr. Long present?

Is Mr. William E. Long present?

Is there a representative of the Louisiana Insurers Association present?

If not, our time has come for going to the House floor. We have a very important piece of legislation there. The committee will stand in recess until tomorrow morning at 10 o'clock.

(Whereupon, at 11:10 a.m., the hearing was recessed, to reconvene at 10 a.m. December 5, 1963.)

INVESTOR PROTECTION

THURSDAY, DECEMBER 5, 1963

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE
OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to recess, in room 1334, Longworth Building, Hon. Oren Harris (chairman of the full committee) presiding.

Mr. HARRIS. The committee will come to order.

The first witness this morning as we continue the hearings on the proposed amendments to the Securities and Exchange Commission Act will be Mr. Carl L. Shipley, National Press Building, here in Washington, D.C.

Mr. Shipley, we are glad to have your testimony.

STATEMENT OF CARL L. SHIPLEY, SENIOR PARTNER, SHIPLEY, AKERMAN & PICKETT, WASHINGTON, D.C.

Mr. SHIPLEY. Mr. Chairman, I have a statement consisting of a number of pages which I would ask be included in the record following my remarks. I will very briefly touch on three or four considerations which I think are of importance in connection with the pending legislation.

My name is Carl Shipley. I am the senior partner in the law firm of Shipley, Akerman & Pickett.

Our interest in this legislation is threefold: First, our firm represents a number of persons and businesses in the securities industry, not only broker-dealers, investment advisers, and mutual funds, but investors themselves.

Second, we are concerned as lawyers with some features of the proposed legislation which we think bear importantly on the basic legislative and administrative policies of our National Government.

Third, just as citizens, taxpayers, and investors ourselves, we have a continuing concern with legislation of this kind because we feel with members of this committee and most other Americans that investor confidence is extremely important to an expanding, full-employment economy based on the private sector of our economy rather than on Government spending.

Although we represent a number of people in the securities business, this statement is our statement and does not necessarily reflect the views of any of our clients or business associates. Members of this committee know some of the people with whom we are con-

cerned and I suppose they would oppose some of our views, share some of our views, and not be too concerned about some of our views.

With respect to the proposed legislation, and I am speaking broadly of the Senate bill S. 1642, plus the two House bills under consideration, we think that the two basic purposes will contribute a great deal to an expanding economy, to investor protection and to expansion of investment over the long pull. Certainly the extension of the reporting, proxy and insider trading requirements imposed on companies whose securities are traded on stock exchanges to over-the-counter companies is extremely important and should become a part of the law.

The other broad purpose, as we understand it, is to increase the training, experience, and financial responsibility of persons entering or in the securities business, and is similarly important to the broad development of our free enterprise system.

However, Mr. Chairman, we do believe that some features are extremely bad. We believe that some provisions of the bills would further erode the concept of dual State-Federal sovereignty which is important to our Federal system. We believe that some features of the bill unnecessarily interfere with States rights. We believe the bill will upset the checks and balances of federalism by reducing State responsibility and State authority in the securities field and by extending Federal authority through SEC controls and regulations to a degree that is not justified.

Further, some aspects of the legislation would give to the SEC as a Federal agency something in the nature of quasi-police powers over individuals. This again is a further extension of Federal police power which, unless unavoidable, isn't necessarily in the national interest.

We believe, Mr. Chairman, that the proposed legislation also will further erode the independence of Congress as an equal and coordinate branch of the Federal Government.

Under the legislation, the SEC will be given power which is almost akin to legislating and will be given the power to delegate to semiprivate trade or business associations a similar power to legislate or semilegislate. We think this is probably unconstitutional and we think it raises questions of due process of law.

Now, just very briefly, let me give you some of the examples which I am hopeful the committee staff can consider as they look through the testimony and consider these important problems.

The first example which I think is extremely serious is the proposal to amend section 15(a) of the Exchange Act of 1934 to eliminate the intrastate exemption. As this committee knows, five of the six bills administered by the SEC now have a specific provision reserving to the States full power not only over intrastate securities business but interstate business as well, a clear congressional policy of dual responsibility in this area. Yet, the SEC proposes to amend section 15(a) by eliminating that phrase which exempts from SEC regulation those persons whose business is "exclusively intrastate."

This committee knows that State regulatory agencies in all States but one have agencies of one kind or another, and have dealt with securities problems going way back to 1903.

If the intrastate exemption is eliminated, however justifiable the reasons may be, it certainly disturbs the whole notion of dual sovereignty and dual responsibility as it affects the State and Federal Government.

A second proposed amendment to section 15(a) is compulsory membership in the NASD or a similar securities association. We think this again gets into problems of constitutionality, and changes the whole character of the self-regulatory scheme. Indeed, when you get into compulsory membership and put one person at the mercy or at least under the direct control of his competitors, the whole idea of self-regulation is eliminated.

I think most of us are familiar with the fact that when the self-regulatory features of the Exchange Act of 1934 were under discussion back in 1938, the then Chairman of the SEC and now Justice Douglas of the Supreme Court made a very strong point of the fact that this was to be a voluntary and not a compulsory program, that the whole idea was voluntary obedience to the law. In our statement we have gone into this aspect of the matter more extensively.

I think a third area which raises questions of due process and basic legislative policy is the proposal to amend section 15(a) to eliminate necessity of proof of use of the mails or interstate commerce in connection with certain alleged wrongdoing on the part of persons in the securities business This is an almost fantastic proposal. When the Investment Advisers Act was amended in 1961, this idea was imported into that act and it wasn't questioned too much. But when a person reflects upon it as a lawyer, and what it means in terms of Federal police power, to eliminate proof of interstate commerce or use of the mails as a jurisdictional prerequisite to imposing penalties, forfeitures, and punishment in the nature of keeping people out of business or even worse, the seriousness of it can be understood.

We think another area, Mr. Chairman, which should be considered carefully is the proposal to extend SEC jurisdiction to certain nonsecurities offenses. It is proposed to change section 15(a) of the Exchange Act to give the Commission greater power to deny or revoke or suspend the registration of a broker-dealer who has been convicted of a felony or a misdemeanor than is in the existing law. The SEC wants to include a misdemeanor which the Commission finds—not a judicial court, not a jury, but which the Commission finds—involves embezzlement, fraudulent conversion, or misappropriation. These terms, "embezzlement, fraudulent conversion, or misappropriation," are terms of art. They are legal terms used in the criminal law. There isn't anybody in the SEC who now, in the past, or in the future, is a particular expert in the field of criminal law. There is no reason why the Commission should be empowered by Congress to determine whether or not a misdemeanor of which someone in the securities business might have been convicted, whatever that misdemeanor might be, amounts to embezzlement or fraudulent conversion or misappropriation It seems to me this would extend to the SEC the power to act as a kind of prosecutor, judge and jury to determine complicated questions of criminal law involving these nonsecurities crimes. Indeed, the SEC could find "embezzlement" when a judge and jury had not so found.

I think we all agree the SEC is expert in the field of securities, but no one would suggest they are experts in the field of criminal law or ought to be empowered to make criminal law determinations of this kind.

Another point, Mr. Chairman, in connection with this problem of SEC determination of whether or not a misdemeanor involves a nonsecurities financial crime such as embezzlement. It seems to me it is something like a bill-of-attainder, giving an administrative agency the power to legislate or semilegislate and make rules or come to quasi-legislative determinations in criminal matters. It looks like punishment of a crime by a legislative or administrative act rather than through the normal judicial procedures.

Section 15(a) is also proposed to be amended to create some kind of new area of police power, if I may call it that, or regulatory power by the SEC. That is, a new wrong called failure to supervise. Instead of some positive wrongdoing, here we have a failure to do something, can be punished without any guidelines as to what constitutes failure to supervise. I suppose this means it will vary from Commission to Commission and Commissioner to Commissioner and staff member to staff member as to what amounts to failure to supervise.

It is extremely vague, indeed so vague as to suggest it might be unenforceable in any reasonable or practical way.

I think it is something that is unknown to the law as the basis for a penalty. Laws involving penalties should be specific and exact, not vague and general.

In connection with this proposed new wrong of failure to supervise, the SEC proposes to change the present law, which provides for a normal administrative hearing, by depriving people of due process of law who might be charged with failure to supervise, by modifying the hearing requirements to limit the hearing solely to affidavits and oral arguments.

Now this, again, is something that is not known under the Administrative Procedure Act of 1946. This kind of hearing is unknown to our system of law. I would suggest it is a serious interference with due process of law, that a hearing is a hearing, and a hearing limited solely to affidavits and oral argument is not a hearing within the accepted concept.

Mr. Chairman, in the Senate they did deal with the problem of the new term the SEC proposes to substitute for "controlled persons." That is this new term "persons associated with," which certainly is an extension of power.

In the original bill proposed by the SEC, people could have suffered a penalty or a forfeiture on the basis of wrongs by persons with whom they were associated without any knowledge or fault on their part. The Senate bill was amended to require something equivalent to knowledge and fault in this connection, which I think should certainly be incorporated in either of the House bills.

Finally, with respect to compulsory membership in a self-regulatory group, Mr. Chairman, it must be borne in mind that it is entirely proper and indeed important that all broker-dealers be registered with the SEC as is now the law. Under the present law the SEC has the broadest possible power to regulate these people, and has had such power since 1934. In the proposed amendment to section 15, it

is provided that one of these semiprivate regulatory associations, of which there is only one now in existence, the NASD, rather than the SEC itself, will be authorized to establish, and I am quoting—

> appropriate standards with respect to the training, experience, and such other qualifications of such person as the association finds necessary or desirable and in the case of a member the financial responsibility of such member.

Not the SEC, but this semiprivate NASD, will define these requirements.

This seems to me to be the type of unfettered discretion which the Supreme Court condemned in cases in the past dealing with the possible delegation of legislative authority to private groups. Those cases are reviewed and quoted in the statement which I am filing with the committee. This kind of broad delegation of power raises all kinds of problems. Even if it were proposed to give this broad power to the SEC itself, rather than a private self-regulatory group, Congress should establish guidelines. To give such power to the NASD is worse. For example, the District of Columbia is one of the two jurisdictions in which there is no "blue sky" law. We now have a bill pending before the House District Committee, H.R. 4200, which follows the pattern of the uniform State laws in this area and would impose certain financial requirements. No sooner was the bill introduced, than we got into a discussion here in the District of Columbia as to what these financial responsibility requirements should be. Some of the large broker-dealers wanted a $50,000 minimum. We were immediately assaulted with small business people who said, "We couldn't possibly do this, we would be put out of business if you asked for $50,000." The uniform State law proposes $25,000. The bill now pending in the House District Committee provides for $25,000. I have heard some people around the SEC discuss a minimum financial responsibility of $5,000.

Here is an area that should not be left to the SEC. The philosophy of the SEC changes along the lines Chairman Staggers referred to here in the early part of these hearings, when he asked why some of the proposals in the legislation under consideration in 1959 were not in this 1963 bill. The answer by one of the SEC Commissioners was that "Well, we have a different Commission now."

What does this mean in terms of financial responsibility and creating a "closed shop" and shutting out small business people who might otherwise be qualified? There ought to be some guidelines in the field of financial responsibility. The same is true as to other qualifications. Is it going to be 1 year training and experience, a Ph. D., or a college major in economics or securities study? Certainly something is required, but Congress has a responsibility to establish guidelines and define some maximums and minimums. In the criminal law, Congress sets minimum and maximum sentences and fines and does not give the courts unfettered discretion. People have a constitutional right to get into the business of their choice subject to the right of the Government to impose reasonable qualifications. But this blanket authority to a private group to legislate on matters so important as to who gets into the business, who stays in the business, and how much money they have to have, seems to put the power to legislate business life or death in the hands of a group which is not presumptively so concerned with the public interest as the SEC itself is.

This is an area about which we have great concern, along with the proposed compulsory membership requirement, which seems to be wholly out of step with anything known to our law. It runs counter to the idea of public responsibility for Congress to authorize private administrative agencies to fill in the law and carry out the law. It closely approaches the kind of corporate state that was developed by Mussolini in Italy. It is a departure from the basic pattern of the American scheme. Voluntary NASD membership is one thing, but compulsory membership is quite another.

Mr. Chairman, I will close my remarks and request that the more extensive treatment of these areas we have provided in the statement filed with the committee be considered by the staff along with all the other material which will be considered.

We appreciate the opportunity to be with you.

Mr. HARRIS. Mr. Shipley, your statement referred to will be included in the record.

(The statement referred to follows:)

STATEMENT OF CARL SHIPLEY ON SEC LEGISLATION, 1963

An expanding economy depends upon continuing and increasing investment. This in turn contemplates investor confidence in our securities industry, and a knowledge that the Federal securities laws are reasonable.

Federal regulation in the field of securities is not an end in itself. Each new regulation adds to the cost of the securities the public buys, and to this extent impedes the free flow of capital into new investment and of new investors into the market. There must be a real showing of need by the proponents of the SEC's proposed legislation before Congress can justifiably extend the SEC's regulatory power to new areas.

In its letter of transmittal dated April 3, 1963, transmitting the first segment of its report of the Special Study of Securities Markets to the Speaker of the House, the SEC said:

"* * * The report demonstrated that neither the fundamental structure of the securities markets nor of the regulatory pattern of the securities acts require dramatic reconstruction."

But in the pending legislative proposals the SEC asks compulsory self-regulation for broker-dealers, elimination of the "intrastate" exemption, abolition of proof of interstate commerce or use of the mails in alleged securities violations, and the imposition of penalties on persons without knowledge or fault—an extension of power so broad as to alter the fundamental and historical structure of the industry.

Indeed, the SEC at that time cautioned that "the report should not impair public confidence in the securities markets," and called attention to the fact that the "study confirms the strength" of the Federal securities laws. If Congress accepts these SEC conclusions, it is difficult to justify the far-reaching powers the SEC now asks Congress to authorize for it.

The SEC's proposed legislation for 1963 will extend to over-the-counter securities the same SEC regulatory controls as are now exercised by the SEC over securities listed on a stock exchange under the Securities Exchange Act of 1934. Over-the-counter companies will be required to file a registration statement containing full financial and business operations information, which must be kept current with periodic and annual reports, and furnish shareholders a proxy statement in vote solicitations. Corporate "insiders" will be required to report securities transactions, pay to the corporation short-swing profits, and will be forbidden to sell short. Certain companies will be exemp because of lack of size in terms of assets and investors. Another purpose of the SEC legislative proposal is to impose more stringent qualification standards and controls over persons and firms in the over-the-counter securities business. No reasonable person will quarrel with these goals, but the SEC's proposed remedies raise grave questions of legislative policy and administrative procedure.

The securities industry is already heavily regulated by the SEC and nearly all States. Only Delaware and the District of Columbia have no State "blue-

sky" laws at present. A complete new securities law was adopted in Nevada this year, effective July 1, 1963, and a new act for the District of Columbia (H.R. 4200) is pending in Congress. Delaware had a "blue-sky" law from 1941 until 1953, when it disappeared from the code. Most States prescribe qualifications for broker-dealers and salesmen, many of which are more restrictive than those contained in the exchange act of 1934. Apparently the SEC has concluded that the State governments are incapable of properly controlling the securities business, or that State governments do not reflect the will of the people.

How do these State laws fit into the SEC scheme? Are they ignored? Do they duplicate? Do the States contemplate more laws? The Midwest Securities Commissioners Association recently passed a resolution condemning the SEC's effort to abolish the present "intrastate" exemption for broker-dealers and the SEC plan to compel all broker-dealers to join NASD or other registered private self-regulatory trade groups. A copy of their resolution is attached hereto.

The typical State securities law is paternalistic, as distinguished from the disclosure philosophy of the Federal laws, and establishes qualitative standards. The first "blue-sky" laws were two decades old when the securities act of 1933 went on the books. For example, Connecticut has had a law since 1903, and 17 States have had laws since 1917. Obviously, securities regulation has been the subject of considerable State experience. State governments have regulated the industry for 60 years. In five of the six statutes administered by the SEC, Congress inserted a provision specifically reserving to the respective States their power to regulate interstate securities activities. If the colossus of the Federal Government is going to occupy the whole field, maybe Congress should eliminate the dual burden of State and Federal regulation.

Most brokers and dealers now must register with one or more regulatory agencies, including the SEC, the NASD, the registered national securities exchanges, or a State agency. Very few broker-dealers are unregulated by reason of doing business solely in exempted securities or exclusively in non-blue-sky jurisdictions. The States, with their Governments much closer to the people, have not enacted any securities laws like the SEC bill. Either the SEC exaggerates the need for additional legislation, or the States have failed. If the SEC knows best, then perhaps the States should be removed from the securities regulation picture altogether. Interlocking, overlapping, and conflicting State and Federal regulatory schemes are a drag on the industry. The SEC has said that because of a present lack of coordination, "members are saddled with added costs and burdens." (SEC Rel: 63–8–6.)

The SEC bill proposes to abandon a fundamental concept concerning standards of qualifications for entry into the securities business as a broker and dealer. Chairman Cary has said:

"The exchange act presently embodies the concept that entry into the securities business or the assumption of any role in that business should be right of anyone—except those guilty of recent securities violations * * *. This concept is obsolete and no longer in the public interest." (Senate hearings SEC legislation 1936, June 18, 1962.)

Excessively stringent entrance requirements can lead to a closed shop and a restraint of trade. Can such a responsibility properly be left to a compulsory self-regulatory group, as proposed in section 6(a) of the SEC bill?

The SEC has at present almost total control over broker-dealers and their employees under section 15 of the exchange act of 1934. Every broker-dealer in interstate commerce or who uses the mails must register with the SEC. The SEC must under section 15 require in the registration application:

"* * * such information in such detail as to such broker or dealer and any person directly controlling or controlled by, or under direct or indirect common control with, such broker or dealer, as the Commission may by rules and regulations require as necessary or appropriate in the public interest or for the protection of investors."

When it gets this information from an applicant for registration, the SEC is presently directed by section 15 of the 1934 act to "deny or revoke the registration if anyone connected with the broker-dealer:"

(1) Has made a false or misleading statement in the registration application;

(2) Has been convicted of a securities misdemeanor or crime within 10 years;

(3) Has been enjoined by any court from engaging in any securities activities, whether or not at the instance of the SEC; or

(4) Has violated the securities laws.

In addition, section 15 prohibits broker-dealers from using any manipulative, deceptive, or other fraudulent device or contrivance in connection with securities transactions; and prohibits them from engaging in securities transactions "in contravention of such rules and regulations as the Commission may prescribe." In short, Congress has already given the SEC almost unlimited power over every phase of the broker-dealer's business. If this authority has been used to the extent Congress intended, why is more power necessary?

Nonetheless, section 6(a) of the pending SEC bill would expand the basis for disqualification of brokers and dealers by including nonsecurities offenses, and would make failure to supervise employees a new offense. Section 6(a) would also expand the SEC's police power and permit direct action against individuals instead of their employers, and permit new SEC sanctions in addition to revocation of SEC registration, such as censure and temporary suspension.

Congress has a responsibility to examine carefully into the facts before it grants extensions of regulatory and police authority to any Federal executive agency, including the SEC. The SEC's 28th Annual Report indicates it recommended prosecution of only 191 persons in 1962, which is not many more than the 174 recommendations in 1940. Only 27 indictments were obtained in 1962, while 51 were obtained in 1940. Similarly, the SEC sought injunctions in only 47 cases in 1962, as against 40 cases in 1949. At the close of 1962 the SEC had 5,724 effective broker-dealer registrations. During the year it had suspended only 5, revoked only 47, and denied 2. These figures are almost de minimus, despite the fact that the securities industry has expanded enormously in the past 20 years (e.g., the value of assets of shares on the New York Stock Exchange alone has multiplied 6½ times). This raises questions as to whether additional authority is really required by SEC, whether it is making adequate use of authority it now has, and whether the pending SEC legislation is the right answer to any problem that might exist. Further, Congress should know the attitude of the State regulatory bodies who share responsibility for securities regulation. Have they been consulted? A number of States, such as those in the Midwest Securities Commissioners Association oppose major portions of the SEC bill, as per the attached Wall Street Journal story.

Certainly section 6(a) of the SEC legislative proposal should be deleted from the bill, as recommended by the Midwest Securities Commissioners Association. In section 6(a) the SEC proposes to make membership in NASD or some other registered self-regulatory industry group of broker-dealers mandatory for about 90 percent of SEC registered broker-dealers. Section 15A of the Exchange Act of 1934, known as the Mahoney Act, provides at present for registration with the SEC of national securities associations and establishes standards for such associations. The rules of such asociation must be designed to promote just and equitable principles of trade, and to prevent fraudulent and manipulative acts.

Such associations are intended to be essentially disciplinary in purpose and serve as a medium of self-regulation of over-the-counter brokers and dealers. Only one association, the National Association of Securities Dealers, Inc. (NASD) is registered under the act. According to the SEC's 28th Annual Report, it has 4,925 members and 102,405 individuals registered as representatives. Self-regulatory groups were criticized in the Special Study as follows:

"* * * self-regulation inherently has certain disadvantages and limitations as compared with governmental regulation, the most obvious of which was early identified as the weakness of human nature." (H. Doc. 95, pt. 4, p. 722.)

Membership in the NASD is not now a legal requirement for over-the-counter brokers and dealers. The congressional policy which gave rise to the NASD under section 15 of the act was "voluntary obedience." (H. Doc. 95, pt. 4, p. 606.) About 85 percent of all brokers and dealers are members, but membership is voluntary and submission to the rules and regulations of the NASD is voluntary. A member can withdraw if his important interests are being unreasonably compromised by the association or a majority of its members, but he will continue in business under his SEC registration and SEC supervision. Voluntary self-regulation under the supervision of the SEC is a quite different proposition from compulsory membership in a private group of competitors. The wrongness of compulsory membership in a self-regulatory group was emphasized by Supreme Court Justice (then SEC Chairman) Douglas in 1938:

"By self-regulation I do *not* mean private lawmaking. By self-regulation I do *not* imply a private club whereby a few can control the many. By self-regulation I do *not* mean a guild system above the law. * * * I mean groups

* * * *voluntarily* organized * * *." (H. Doc. 95, pt. 4, p. 699.) [Emphasis supplied.]

All of the evils Justice Douglas foresaw automatically come into play, once membership in a private group is made compulsory—private law, private club, control of the many by the few, a guild system. If a member has strong economic incentives and benefits to belong, but can voluntarily join or not join, there is a check and a balance. NASD rules preclude a member from dealing with a nonmember, except as a member of the public, which is an economic inducement to membership as an essential to obtaining underwriting discounts in distributions and other benefits. This does not change the voluntary character of membership or submission to NASD rules. As a voluntary trade group, the NASD has been a useful adjunct to the SEC. But if its fundamental character is changed from voluntary to compulsory, there is a serious question of congressional policy involved. The NASD has been criticized in the Special Study as having "fallen short of its potential as a self-regulatory agency." (H. Doc. 95, pt. 4, p. 679.) This in itself would seem to argue against compulsory membership.

The dissident minority, compelled to join against its will, can become the prisoner of its competitors. No one should be compelled to be a member of a "private club" as a condition of doing business, especially if his competitors are empowered to deny him membership and thus exclude him from the securities business.

Section 6(a) of the SEC bill, which proposes to require membership in a registered national securities association on a compulsory basis, argues against itself by leaving out 800 of the brokers and dealers in the United States. Why some but not all? Further, there is every indication that this proposal may be unconstitutional. There is involved a basic question of whether Congress has any power to require compulsory membership in a self-regulatory industry organization. It amounts in practice to a delegation of licensing authority to a non-Government agency, or private group, which in turn is given broad power to establish standards of training, experience and competence for members and their employees, and to establish capital requirements for members. This is the power to legislate. This is the unfettered power of business life and death. The U.S. Supreme Court has outlawed such arrangements, and rightly so.

In *Carter* v. *Carter Coal Co.*, 298 U.S. 328, 311 (1936), the question was whether Congress could delegate to a self-regulatory group made up of two-thirds of the coal producers and one-half of the miners the power to fix wages and hours. In holding such delegation unconstitutional, the Supreme Court said:

"This is legislative delegation in its most obnoxious form, for it is not even delegation to an official or an official body, presumptively disinterested, but to private persons whose interests may be and often *are adverse to the interests of others in the same business.*" [Emphasis supplied.]

In *Schechter* v. *U.S.*, 295 495, 537 (1935), the Supreme Court also held that private trade groups could not be empowered to issue binding rules concerning methods of competition. In holding the law involved to be an unconstitutional delegation of legislative power, the Supreme Court said:

"The Government urges that the codes will consist of rules of competition deemed fair for each industry by representative members of that industry * * * by the persons most vitally concerned and most familiar with its problems * * *. But would it be seriously contended that Congress could delegate its legislative authority to trade or industrial associations or groups so as to empower them to enact the laws they deem to be wise and beneficient for the rehabilitation and expansion of their trade or industry? * * * The answer is obvious. Such a delegation of legislative power is unknown to our law and is utterly inconsistent with the constiutional prerogatives and duties of Congress."

If section 6(a)(B) is not stricken from the bill, Congress will have disregarded these two decisions of the U.S. Supreme Court. It will establish a dangerous precedent which will come back to haunt the Congress over and over again. This SEC legislation moved so quickly in the Senate there was little time for thoughtful consideration of its impact.

The basis for the far-reaching compulsory membership proposal in section 6(a)(B) of the SEC legislation seems to be an idea, unsupported by any substantial evidence, that 90 percent of all over-the-counter brokers and dealers should be members of NASD or some similar group, whether or not they find it economically desirable. Why? According to the SEC there are a total of 5,785 registered broker-dealers, of which 4,750 are members of NASD. Most of the remaining 1,035 broker-dealers consist largely of firms which, although

registered with SEC, would continue to be exempt from membership under the compulsory provisions. In the SEC's words:

"A limited number * * * restrict their operations to retailing direct to the public securities of companies with which they have some association—for example, as the sole underwriter. It is important that this group, which includes retailers of mutual fund shares and real estate securities, be brought within the self-regulatory scheme."

The SEC has not indicated why it is important to bring some but not all of these brokers and dealers already registered with the SEC into NASD or a similar association. Actually, the nature of their business is quite different from that of the broker-dealer who buys and sells securities for other people's accounts on a commission basis. The SEC has stated that only 200 of its 1,035 registered broker-dealers who are non-NASD members will be compelled to join self-regulatory groups under its proposed new law. The 200 non-NASD members include only 12 mutual fund distributors, and 37 mutual fund sales organizations, as one of the categories mentioned by SEC. These mutual fund companies should be exempt and not compelled to join, since they are like the 835 other broker-dealers the SEC proposes to leave out. A direct seller of mutual fund participations, for example, has entirely different problems from a broker and dealer who is engaged in the business of selling over-the-counter securities in unlisted industrial companies on a commission basis. He is no more a broker-dealer in the usual sense than the other 835 specialized broker-dealers the SEC will exempt. It is well within the existing power of the SEC to deal with this mutual fund group as well as the balance of the estimated 200 non-NASD member brokers and dealers under existing and proposed SEC authority, without compulsory membership in an industry association.

Voluntary self-regulation is an excellent vehicle for cooperation between Government and private enterprise. As stated in the SEC special study:

"Self-regulation as a part of the total regulatory pattern of the securities industry involves certain advantages that have been recognized since the concept was first introduced. The expertness and immediacy of self-regulation often provide the most expedient and practical means of regulation." (H. Doc. 95, pt. 4, p. 722.)

But compulsory membership in a self-regulatory group undermines and negates the whole concept. A compulsory group simply becomes the SEC itself, camouflaged in another bird's plumage.

In addition to membership in a self-regulatory agency, the SEC bill proposes in section 7(a)(3) that responsibility be given to the NASD or similar associations for the establishment of standards, including those relating to training and experience for its members and their employees, and capital requirements for members. The SEC bill is totally without guidelines; unfettered discretion is what the SEC asks.

Equally as important, section 7(a)(1) of the SEC bill would authorize the NASD or similar associations to adopt rules which would permit exclusion from membership of persons who have been suspended or expelled from an exchange for violation of any of the exchange's rules. Would this be fair? The concept of permitting one agency to punish someone on the basis of another agency's findings and conclusions is foreign to our judicial and administrative philosophy.

If compulsory membership in a private industry group becomes law, Congress will have transferred to such groups the power to legislate with respect to entrance into the securities business, exclusion from the securities business, and other vital matters, which should be the subject of rulemaking only by a public agency and not a private agency.

The basic weakness in compulsory membership is that it puts in the hands of a private group the power to establish a "closed shop." It puts in the hands of a private group the power to impose rules adverse to the interests of a minority who might be their competitors. It puts in the hands of a trade association the power to exclude others from engaging in the securities business, a property right protected by the Constitution (*Transamerican* v. *U.S.*, 51 F. Supp. 405, and cases cited). It puts quasi-legislative and quasi-judicial power in the hands of a private group motivated by self-interest and not the public interest.

With the increased authority of the SEC under section 6(a) of the bill, authorizing the Commission to act directly against individuals where that course is appropriate; and the authorization for the SEC to impose intermediate sanctions such as censure or temporary suspension rather than putting a broker-

dealer firm out of business; and to dispense with proof of the use of the mails or interstate commerce facilities in the case of alleged securities violations; there is no rational basis for turning to compulsory membership to reach a handful of non-NASD members. This is particularly true when it is considered that the SEC has already announced that it will either grant exemptions to or not include 835 of the 1,035 non-NASD member broker-dealers now registered with the SEC.

If section 6(a)(B), requiring compulsory membership of broker-dealers in private industry groups, cannot be eliminated from the bill, certainly any company which serves as administrator, investment adviser, and/or distributor for a mutual fund, in addition to acting as principal broker, should be exempt from the proposed bill. Mutual fund sponsors and management companies performing these functions are closely regulated by the SEC under the Investment Company Act of 1940. There is absolutely no justification for compounding the redtape and administrative difficulties incident to more Federal regulation. They are subject to a special statutory scheme tailored to the special requirements of the mutual fund industry structure. They should not be indiscriminately lumped with non-mutual-fund securities dealers not having common problems. A management company which distributes its fund through a direct selling organization should be exempt, since it too would fall in that group of broker-dealers described by the SEC recently as generally not regarded as being engaged in the general securities business, such as exchange members who do a limited over-the-counter business, or those who deal primarily in real estate, oil royalties, savings and loan shares, insurance, etc. (See p. 43, S. Rept. 379, to accompany S. 1642.) The proposed SEC legislation is class legislation, exempting some but not others of the same class from compulsory membership. The Federal courts have stated:

"The 14th amendment is a pledge of protection of equal laws, and no impediment may be interposed to the pursuits of anyone except as applied to the same pursuits by others under like circumstances" (*Sneed* v. *Shaffer Oil*, 35 F. 2d 21; 16A CJS par. 510).

The pending SEC proposals will penalize some, favor others, exempt this class, include that class, and create endless litigation, constitutional and otherwise, unless modified (*Hartford Ins. Co.* v. *Harrison*, 301 U.S. 459). Even though equal protection is only a Federal constitutional restraint on State action, the underlying supposition that there should be equal treatment for all businesses similarly situated should control the SEC legislative proopsals. Congress should redress the imbalance.

[From the Wall Street Journal, Nov. 5, 1963]

SOME STATE SECURITIES OFFICIALS OPPOSE PLAN TO FORCE BROKER-DEALERS INTO NASD

(By a Wall Street Journal staff reporter)

NEW ORLEANS.—A group of State securities administrators called for direct regulation by the States and by the Securities and Exchange Commission of broker-dealer firms that aren't members of the National Association of Securities Dealers rather than requiring them to join the NASD, official over-the-counter self-policing trade group.

An SEC-backed measure before Congress would require unaffiliated broker-dealers, including those involved only in intrastate business, to join a regulatory trade group. The proposal grew out of the SEC's recently completed Special Staff Study of the Nation's securities markets and is contained in a Senate-approved bill that comes before the House Commerce Committee later this month.

Members of the Midwest Securities Commissioners Association said in a policy statement they were opposed to the "principle of forcing a broker-dealer firm to join any trade group." Spokesmen for the association added that much of this opposition stemmed from criticism of the effectiveness of the NASD as an industry-policing organization.

FOUR-YEAR-OLD UNIT

The Midwest association is a 4-year-old organization of securities administrators in 18 States that have stiffer securities regulatory laws than most States. Association members met at the start of the Sixth Annual Conference of North

American Securities Administrators, a broader organization whose membership embraces all U.S. States, Canadian Provinces, and Mexico. The NASA conference opened yesterday here and will continue through Thursday.

William L. Cary, SEC Chairman, is slated to address the conference's closing session. SEC Commissioners Manuel F. Cohen and Jack Whitney II, along with several top SEC aids, also are scheduled to meet with State securities chiefs Thursday.

A spokesman for the Midwest commissioners said the group objected to the SEC's trade association membership proposal, not only because of the "compulsory aspect" but "because of the shortcomings of the NASD." Some State securities supervisors long have criticized what they say has been NASD policy of refusing to furnish their offices advance information on disciplinary actions involving NASD member firms. "The situation has improved somewhat lately," said the securities chief of a big midwestern State, "but I don't believe the NASD has enough paid staff people to do all the things expected of it."

The SEC special staff in the third and final installment of its 5,600-page study last August said the NASD, despite many accomplishments, had "fallen short of its potential as a self-regulatory agency" and requires among other things a major reorganization, including a bigger staff. The report urged the SEC itself to take a more active role in supervising the NASD which, by law, has direct authority over the over-the-counter affairs of about 4,000 member firms.

NONMEMBERSHIP NOTED

The report noted that more than 1,000 broker-dealer firms registered with the SEC, including some large mutual fund sales organizations and intrastate broker-dealers, weren't members of the NASD. The proposal thus aims at bringing such firms under the umbrella of industry self-regulation.

The Midwest Securities Commissioners resolution suggested that if the SEC chose not to directly supervise unaffiliated broker-dealers, then supervision should be left to the States. In the resolution vote, States favoring the policy statement were Arizona, California, Colorado, Illinois, Iowa, Kansas, Missouri, North and South Dakota, Oklahoma, Tennessee, and Wisconsin. Michigan voted against the resolution and Texas abstained, according to Richard E. Pringle, Kansas securities commissioner and secretary of the group. Robert G. Cronson, assistant secretary of state of Illinois and the State's chief securities overseer, is chairman of the Midwest group.

It was reported at an NASA session that plans are complete for a program to permit applicants for licenses as securities salesmen or broker-dealers to take a battery of qualifying tests at one place and time. About 20 States in the past year or so have been giving applicants standard examinations to check their familiarity with securities law; such tests, however, often have been available at different places and times in any one State. Under the new testing procedure, to be administered by the NASD, tests will check applicants' knowledge of securities laws generally, listed trading procedures, over-the-counter trading, and the stock laws of the State in which they will work.

On September 1, Oklahoma became the first State to offer all four tests at a single place, Oklahoma City University. Missouri launched a similar program November 1, and Kansas and Texas are slated to do the same December 1, according to Hugh F. Owens, Oklahoma securities administrator and chairman of the NASA committee on uniform requirements.

Mr. HARRIS. I observe that you have a news article attached to it. I am not sure if this is already in the record or not. I know it has been referred to.

Mr. SHIPLEY. It was my understanding, Mr. Chairman, that the Midwest Association, which passed a resolution opposing the compulsory membership features of the legislation, did send a copy of their resolution to your committee.

Mr. HARRIS. I know; I saw it and read it. I do not know if they included it in the record with their statement or not. If they did, it will not be necessary to include it in the record again.

I assume you want it in the record one way or the other.

Mr. SHIPLEY. Yes, sir.

Mr. HARRIS. We will accept it under that condition.

If it is not already in, it may go in at this point.

Mr. SHIPLEY. Thank you, sir.

Mr. HARRIS. You mentioned the Midwest Securities Association. Do you represent that association?

Mr. SHIPLEY. No, sir, we do not. We were simply aware of the fact they passed this resolution. When it became clear to us that the SEC made little effort to consult with the various State securities regulatory bodies with respect to this legislation, we undertook as a matter of public interest to get in touch with them and point up what we thought was the pertinent area. We did not attempt to persuade them one way or the other, but we supplied them with copies of our statement suggesting they might have different views. We had responses from very many of them in this connection, including your own State or Arkansas, which was apparently opposed to some features of the legislation.

Mr. HARRIS. Are you talking about the State insurance commissioners?

Mr. SHIPLEY. No, sir. The title of the State securities regulator varies from State to State.

Mr. HARRIS. In our case it is the insurance commission.

Mr. SHIPLEY. I know we had a letter from Mr. Jones, as I recall, in your State.

Mr. HARRIS. Mr. McCombs is the commissioner of the State insurance.

Mr. SHIPLEY. We had a letter from the person who regulates the securities there. We supplied a copy to your office.

We asked whether or not this was the appropriate official because we were rather curious about it.

He referred to some aspects of the legislation. We had letters from various States.

Certainly this committee through its counsel might want to consult the views of these States to the extent that the SEC did not. It seems to me it bears very importantly on the Federal-State relationship.

Mr. HARRIS. That is the reason I raised the question, Mr. Shipley. I know it is impossible for any of us to know all of the facts and what has been going on and what consideration has been given, but the State commissioners have been, notwithstanding what you have said, consulted about it, because I know some of that consultation went on in my office.

I held three meetings on it. At one time there were innumerable commissioners from the various States, including those around in this area, the Southwest, and the West, and other States.

If it might be of any information to you, I brought about a meeting between a representative of the State agencies and the Chairman of the Securities and Exchange Commission. They had an extensive meeting on this matter in an effort to see if we could not resolve the differences.

So, I do not believe that your information that they have not been consulted is altogether the fact in the matter.

Mr. SHIPLEY. I was aware of some of the meetings, Mr. Chairman. I am not suggesting that the State insurance regulations weren't thoroughly consulted, but I thought we had some curious responses

because they seemed to indicate some strong opposition to some phases of the legislation from State securities agencies, who are a different group. We got the impression from reading them that these people didn't know that legislation was pending. These two types of regulations come from different areas of the State governments. I don't think it is too material.

Mr. HARRIS. I think it is very material because that is where the major opposition is coming on this, from certain insurance people on it, and I have tried for the last 3 months to resolve this question and not been able to do so.

I might say to you, since apparently you represent some of these State commissions——

Mr. SHIPLEY. No, sir; we do not. We represent people in the mutual fund field, investment advisers, and so on. But, as I said in the beginning, our statement does not reflect the views of any client. It was not submitted to our clients prior to preparation. It represents our views. Some of the views parallel the views of some of our clients.

Mr. HARRIS. I raise this question because it is important here in this discussion. I have received several letters from the State agencies in which they have raised certain questions based on information that you have given.

Mr. SHIPLEY. Yes, sir; we provided all of them that we could get, we got from the SEC a list of all the people they considered the authorities in the States. We sent them copies of our statement and a copy of your hearing notice so that they could make their views known to this committee.

Mr. HARRIS. Did you do that on the basis of just informing them? You say you don't represent them.

Mr. SHIPLEY. Yes, sir; simply as a matter to develop the relationship between the SEC legislation and State securities regulation.

Mr. HARRIS. That raises another question. We are going to have some of these people on here. I did ask Mr. Cary, Chairman of the Commission, a lot of questions. I interrogated him rather extensively following a letter that I received from an attorney general which apparently represented the action or, at least, the position of the various attorneys general from the various States.

It was quite obvious from the answers which Chairman Cary gave that somebody has been misinformed or else Mr. Cary was not well advised, and his answers were not altogether correct.

There is something in this that makes it necessary for us to dig into it and get the facts.

Now, on one meeting in my office, for your information, and the reason I am bringing this up now is because you say you do not represent the State agencies.

Mr. SHIPLEY. No, sir.

Mr. HARRIS. But you do represent certain insurance companies?

Mr. SHIPLEY. No, sir, and I think there is a part of the trouble.

Mr. HARRIS. Whom did you say you represented? You said mutuals.

Mr. SHIPLEY. We represent mutual funds, investment advisers, broker-dealers and just plain investors across the board.

Mr. HARRIS. They are not involved here.

Mr. SHIPLEY. They are involved to the extent that their securities are sold by broker-dealers. And then they are involved to the extent that the compulsory membership feature of the proposed SEC legislation would compel certain large mutual funds who do not sell their securities through broker-dealers but who are direct sellers to join NASD or a similar association at a cost of many thousands of dollars that has to be paid ultimately by the shareholders and investors when they are regulated by the SEC under the 1933 act and 1934 act. In addition, they would be compelled against their business judgment to become members of NASD at a cost of as much as $75,000 a year.

They are not like brokers and dealers in the business of buying and selling other people's securities on a commission basis.

Mr. HARRIS. No. 1, Mr. Shipley, mutuals are not included in this.

Mr. SHIPLEY. Direct sellers of mutual funds would be, Mr. Chairman, under the compulsory membership to the extent that they are brokers and dealers.

Mr. HARRIS. If they become a broker-dealer then they get out of the mutual business.

No. 2, either you are wrong and the State agencies are wrong and the attorneys for them and the insurance companies or the SEC Chairman has misinformed this committee.

Mr. SHIPLEY. No, sir.

Mr. HARRIS. Yes, they are, too.

I am determined that I am going to get to the bottom of it and find out.

What I tried to do with them in the office—and then there happened to be a number of attorneys representing insurance companies that were in there with them, and at one point it got to a discussion where it raised a question in my mind. There were six insurance commissioners from the various States on this, and when the discussion reached a certain point it was not the insurance commissioners, it was the lawyers for the insurance companies. I raised the question with them, "Now you gentlemen from the various States came in here to see me about encroachment on your prerogatives and so forth. Now, here you let the attorneys for the various insurance companies do your talking. Now, are you here representing the States and their prerogatives, or did you come here with the insurance lawyers to represent the insurance companies?"

We are not getting very far in clearing this up.

Mr. SHIPLEY. I think I can shed some light on it, Mr. Chairman.

Mr. HARRIS. This gives me an opportunity to make a preliminary announcement here again to those representing insurance people that they have made certain representations to me and to a lot of others on this committee and all. I have laid the predicate by asking these various questions of the Chairman of the Commission himself. He has answered them very forthrightly and I have suggested to these State agencies to take that transcript and help clear up this thing for this committee.

Now, Senator Robertson, chairman of the Senate committee, considered all these matters and wrote me a letter about it, which I have, and he went into it. I do not think anybody would say Sena-

tor Robertson, of Virginia, is a man who wants to extend the Federal arm to unnecessary encroachment on State agencies.

What we want to do is to really develop the facts in this thing.

If you will go back and read the transcript of Mr. Cary's testimony, he said this contention of $75,000, a figure which you used, and there have been other figures used, was simply not so. Somebody is wrong. I do not know.

What I want to do is find out who is wrong. If Chairman Cary is wrong, we want to know it.

Mr. SHIPLEY. Let me see if I can clarify one aspect of this, Mr. Chairman, which I do think is quite important because I was here the day you read the Attorney General's letter.

Mr. Chairman, I think part of the problem arises from this:

First, the State insurance commissioners are not the same people as those who are the State securities regulators. You have to start with that division in your mind.

Now, historically, in our country, as you know, Mr. Chairman, the insurance business has been a wholly State regulated business. There have been many attempts to extend Federal control to insurance companies but they are basically supervised by the States. We do not represent any insurance company, we do not speak for any insurance company, but we as lawyers, know the legislative problems they have had with respect to variable annuities and various other types of policies which Federal authorities say are securities and should be within the grasp of Federal regulation.

I think the State regulator should defend against Federal encroachment to the extent it gets involved in Federal jurisdiction, interstate commerce and use of mails, and so on. That is a separate problem. Those are the people who have been coming to you, lawyers for the insurance companies on a very proper problem. Under the SEC legislation, insurance companies will have to follow the same reporting, proxy, and insider trading regulations as other over-the-counter companies.

We are about to change the basic structure of regulation of insurance from State to Federal. This committee will want to consider that very carefully, separate and apart from variable annuity insurance problem, and let me say that involves stock companies and mutual insurance companies which are wholly in the insurance field. We are not concerned with them and I am not speaking about those at all.

The State authorities we have dealt with are an entirely different group. These are the men who are under State law empowered with the responsibility to regulate people in the securities industries. They have nothing to do with this insurance business. They regulate brokers and dealers who buy and sell securities in intrastate commerce. They are also empowered by this Congress, these State agencies—I say not empowered but they have been specifically protected in this responsibility not only as to intrastate business but they can exercise State authority on interstate business under five of the six statutes, the 1934 act, 1933 act, the Investment Company Act, and so on, five of the six statutes administered by the SEC.

Those are the people, the securities people, that we thought were not completely briefed in and consulted.

I did not hear Chairman Cary indicate that they had been. When you asked him that question, he was confused as to whether you were talking about insurance, mutual insurance companies or securities people and mutual funds who are in the securities business. You asked Mr. Cary, "Well, did you consult with the State authorities?"—he said, "Well, not directly." Then Mr. Loomis got up here and said, "We did not actually get in touch with them, no, but we have from time to time talked with them."

I was left with the impression that they had not sat down and written letters to 50 States and could come to your committee and say, "Here is the problem. We got 50 answers. Some States are in favor of it or some are against it." To my knowledge, this has not been done.

So far as I know we are the only people who stuck our oar in because we were concerned with the fog in this area and wrote to the State securities regulators.

Maybe Mr. Cary has now written to these men and submitted the legislation and the Senate committee report on S. 1642 for their consideration.

Mr. HARRIS. I do not know of any action which has been taken since these hearings started.

Mr. SHIPLEY. That is all I am suggesting, Mr. Chairman.

Mr. HARRIS. We had a meeting with what I thought was the appropriate State agencies involved.

Mr. SHIPLEY. Those were State regulators for insurance but not securities. They don't have anything to do with a broker-dealer who buys and sells A.T. & T. or a share of a mutual fund or of an over-the-counter company. These insurance outfits are very experienced, independent, and know their business. They are highly qualified. They simply are not in the securities business. They are in the insurance business.

The SEC bill eliminates the intrastate exemption as to the securities business. It also extends its police authority to individuals as well as companies. It seems to violate the basic premise that there should be dual regulation and dual responsibility in the field of securities.

Now, Mr. Chairman, in the field of radio and TV, the FCC and other agencies under the jurisdiction of this committee, the Federal Government has occupied the field. No State sets up any radio or TV regulations or has a regulatory body because Congress set the policy that this was a wholly National and Federal matter and the States had no business in it.

Under the 1934 Communications Act, that is the way it is.

I say to you, Mr. Chairman, the policy problem which this committee should consider is whether or not the time has come or we have reached the place where the basic congressional policy of dual responsibility in the field of securities is to be abandoned. If you are abandoning it piecemeal, you might as well face up to it and say the States are out of the securities regulation business. If the SEC is going to be like the FCC and occupy the complete field, no State will have any power. This is what will happen, really, when Congress eliminates the intrastate exemption.

I suggest to you that this is a fundamental legislative policy change which upsets the whole basic structure of Federal regulation in the

securities field. That is a problem separate and apart and not related to the insurance industry.

The insurance people have a different problem. They have always been wholly intrastate. They are now to become federally regulated. They are concerned about that.

I hope that adds something to clarification of this situation. I think it might be helpful if we file with the committee the various letters from State securities people. We have no letters from State insurance people. I think you have lots of correspondence from them and their representatives.

Mr. HARRIS. We had Mr. King, who was a member of the State Securities Commission of the State of Texas, who testified this week. It was rather interesting that he testified as a private individual.

Mr. SHIPLEY. I think they are like people in the securities business. They don't all have the same view. I know we have run into this.

Just a few days ago, the Prudential Insurance Co. filed with the SEC an insurance policy, a variable annuity to be registered as a security, which brings it under Federal control. Few other insurance companies like that. The Prudential takes a different view. But that is wholly unrelated to the securities business.

Mr. HARRIS. We had some interest manifested in the variable business. I do not believe you are altogether correct in stating that was an insurance policy filed with the Commission.

Mr. SHIPLEY. Mr. Cary says it is a security and Prudential apparently agrees because they registered it with the SEC.

When does insurance quit being insurance and become a security? This is the problem you have with Mr. Saxon. When does a common trust fund quit being a fiduciary responsibility and a banking function and become a mutual fund subject to SEC registration? That is another battle in a different area.

We think that bank-sponsored mutual funds are securities and they should be registered with the SEC because everybody in the mutual fund business should operate under the same rules.

We are talking in that area of 5,000 national banks, maybe 10,000 State banks. This is 15,000 new mutual funds. It is fantastic to suggest that these people should not be regulated by the SEC. Mr. Cary has taken that position and we think it is a very sound position. Whether or not a variable annuity is a security, we are not prepared to say. We are not insurance lawyers. The courts have ruled that it is a security. The insurance companies still insist it is exempt from regulation under the Investment Company Act of 1940—under the insurance exemption.

Apparently Prudential thinks it is exempt. Mr. Cary thinks it is not. A great many State insurance people think it isn't. Mr. Cary will have to resolve that problem some later day, if the courts do not.

Mr. HARRIS. I thought an initial decision had been made on that subject not too long ago.

Mr. SHIPLEY. The SEC certainly has and they have argued it in the court of appeals that a variable annuity is a security and that the insurance company exemption does not apply.

Mr. Conwill discussed his recent argument when he was testifying a couple of weeks ago that they had tried to assert in the circuit

court of appeals to uphold their decision that variable annuities were securities and not subject to the insurance company exemption in the Investment Co. Act.

As I say, Prudential shared their view, because they registered a new policy, which was a variable annuity, as a security. But Prudential still claims complete exemption under the 1940 act.

Those are two problems not related to the central issues I have raised here which deal with brokers and dealers, people who buy and sell A.T. & T., Gulf Oil, and all securities that are traded either in the exchanges or over-the-counter market. These people, the great bulk of the over 6,000 of them, are not in the mutual fund business; they are in the business of buying and selling on a commission basis for other people's accounts. These are the people, of whom a thousand are not members of the NASD or any self-regulatory group. The SEC says, "We think another 200 or 300 of them ought to be in the NASD," and they include the direct sellers of mutual funds and other people who really are not in the securities business in the sense that they are buying and selling on a commission basis for other people's accounts, or as principals or dealers for their own account.

Mr. HARRIS. I was quite concerned with that provision, I would like you to know, and raised some question about it. You have some mixed feelings on it but it is the policy which the industry has insisted on, which the Congress has gone along with, which you have indicated very strongly that you support.

Mr. SHIPLEY. No, sir—only voluntary, not compulsory.

Mr. HARRIS. Just wait a minute until I get through.

Mr. SHIPLEY. Excuse me, sir.

Mr. HARRIS. You have, too, for self-policing, self-regulation. You made that statement very flatly a moment ago.

I might use as an example, I think, that this subcommittee of this committee in 1951 and 1952 was responsible for the industry adopting a code in the communications industry. You mentioned that a moment ago.

Mr. SHIPLEY. Yes, sir.

Mr. HARRIS. There was a tremendous interest throughout the United States about the programing. It developed, of course, that the Congress had given full leeway to the industry. The industry maintained it ought to police itself, or self-regulation. It was recognized throughout all these hearings it has not been doing the job.

On March 1, 1952, the industry developed a code. At that time it was of such interest, particularly to the TV industry, that practically every television facility in the country became a member of it.

Now, I have feeling about this business of requiring people to belong to an organization. I have the same feeling with reference to labor problems requiring an individual to belong to something that he does not feel he should be forced to belong to. You know what the policies of this country have been. Now we have given much greater leeway to this industry to regulate itself. If they do not have some kind of organization or some kind of procedure set up for self-regulation among themselves, then what are you doing to do with those people who do not agree that they should follow certain codes or uniform rules or certain things that are necessary if it is going to be a healthy or stabilized industry? What are the alternatives? If

we are going to follow this principle, then what can we rely on that it will be carried out in the interest and protection of the public if we do not have something?

So, I am frank to admit that right now I am not too sure. If we are going to follow the principle of self-policing, regulation, among the industry, then I think maybe there is something to this idea of having them set up some kind of group that can do it.

We have that right now in the rating problem with the broadcasting industry. I do not have to remind you that that thing got almost out of hand. Now they are in the process of trying to set up some kind of bureau, such as the newspaper industry many years ago, the auditing bureau organized and everybody become a part of it.

I would suggest that these things be given very careful consideration so that we try to do whatever is best.

Mr. SHIPLEY. Mr. Chairman, I think what you are saying is extremely important because, as I understand the securities business, and as I say we do quite a bit of work in it, the industry wholeheartedly across the board supports the idea of voluntary self-regulation.

As I say, section 15(a), the Maloney Act that set up the NASD and the national securities associations, was based on the idea of voluntariness. When Justice Douglas—then SEC Chairman—discussed this, he made a great point: he said congressional policy which gives rise to NASD is voluntary obedience.

Here is what he said in 1938:

> By self-regulation I do not mean private lawmaking. By self-regulation I do not imply a private club whereby a few can control the many. By self-regulation I do not mean a guild system above the law. I mean groups voluntarily organized.

Now, all of these evils, private clubs, closed shop, so on, Justice Douglas foresaw, automatically come into play, Mr. Chairman, once you take membership out of the realm of being voluntary and make it compulsory. Then it becomes an extension of the SEC.

I think you have to bear in mind that all of these broker-dealers who use the mails or are in interstate commerce are now registered with the Federal SEC and subject to very stringent regulation. The SEC has very broad powers under section 15 of the act over broker-dealers in the securities business.

Now, by the SEC's own figures, if you, if this committee, ultimately authorizes or requires compulsory membership in the NASD or a similar national securities association, will that mean that every broker-dealer in the United States who uses the mails or is in interstate commerce is a member of the same trade association or a similarly registered trade association? The answer is "No."

The SEC says there are now 1,035 non-NASD members out of the 6,000 broker-dealers. Now, that is 16 percent, roughly, who are not members of the NASD.

You have asked, members of this committee have asked, how many of that thousand who are nonmembers on a voluntary basis will become members on a compulsory basis? Mr. Cary says 300. Mr. Loomis said 200 over in the Senate. So we are going to have somewhere between 700 and 800 who are using the mails, doing interstate commerce, they are broker-dealers who are going to be exempt by the SEC. If the rule is good, it is good for everybody—not all but 800 broker-

dealers. So I say the rule argues against itself. The SEC has proposed it against a historical background of voluntary obedience, says NASD membership must be compulsory, then proposes to exempt all but a handful of present nonmembers.

Bear in mind all these broker-dealers are registered with the SEC or a State agency or both unless they deal exclusively in exempted securities or exclusively in an intrastate business in a jurisdiction which is not a blue sky jurisdiction, of which there are only Delaware and the District of Columbia, and the District of Columbia is about to get a "blue sky" law.

So the problem is a curious one. This does not mean that people are unregulated. This does not mean they are even unself-regulated. They belong to associations which have codes and ethics. But such associations are not registered with the SEC.

This proposal does not mean that everybody is going to be in a private regulatory group. It means that the SEC will reach out and pick out 200 or 300 more in a special phase of the securities business.

Mr. Cary mentioned some of them: real estate, oil, mutual fund direct sales. This is where I say it is wrong to compel NASD membership of a mutual fund direct seller, because we have clients in this area. They don't buy and sell A.T. & T., Gulf Oil, et cetera, for somebody else. They are the principal underwriters for a mutual fund. They have their own sales organization. They don't handle other people's money, they are not commission broker-dealers in the historical sense of the business; that is, buying and selling securities for their own or other people's accounts.

If you and I are going to buy a share of the stock we go to a broker-dealer. He ought to have financial responsibility, he handles our money. We are entitled to competence and honesty when we do that. If we go to one of these mutual funds—and you can count them on both hands—who sell their own securities and nobody's else's, that is quite different. That is like going and buying a house from a man, a man selling his own product. It is not a question of acting as agent or principal for somebody else. He is selling his own product and, bear in mind, these funds are subject to SEC control. They are regulated under three different Federal laws.

The average broker-dealer is not regulated under the Investment Act of 1940. A mutual fund has to meet reporting, insider trading, proxy requirements, so far beyond anything else in the securities field, that there is no comparison, and perhaps rightly so. At least they live under this complicated web of regulation that manages every aspect of their business.

To come along and say to these people, "You come under the 1933 act and 1934 act with respect to broker-dealers and under the 1940 Investment Company Act with respect to all your mutual fund and your financial responsibilities, in addition you have to join the NASD or a similar semiprivate group," I say it does not make economic sense, it does not make regulatory sense, it is unreasonable, impractical. I think in the end it will be unworkable because I don't think the industry can struggle along tangled in a web of redtape and additional controls.

The questionnaires that went out in connection with the original SEC investigation—and many of them were debated over in the

Bureau of the Budget as to the form of these questionnaires as to whether or not they met the requirement of the Federal Reporting Act, where the industry was not required to supply information more than a couple of times—just pounds, thousands of pages, and hundreds of thousands of man-hours to provide information. Every year every mutual fund goes through this for the SEC. They are not objecting, they think it is necessary. But they think there must be a limit to the kind of regulation which they reasonably must be expected to bear.

Would this add anything to investor protection? No.

Would this add anything to investor confidence? No.

Would this add anything to SEC's responsibilities? No. Their responsibilities are absolute under these three statutes I have referred to—the 1933 act, 1934 act, and the Investment Company Act of 1940.

Then why does the SEC propose it?

I have gone through all the statements and all the testimony in the Senate. The answer is that they don't suggest any evidence of need or any substantial reason. They say they simply think that compulsory membership would bring about 300—let me see the kind of people the talk about. I want to call your attention to this because I know thousands of papers cross your desk and hundreds of problems occupy your mind. I get the impression sometimes that some aspects of these things are not understood. Those of us in the business know them very well and we assume other people know them very well. The truth is that others could not possibly know them very well because even we can't remember them ourselves if we take our mind off them 2 or 3 hours—here is what the SEC says about this thing: I think it is very pertinent to what I am talking about.

Now, the basis for this far-reaching compulsory membership proposal, as nearly as I can tell, just seems to be an idea, Mr. Chairman, that is unsupported by any substantial evidence, an idea that this 90 percent of these over-the-counter brokers and dealers should be members of either the NASD or some similar group.

Mr. HARRIS. The mutual funds are over the counter.

Mr. SHIPLEY. They are sold over the counter. They are not listed on the New York Stock Exchange or other exchanges.

As you know, they are very peculiar securities with continuing offerings. They come under these provisions of holding themselves ready to redeem the securities at net asset value. That is why the Congress, in 1940, set up the Investment Act of 1940, which is as comprehensive a scheme to control the mutual funds as it is possible for the human mind to devise, believe me.

Let me say there has been less litigation under that statute than any of the securities laws. It has been a more successful statute than any of the securities laws. There has been less conflict even despite the comprehensive scheme. The reason? There were months of hearings, they had all the industry spokesmen, they debated the basic policies. They came out with a real workable statute, not jammed through in a hurry. It was a thoroughly done job and it has been a very successful statute and the industry has learned to live with it and the mutual fund industry has brought low- and middle-income investors into the market where they are completely protected.

The loss ratio, the allegations of wrongdoing, are almost minuscule in total in relation to the $23 billion of assets of that industry. All the wrongdoing in the securities business is elsewhere. It is important to bear that in mind.

Let me say your figures show from the SEC's latest annual report that the SEC today, with the stock market share value at six and a half times what it was two decades ago, mutual fund assets at 35 or 40 times, today the SEC is recommending not any more prosecutions than it did in 1950, indeed about the same as 1940. In 1940 the SEC referred 59 cases to the Department of Justice, in 1950, 18, in 1962 only 60. So, the ratio of crimes has simply not gone up in terms of crimes. And only half the alleged wrongdoers were convicted; a low ratio.

In the mutual fund business crimes are virtually nonexistent.

We have had a couple of bad funds that went bad, just a couple. That is all, out of these hundreds of funds. And there were little or no shareholder losses—just questionable management.

Here is what the SEC says as to why it has to reach out to include these thousand nonmembers in the NASD because they made a voluntary choice not to belong. They don't escape Federal regulation or State regulation by not belonging to NASD. They are registered with SEC and State agencies. But here is what the SEC says. This is all they say:

> A limited number of these types of broker-dealers restrict their operations to retailing direct to the public securities of companies with which they have some association; for example, as the sole underwriter. It is important that this group which includes retailers of mutual fund shares and real estate securities, be brought within the self-regulatory scheme.

I say that is a negation in terms. They say it is important, they have never said why. But to lump mutual funds which are regulated under the Investment Act of 1940 with real estate securities which are not, does not make sense. It is apples and oranges. The real estate securities are not regulated under the Investment Act of 1940. None of these classes of people that Mr. Cary mentioned are regulated by the Investment Act of 1940, except mutual funds.

I would suggest to the chairman that he try and find out what underlies the SEC proposal to bring these mutual fund direct sellers into NASD. Mutual funds are sold in three ways: First, through the traditional broker-dealer relationship. There is no question but what those broker-dealers should be subject, and they are, to the same regulations as anybody else.

Then you get the second class, the ones I am talking about now. These are the mutual funds who, under the law, have this interlocking and overlapping relationship, as the sponsor of the fund and the principal underwriter with its own direct selling organization. The only thing they sell is their own product. That is all. They don't sell A.T. & T. or anything else. Those are the people Mr. Cary says ought to be in the NASD along with people who do buy and sell Gulf, A.T. & T., and other securities.

Mr. HARRIS. Whom are they selling their own product to?

Mr. SHIPLEY. To the public, just like you or I if we owned a piece of real estate and went out and sold it, but we are not selling a security, as brokers. I mean we are not buying and selling for other people's accounts on a commission basis.

The broker-dealer in the technical definition is a man who buys and sells securities for his own account or for other people's accounts. This is the fellow who, if he uses the mails or interstate commerce, must register with the SEC. This is the fellow who, if he does it in a blue sky State, must register with a State organization and meet their requirement as to training and experience and financial responsibility.

Many of the States have financial responsibility requirements.

As I pointed out, in the District we are going to have a $25,000 minimum for broker-dealers. Out of our 80 broker-dealers probably 75 percent of them will be put out of business, maybe more. There will be none left except Merrill Lynch, Bache, and other large firms. These are the kind of choices and alternatives that a responsible government has to make.

Certainly something is going to happen when the District of Columbia law goes into effect. Small firms will go out of business, a lot of people will lose jobs. But this mutual fund problem, those funds in the direct selling business are not broker-dealers in the traditional sense of the word. I think the SEC should exempt them because they are regulated comprehensively far beyond anything that the NASD would do or would be authorized to do. Under the Investment Act of 1940, they are completely regulated. As I say, it is a thoroughly comprehensive scheme.

I appreciate very much your time and your courtesy, Mr. Chairman. I know of your long experience and keen interest in this whole field. You perform a great service for our country.

I say to you there isn't anything more important to the health of our economy, to the confidence of all our people in our Government and in our free enterprise system than this legislation. This very tenuous thing, investor confidence, we saw go all to pieces in May 1962. Many people thought the market break grew out of excessive publicity related to proposed SEC regulation. There was a widsepread idea that there was something wrong and this caused tremendous redemptions in mutual funds. This caused a tremendous upset in the market.

Now we have got back pretty much to where we were before things went sour. Our economy is sound and expanding as investment increases. The securities industry should be encouraged.

I think this legislation will be ultimately beneficial. I hope it will be amended in some of the particulars I have addressed myself to. But certainly the basic substance that the securities of over-the-counter companies should meet the reporting, insider trading, and proxy requirements of companies whose securities are listed on the national stock exchanges should become the law. Everybody agrees to that.

The second thing, certainly people in the securities business ought to have some degree of financial responsibility and some degree of training and experience for the reasons I outlined earlier.

Now, whether it is wise to say to the NASD, "You fellows decide; we are not going to tell you whether financial responsibility means $5,000 so a number of competent and small business people can be in the business, or means $100,000 so that nobody can be in the business but Kahn, Loeb, Merrill Lynch, et cetera," that seems to be a delegation of power to private people. This is what Justice Douglas meant when he warned against a private club or guild system or putting people at the mercy of their competitors.

You know all this came up years ago, Mr. Chairman, before you and I were concerned with these things as we are now, back in the early days of the New Deal when Government was seeking solutions to many of these problems which have since been solved. This question of self-regulatory power came up in the *Carter Coal Company* case.

I want to read you a sentence when the Supreme Court held that delegation of legislative power to private groups like NASD is unconstitutional:

> This is legislative delegation in its most obnoxious form, for it is not even delegation to an official or an official body, presumptively disinterested, but to private persons whose interests may be and often are adverse to the interests of others in the same business.

In that case, Congress had delegated to self-regulatory groups, made up of two-thirds of the coal producers and one-half of the miners, the powers to fix wages and hours.

The Supreme Court said no, Congress must do this through a Federal agency. You can't hand the power to legislate over to a group of industry members to be regulated, to make up their own minds.

Then the NRA came up in the *Schechter* case in 1935, which was similar. There these private trade associations were empowered by Congress to issue binding rules to control competition. The Supreme Court said that is an unconstitutional delegation of legislative power and went on to say:

> The Government urges that the codes will consist of rules of competition deemed fair for each industry by representative members of that industry, by the persons most vitally concerned and most familiar with its problems.

Those are the arguments that the SEC makes for compulsory membership today. The Supreme Court went on to say:

> But would it be seriously contended that Congress could delegate its authority so as to empower them to enact the laws they deem to be wise and beneficent for rehabilitation and expansion of their trade and industry? The answer is obvious. Such a delegation of legislative power is unknown to our law and is utterly inconsistent with the constitutional prerogatives and duties of Congress.

Now, that basic policy, despite the fact they were dealing with the NRA and in an atmosphere of national economic crisis, the basic policy stated there, Mr. Chairman, seems to me to be as sound today as it was then.

This presumptive objectivity of a public body certainly is a cornerstone of our regulatory system. The evils that were anticipated in giving these private groups authority to make their own rules, without any limitations, is what I say ought to be considered carefully here when you just say to the NASD, you set financial responsibilities and training experience standards. That is all the statute says, eight or nine words. That is what the SEC proposes—unfettered discretion.

Mr. HARRIS. We could go on but we have a lot of witnesses.

Mr. SHIPLEY. I appreciate that.

Mr. HARRIS. Mr. Glenn, do you have some questions?

Mr. GLENN. Mr. Chairman, I have no question but I would like to compliment the witness on raising these points in opposition and in relation to the weaknesses in the bill. We all know that Mr. Shipley is one of the outstanding members of the District of Columbia bar and perhaps considered one of the best of the experts from the legal standpoint in this field of the securities and exchange markets. I am sure

the record has been enriched. I am sure the committee will benefit from your comments.

Mr. SHIPLEY. Thank you, Congressman Glenn.

Mr. HARRIS. Mr. Curtin.

Mr. CURTIN. Mr. Chairman, I, too, think Mr. Shipley in his statement and in his remarks has given us much information that will be useful.

There is, however, one thing I would like more information on, Mr. Shipley. I understood you to say you have been informed by some of these larger companies that it would cost them as high as $75,000 a year to belong to NASD.

Mr. SHIPLEY. Yes, sir.

Mr. CURTIN. I have had a number of smaller companies get in touch with me who were complaining that the $10,000 limitation on registration fees would give a very wholesale benefit rate to these large companies.

Is it your understanding that there is such a $10,000 maximum?

Mr. SHIPLEY. Yes, sir.

Mr. CURTIN. I am curious as to where the additional cost between the $10,000 and the estimated $75,000 would be.

Mr. SHIPLEY. I haven't gone into the details. I have inquired of people in the industry about it but it seems to be the additional overhead and administrative cost to comply with yet another regulatory agency. This means more people, more reports, more staffing, more cost to the shareholders and investors. The membership fees alone don't determine the total cost. There is a tremendous overhead involved in all these things.

Mr. HARRIS. Thank you, Mr. Shipley.

Mr. SHIPLEY. Thank you, Mr. Chairman.

I appreciate your time and courtesy and interest in this matter.

Mr. HARRIS. Mr. Schapiro.

STATEMENT OF MORRIS A. SCHAPIRO, PRESIDENT, M. A. SCHAPIRO & CO., INC., 1 CHASE MANHATTAN PLAZA, NEW YORK, N.Y.

Mr. SCHAPIRO. Mr. Chairman and members of the committee, my name is Morris A. Schapiro, president of M. A. Schapiro & Co., underwriters, brokers, and dealers in bank stocks. I am also president of its affiliate, the Second District Securities Co., which is a Government-bond dealer.

I intend to be brief and would like to refer and restrict my remarks to that section of the bill (H.R. 5678) relating to quotations.

I refer to page 30, line 4, and I quote:

> Such rules relating to quotations shall be designed to produce fair and informative quotations both at the wholesale and retail level to prevent fictitious or misleading quotations and to promote orderly procedures for collecting and publishing quotations.

At the outset, I would like to express my support in full for this provision. I regard it as essential and necessary for the protection of investors in bank stocks.

I will limit my remarks to bank stocks, the field that I have been in for 36 years.

This provision is in line with the principles of disclosure and competition which are the foundation of the country's economic policy. Disclosure has brought confidence and the securities industry has benefited.

As matters stand today, the quotations which are published are misleading. The publication of so-called retail prices or quotations at the retail level, Mr. Chairman, and the suppression of quotations at the wholesale level, make possible different prices for different people throughout the country all at one time. This, in my opinion, is detrimental to the banking industry where private capital today has a stake of $25 billion. It is the presence of this capital and the need for additional capital which make, in my opinion, the disclosure of the true markets necessary.

Our firm has taken this position for some time. With your permission, I would like to leave with you an article called The Need for Better Quotations, which appeared in our publication, Bank Stock Quarterly, in the December issue of 1962. In this reprint are shown the quotations at the retail level and the quotations at the wholesale level. The wholesale quotations are not public but are made available to people who are professionals in the securities business.

Mr. HARRIS. Do you wish that to be filed with the record?

Mr. SCHAPIRO. With your permission.

Mr. HARRIS. Let it be included.

(The article referred to follows:)

[From the Bank Stock Quarterly, December 1962, published by M. A. Schapiro & Co., Inc.]

THE NEED FOR BETTER QUOTATIONS

Publications throughout the United States carry quotations for bank stocks. The familiar samples on page 17 appeared in the New York Times and San Francisco Examiner of Thursday, November 29, 1962. Hence, these quotations are a representation of the state of the market on Wednesday, November 28, 1962. These quotations, the Times explains, are "supplied by the National Association of Securities Dealers [and] reflect prices at which securities could have been sold (bid) or bought (asked)."

How do these published bid and asked prices compare with the markets of the bank stock dealers themselves for the same day? The six illustrations of quotations by dealers are taken from the "pink sheets" for Wednesday, November 28, 1962, distributed by The National Daily Quotation Service to its broker-dealer subscribers.

One can see that the bid prices printed in the Times and the Examiner conform to those of bank stock dealers. But the asked prices printed in the newspapers do not conform. They are consistently higher than those shown by the dealers. In the quotations presented to the public the spread has been widened. Shares of Morgan Guaranty Trust Co., for example, are quoted with a 1-point spread by each of 11 competing dealers, while newspaper readers in the East see a 3-point spread and west coast readers, an 8-point spread.

This is accounted for by the fact that the National Association of Securities Dealers obtains quotations from The National Daily Quotation Service which transmits the dealers' bid prices, but asked prices are increased by arbitrary rules. The resulting spread conveyed to the newspapers does not give readers an adequate picture of the market.

A wide spread for a given issue generally means that interest in that issue is limited and transactions infrequent. Therefore, the representation of the market furnished to the newspapers by the National Association of Securities Dealers is misleading. In point of fact, the market for major bank stocks, as the illustrative dealers' quotations show, is as good as that for listed securities.

In recent decades investor interest in banking has grown. Total stockholders' equity in the Nation's banks has increased from $9 billion in 1945 to $23 billion today. In the same period bank stocks have moved from discount

to premium. There are many more shares outstanding. The increase results from splits, stock dividends, new issues, and sales of additional shares.

The list of issues quoted in the press has lengthened. Currently, the New York Times carries 108 listings daily. In 1945, the Times listed 71 issues. This increase is greater than the figures indicate since bank mergers have often resulted in the merger of two listings. In New York City, for example, mergers have reduced membership in the Clearinghouse Association from 24 to 11.

More and more bank issues are actively traded and shares of smaller banks outside the cities are now receiving more attention in financial centers. The market for shares of large banks has become a national market.

In view of these developments present policies for published quotations are anachronistic. Prices provided to the press should reflect the dealers' market realistically.

Mr. SCHAPIRO. The trend among banks to issue stock options under existing regulations—or new regulations to come—makes it necessary, in my opinion, to disclose the true market at all times.

As a dealer, we have always recognized the distinction between the true market and the retail price. The retail price is made up of the true market plus the service charge or dealer profit. The suppression of the true market leaves much unknown. The public buyer is not aware of the service charge or what he would realize if he had to sell the shares instantly at the time he bought. I think that this is a misfortune in the business and I do hope that this provision in S. 1642 and H.R. 5678 will be enacted.

Now I would also like to call your attention to some other unfortunate aspects which develop as a result of the suppression of the true market.

I have permission from Mr. Reese H. Harris, Jr., executive vice president of the Manufacturers Hanover Trust Co., to read his letter of December 24, a year ago, which was received as a result of the article which you so kindly included in the record. [Reads:]

May I commend you most forcefully on the value and quality of the latest issue of the Bank Stock Quarterly? I think these quarterlies are about the most valuable thing I read in connection with bank stock investing.

I would particularly like to join in your plea for better bank stock quotations. Incidentally, this could be extended to the insurance stock field as well. These quotations don't cause much difficulty with professionals but they cause trouble in other areas. Two instances will suffice. When I was in Hartford we were having, and I think they are still having, difficulty with the New Haven office of the Federal Estate Tax Service in the valuation of insurance stocks in the estates we handled. They insisted on claiming the mean of the prices quoted as bid and asked over the counter in the Wall Street Journal. It did no good to show them, as we did, the record of actual transactions on the day in question. The result, of course, was an increase of substantial proportions overall in a large estate and yet not big enough to justify litigation. I always regarded this as a mean little gouging operation by the Government, unwittingly aided by the NASD. Certainly the same difficulty would happen with bank stock values.

Secondly, I know of an instance in which a large block of bank stock was purchased privately on the basis of the mean between the bid and asked prices. The parties should have known better but did not, and the result was not fair. There are probably many instances of this that we never hear about. I agree with you that it is time this situation was improved.

(Signed) REESE H. HARRIS, Jr.

I would like to make this available if you would like to have it in the record.

Mr. HARRIS. You have just read it into the record.

BANK STOCK QUOTATIONS FOR WEDNESDAY, NOV. 28, 1962

		Bid	Asked	Prev. Bid
	American Surety&Trust Co. 10	102	113½	103
1—	Bank of Am. NTSA S.F. 2	56⅛	56⅞	55⅝
	Bank of Commerce NY v2½	47½	52	48½
	Bank of Com. Newark 1.60	43	46⅝	43
	Bankers Trust NY 1.80	53	56⅛	52⅝
	Boatmen's Natl Bk St. L. 3	68	72½	68
	Broad St Tr Co Phila. 1.28	32	34½	31⅝
	Camden Trust Co 1.40	39	41⅝	39
	Cent Natl Bk of Cleve 2	53¼	56½	52½
	Cent Penn NB of Phila v2.20	54	57¼	54½
	Chase Manhattan NY 2.60	73⅛	78	74½
	Chemical Bk NY Trust 2.80	83	88⅛	82¼
	Citizens & NatlSavannah v1.20	77	81	76½
	Cleveland Trust 6	335	352	330
	Comm Bk Na Am 50c	34	36⅛	33
	Comm Trust NJ 1.60	44	47½	44
	Conn B&T Hartford 2	65	69½	65½
	Conn Natl Bank 80c	16½	18⅝	16¾
	Cont Ill Chgo 4	140	144½	139
	County Tr Un Pl 50c	32½	36½	33
2—	Crocker-Angl S F 1.40	46¾	51⅛	48⅛
	City Trust Bridgeport 1.60	50	54⅛	50
	Empire Trust NY 3	278	289	278
	Fairfield Co Trust 1.60	43	46⅝	43
	Federation B&T NY v1.55	35½	38⅛	35½
	Fidelity-Phila Tr v2.75	69½	73½	69
	Fidelity Union Newark 1.60	49¾	52½	49⅝
	Fiduciary Trust NY v1.80	50	54⅛	50
	First Bk Stk Minpls v2.67½	53½	58⅞	55
	First CamdenNat B&T 1	43	45⅞	42⅛
	First Natl Bk Atlanta 1.60	50	53⅞	49½
	First Natl Bk Baltimore 2	53	57⅛	53
	First Natl Bk Boston 3	84⅛	89¼	85
	First Natl Bk Chicago 1.60	73	77	72½
	First Natl Bk Dallas 1.36	54⅞	58	54¼
	First Natl Bk Jer City 1.40	40½	44⅞	40½
	First Natl Passaic Co v3½	92	97	92
	First St. Louis 1.60	29½	31¾	29½
3—	First Natl City NY 3	88⅝	91⅞	88½
	First Pa B&T Phila 1.20	30	32⅛	29¾
	First Westchestr n Roch 60c	33	32⅜	28
	Franklin Natl NY 1	42½	48	45
	Girard Corn Ex Phila v2.75	65½	69	65½
	Harris Tr Chicago 2	88	93½	87
	Hartford Natl B&T 2	57	60¼	57
	Hudson Co Nat Jer City 1	27	29⅜	27
	Hudson Trust UnionC 80c	21	23	21
	Indust Nat Prov 2	49½	53¼	49
	Indust Valley Phila v85c	23½	25⅜	23½
4—	Irving Tr NY 1.60	44	46⅞	43¾
	Kings Co Tr Bklyn 2.20	51½	55¾	51
	Liberty Rl Est Phila 1.65	38	41¾	38
	Long Isl Tr GardenC 1.20	29	31⅛	29
	Manuf & Trad Buffalo1.20	27¼	29⅛	26½
	Manuf. Hanover 2	30	33¼	32¼
	Maryland Natl Bank 2½	75	80½	75
	Meadow Brk Nat NassCo 60c	25½	27	24
	Mellon Natl Pitts 2	62½	65¾	61¼
	Mercantile Tr St Louis 1.80	42½	45⅞	42½
	Merchants Bk of NY-(new)	49	53⅛	49
	Monmouth Co Nat RedBk12c	6⅞	7¾	6⅝
5—	Morgan Guar N Y 4	121½	125¼	120½
	Nat Bank Detroit 2	62	65½	61½
	Nat Bk Westchstr Wh Pl 60c	26½	28¼	26¼
	Nat City Bk Cleve 1.60	32	35½	31¼
	Nat Comm Albany 1.60	48	52⅛	48
	Nat Comm Rutherfd v1.20	38	41¼	38
	Nat Newk & Essex 1.40	36½	39⅛	36½
	Nat Shawmut Boston 2.60	64½	68½	63
	Nat State Newark 1.20	40½	43¼	40½
	New Eng Merch Natl Bk 2	49½	53¼	49¼
	New Jersey B&T 1.60	40½	43¼	41
	Na Carolina Nat Bk 1	32	35	32
	Northern Tr Chicago	123	129½	122
	Peoples Tr Co Bergn Co v90c	29½	30½	29½
	Philadelphia N Bk v2.25	52¼	55⅞	51¾
	Pittsburgh Natl Bk 1.52	37	39⅝	36½
	Prov Trds B&T Phila v3.10	71	74½	71
	Republic Nat Dallas 1.68	40½	43⅞	40½
	Riggs Nat Wash. DC v40c	163	172	163
	Rockind Nat Bnk b25c	25½	27¼	23½
	Royal Bk of Canada-Montrl.	70½	74	71
	Royal State NY 50c	28½	31⅛	28½
	Seattle First Nat Wash 1.70	32¾	41¼	32¾
	Second Nat Phila 1.60	39	43¾	39
6—	Security First Nat LA 1.60	71½	75	70½
	Security Nat Long Isl 1	28½	30⅞	29
	State Bank Albany 1.80	74	79½	73
	State Nat Conn 40c	31	34½	31
	State Street B&T 1½	37½	40	37¼
	Sterling Nat NY 1.60	63	68½	63
	Trade B&T NY 80c	28	30⅛	28
	Trust Co of N.J. JerCity 40c	10	11	10
	Union Bank LA 1.28	72¾	82½	78
	Union Commerce Cleve	33½	41¾	36¼
	Union Tr Maryland 2.40	36½	40⅞	36½
	US Trust Boston 1.60	40	43¼	40
	US Trust NY 4	124	141	123
	Valley Nat Phoenix 1	50¾	53½	50½
	Va. Commonwealth Corp 1.10	26¾	27⅞	26¾
	Wachovia Nat 60c	34½	36⅝	34½
	Wells Fargo SF 1.40	58½	61¼	58½
	CANADIAN BANKS			
	Bank of Montreal v3.12½	59½	62⅝	59⅛
	Bank of Nova Scotia v2.45	63¼	67¼	66½
	Canadian Imperial v2.10	58	61¾	57¼
	Royal Bank v2.65	70½	74	71
	Toronto Dominion v2.12½	59¼	62½	59½

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		Bid	Ask
	Eastern Banks		
	Bankers Trust	53½	55¼
	Chase Manhattan	74	78
	Chem Bk NY Tr	82¼	86½
3—	1st Natl City Bk	88¼	92½
4—	Franklin NB NY	45⅜	48½
	Irving Trust	43	45¾
5—	Mfrs Hanover Tr	52½	55½
	Morgan Gty Tr	120½	126½
	Western Banks		
1—	Bk of Am NTSA	55⅛	58⅛
	Bk of Calif SF	51	54
	Bk of Trade	18½	20¼
	Central Vlly Natl	31½	34
2—	Crocker-Angl NB	48⅜	51⅛
	1st NB San Jose	34⅜	36⅜
	1st Nti T&S Sn D	31	35
	1st West Bk & Tr	54	59
	Golden Gate NB	18½	20½
	Hibernia Bk SF	72	79
	United Cal Bk	47	50
	Valley NB Ariz	30½	33½
	Wells Fargo Bk	58⅛	61¼
6—	Sec-1st Natl LA	70¾	74¼
	1st Natl Oregon	54½	60½
	U.S. Natl Portlnd	65⅛	69½
	Seattle 1st Natl	36¼	41½

Quotations for Six Banks by Competing Dealers Reprinted from the "pink sheets" for Wednesday, Nov. 28, 1962

1—BANK OF AMER

55⅞ bid	56¼ asked
54⅞	55¼
56⅛	56½
56¼	56½
55⅜	56⅛
55¾	56⅛
55⅜	56
56¼	56½
55⅞	56¼
56¼	56⅜
56	56¼
56⅛	56½
56⅛	56½
56⅛	56⅜

2—CROCKER ANGLO

48½ bid	49¼ asked
48½	49¼
48½	49¼
48⅝	49¼
49	49½
48⅝	49¼
49⅛	49⅝
48½	49¼
48¾	49½
49⅛	49⅜

3—FIRST NATL CITY BK N Y

88½ bid	89 asked
88½	89
88⅛	88⅞
88⅛	88⅝
88¼	88¾
88¼	88¾
88½	89
88½	89
88¾	89¼
88¼	88¾
88½	89
88¼	88¾

4—IRVING TR

43¼xd bid	43¾ asked
43¼xd	43¾
43⅛	43⅜
42¾xd	43¼
43 xd	43½
43	43½
43¼	43⅜
43¼xd	43¾
43¼	43⅜
43	43½

5—MORGAN GUARANTY TR

121¾ bid	122¾ asked
121	122
121½	122½
121¾	122¾
121½	122½
120½	121½
121½	122½
121¾	122¾
121¾	122¾
122	123
121½	122½

6—SECURITY FIRST NATL BK L A

71½ bid	72½ asked
71½	72½
71¾	72¾
72	73
71¾	72¾
71½	72½
72	73
71½	72½

Mr. SCHAPIRO. Another letter from James F. English, Jr., senior vice president of the Connecticut Bank & Trust Co. in Hartford:

I am always interested in your Bank Stock Quarterly, but I was particularly pleased by your article on "The Need for Better Quotations." We have had a very practical problem in this connection with respect to evaluation for Federal estate- and gift-tax purposes. The IRS at least here in Hartford has stuck pretty rigidly to the practice of using a mean between the bid and asked prices in the Wall Street Journal. Of course, the main impact is on our insurance stock holdings, but it affects bank stocks as well. The effect of the artificially high asked price is, of course, to increase the tax liability of our customers. I can recall one gift tax return where the difference between the IRS formula and a realistic appraisal amounted to $32,000 difference in tax. Perhaps your article will be useful to us in our fairly regular hassles with the IRS.

(Signed) JIM ENGLISH.

Mr. Chairman, I thank you for this opportunity.

Mr. HARRIS. Mr. Schapiro, thank you very much.

Mr. Glenn, do you have any questions?

Mr. GLENN. No questions.

Mr. HARRIS. Mr. Dingell?

Mr. DINGELL. No questions.

Mr. HARRIS. Thank you very much for appearing here.

Mr. Dennis E. Murphy.

STATEMENT OF DENNIS E. MURPHY, EXECUTIVE VICE PRESIDENT, THE OHIO CO., COLUMBUS, OHIO

Mr. MURPHY. Mr. Chairman, members of the committee, since time is getting short, may my statement be included in the record?

Mr. HARRIS. Mr. Murphy, you may have your statement included in the record at this point. Then you may make such comments in summary of it as you wish.

(The statement referred to follows:)

STATEMENT BY DENNIS E. MURPHY, EXECUTIVE VICE PRESIDENT OF THE OHIO CO., COLUMBUS, OHIO

My name is Dennis E. Murphy, of Columbus, Ohio. I am executive vice president of The Ohio Co., of Columbus, Ohio, an investment banking firm engaged in the underwriting of securities on the national and local levels. I am also president of Investment Dealers of Ohio, Inc., an association of some 65 investment firms with home offices in Ohio; but it is in my capacity as an officer of the Ohio Co. that I am appearing before this committee. The Ohio Co. is a member of the Midwest Stock Exchange.

As an investment dealer we are not directly affected by this bill. But we feel a duty to oppose legislation which will impose unnecessary financial burdens on small companies, many of whom are our clients, and possibly affect the soundness of their securities. My testimony will be directed primarily to the proposed amendment of sections 12 and 13 of the Securities Exchange Act.

My purpose in asking to appear before the committee today is to reaffirm the position which I expressed at the Senate hearings on this bill. We have very serious reservations about the wisdom of extending the registration and reporting provisions of the Securities Exchange Act of 1934 to companies with net assets of $1 million or more and 750 shareholders of "a class of equity security." This is to be reduced to 500 shareholders after 2 years.

We feel it is unnecessary from a practical standpoint, and would be unduly burdensome to the many thousands of small businesses throughout the United States. In addition, we feel that it would impose such a tremendous burden upon the Securities and Exchange Commission that it would be unable to process the many thousands of reports that would come to its offices without substantially increasing its staff and imposing substantial additional financial burdens upon the investment industry and the taxpayers.

When a similar bill was under consideration in the Senate in 1957, the committee, after extensive hearings and consideration of the testimony presented, amended the bill so that it would apply only to issuers whose assets exceed $10 million and had 1,000 or more holders of "its equity securities." In report No. 700, the committee stated that "by increasing the assets test figure from $2 to $10 million, the committee is of the opinion that it has removed all serious chance that the bill might possibly hurt small business enterprises."

While that amendment did not fully satisfy our views, we felt that it was a substantial step in the right direction and would remove the burdensome provisions of the bill from a large number of small corporations which would have been most seriously hurt under the previous provisions of the bill. Now we are back again to the point where the number of shareholders is to be reduced to 500, which can be an extremely small company.

NEED FOR PROPOSED LEGISLATION

A careful reading of the testimony on the other bill would indicate that the proponents of that legislation proceeded largely on the assumption that the only corporations which make full and complete reports to their shareholders are those which have securities listed on a national exchange or which have securities registered with the SEC. Many witnesses at the previous hearings testified regarding the remarkable job which most of the corporations with unregistered or unlisted securities outstanding were then doing in making reports to their shareholders and pointed to the progressively enlightened public relations attitude which had characterized business management in recent years.

Everyone is agreed that investors are entitled to full and complete information about the companies in which their funds are invested and I share that view. It seems to me, however, that all of these bills are or have been based on the assumption that investors in unlisted securities are denied information about their investments whereas in the great majority of cases they are furnished full and complete information.

To support this statement I would like to call to the attention of the committee the "Report of the Securities and Exchange Commission on S. 2054 to the Committee on Banking and Currency" relating to an evaluation of reports to stockholders of 1,161 corporations which the Commission studied at that time. The report discloses the degree of compliance with the Commission's accounting standards of 580 reports by companies subject to Commission regulation and 581 reports to stockholders by companies not subject to Commission regulation.

This report of the SEC shows that companies subject to regulation and those not subject to regulation complied about equally with the accounting standards of the SEC except for what the SEC describes as "minor deficiencies." Under this heading the SEC lists corporations as being materially deficient if they fail to show "sales and/or cost of sales." This, in our judgment, is not a material deficiency insofar as small companies are concerned.

It is entirely possible and even likely that this "deficiency" in these reports was, in many instances, intentional because the management did not want to reveal its sales or profit margins to its competitors and did not disclose these facts for reasons which they considered to be in the best interest of their shareholders.

Reports to shareholders in many instances are prepared not only for stockholders' use but also for submission to suppliers, customers, credit rating agencies, and the like. Thus, management may feel it would be harmful to disclose to the public generally information which it might be entirely willing to disclose to shareholders That is a responsibility that management must assume, and it alone should decide whether the submission of such data would adversely affect the company's competitive position.

Competition under our economic system is keen. Many of the small companies are in competition with much larger companies with greater capital, widespread or even nationwide organizations, large sales departments, technical personnel, and huge resources for research and development. These small companies can't hope to compete with the giants in their field in research, management, or financial resources. They must guard carefully, therefore, the things which it would be to the advantage of their competitors, particularly their large competitors, to know about their company. Cost of sales could be of tremendous advantage to a competitor. In such instances it is not, I submit, "in the interest

of the public" to disclose such information—in fact, it might be detrimental to the best interests of the company and its shareholders whom the management has the first duty to protect.

This raises the question, whose interest is paramount in such cases—the interests of the company and its shareholders, or the interest of the "public" which has no investment in the company?

We do not advocate the withholding of such information from shareholders, but there are occasions when management may be justified in withholding information from those not entitled to have it. The SEC report does not indicate the size of the companies which failed to supply "sales" information, but it is reasonable to assume that the list includes a number of small companies. Absence of this type of information, while not complying with SEC accounting practices is not a serious or vital omission insofar as the shareholders are concerned.

More important, it seems to me, is the protection of these small companies from their big competitors. Many States have recognized the danger inherent in the public distribution of such information by providing corporations and their shareholders protection against disclosure of such information for unreasonable and improper purposes. At the same time practically every State recognizes and enforces the right of shareholders to be furnished with information concerning their companies and to examine their books and records for proper purposes.

It is not unreasonable, in my judgment, to classify such reports, i.e., reports where the only omission is information as to sales and cost of sales, as satisfactory. If these reports, therefore, were included with the other two classifications in the SEC report, the Commission's study would indicate that the total number of companies making satisfactory reports to stockholders was 96.6 percent—an eminently impressive record.

I think that, on the whole, the SEC report demonstrates conclusively the lack of any urgent need for this legislation.

REPORTS AT THE STATE LEVEL

Most States have laws governing the sale of new issues of securities which adequately provide for the supplying of information which is available for shareholder examination. In Ohio, for instance, the statutes explicitly provide that every shareholder is entitled to receive annual reports and that all books of account and other records of operations are open to shareholders at all reasonable times except for unreasonable and improper purposes.

As an example of the effort being made by Ohio industry to keep its shareholders and others informed about its business, I have brought along with me copies of the annual reports of several Ohio companies which are doing an excellent public relations job. These fine annual reports are published not because the companies are compelled to do so by law, but because it enhances their image with the public and their shareholders. These are just a few samples of the type of reporting which we see being done more and more frequently.

None of these companies is presently covered by the reporting provisions of the Securities Exchange Act. Nevertheless, I think you will find that these reports are as comprehensive, as informative, and in such detail as to give shareholders all pertinent information about their company and its earnings as if they were covered by that act.

It is my judgment, therefore, that the State laws give ample protection to investors in such securities. As support for my judgment in this connection, I would like to call to the attention of this committee a letter dated July 27, 1955, which the late Judge Savord, former chief of the Division of Securities of the State of Ohio wrote the Banking and Currency Committee of the Senate when the committee had a prior bill under consideration. Judge Savord said in part:

"Practically without exception, every safeguard sought to be realized by the proposed legislation is assured by protective provisions of the Corporation Code of Ohio or rendered certain by proper and efficient enforcement of the regulations and penal provisions of the Ohio Securities Act."

"Under the latter act, with the exception of securities listed on the recognized exchanges and a few well-justified exempt securities and security transactions, all securities or transactions therein are required to be registered and the division through the investigating and examining powers conferred by the act is given ample power to police activities therein. The enforcement provisions of the act are of such character as to fully clothe the division with author-

ity, either through suspension or registration, or criminal prosecution, if necessary, to render certain that positive enforcement of the act is secured.

"In the light of these circumstances, it is difficult to understand why small business, using the term in a relative sense, should be exposed to the additional burden of filing registration statements with the Securities and Exchange Commission and at regular intervals submit complicated financial reports. One speculates as to whether or not small business would not thus become extremely vulnerable to and made the prey of the larger and more formidable entity."

I think these remarks by Judge Savord summarize more forcefully than I could hope to do the safeguards and protection which Ohio laws provide for residents of Ohio in the purchase and sale of securities. His remarks confirm the statement which I have made that, in my opinion, the State laws give ample protection to investors, especially as to reporting requirements.

The extension of Federal power to the regulation of small companies on the State level where information is already available, where adequate regulatory supervision is already provided, and where there is no substantial market interest outside the State in which the securities are sold, would seem to be an unnecessary and inadvisable invasion of the State's right to regulate the securities industry within its own borders and would impose an uncalled-for burden upon the companies subjected to such regulation, as well as upon the SEC.

BURDENSOME COST OF PROPOSED LEGISLATION

In addition to the lack of any need for the proposed legislation, especially as it applies to small companies, consideration should also be given to its estimated cost both to the companies involved and to the public.

It was testified at the previous hearings that the cost of compliance would be approximately $10,000 to $15,000 per year for even the smallest company subject to SEC regulation. Today, I believe the annual cost of complying with all of the provisions of S. 1642 would run closer to $25,000 per year for a small company. Now, to a company with a net income of $1 million per year, such additional cost may not appear to be unduly burdensome, but to a company with $500,000 of net income it would amount to 5 percent of such net income, and to a company with $100,000 of net income it would amount to 25 percent of such net income. The impact upon a small company is obvious.

Readily available and accurate information is essential to the functioning of our capital markets, but I raise the question whether, in view of the adequate laws which we now have at the State level to protect investors, and the enlightened public relations attitude which the vast majority of our small companies have with respect to their duty and obligation to keep their shareholders informed, if there is any impelling reason to apply the provisions of this bill to companies with assets of $1 million and 750 shareholders and eventually to only 500 shareholders. I doubt if anyone knows how many companies it will affect, but we can be sure it will carry into nearly every nook and corner of this country. A million-dollar company today is a tiny company by almost any standard.

One final comment in regard to cost and what it will gain for the public. The principal argument that has been advanced in support of the legislation is the need for reporting to shareholders. But this bill gives no assurance that reports will be furnished to shareholders. The bill does require the filing of information in Washington, but that does not get it into the hands of the shareholders. Is it logical to expect that an Ohio shareholder, for instance, would spend time and money coming to Washington to obtain information on an Ohio company which, by existing State law, must be made available to shareholders by the company? Isn't it more likely that he would contact the company direct? Even more unlikely would it be to suppose that a California shareholder would come to Washington to obtain information about a California company when it could easily be gotten in his own State.

INTRASTATE EXEMPTION

Section 3(a)(11) of the Securities Act of 1933, as amended, provides an exemption for companies whose securities are distributed entirely to residents of the State of incorporation. I believe this is a desirable exemption—one that has operated to the satisfaction of all concerned and with entirely adequate protection of local interests at the State level.

In my judgment any legislation of the character now proposed should provide a specific exemption for local companies which are substantially owned by local

shareholders. I, therefore, suggest that if this bill is favorably considered by this committee that an exemption be given to any company whose shares are substantially owned by shareholders within the State of its incorporation, similar to the exemption contained in the Securities Act of 1933.

It would seem strangely inconsistent to me if the Congress, after having provided under the Securities Act of 1933 for the exemption of intrastate transactions from the provisions of that act, would now in effect nullify that exemption by requiring such issuers of securities to register with the Securities and Exchange Commission and thereby become subject to all the rules and regulations of the Commission and the Securities Exchange Act of 1934.

If this bill passes in its present form, that is the situation which will exist. Under the Securities Act of 1933 an issuer would not be required to register, but under the Securities Exchange Act of 1934, it would.

Small industry is the backbone of our Nation and should be encouraged and not discouraged and burdened by the obligations which this bill would impose. Congress has in many ways, and over a long period ow years, shown its concern for small business as witness the special provisions of our income tax laws, the Small Business Administration Act, and other acts designed to help small business.

The enactment of this bill would be a step in the opposite direction.

CONCLUSION

I, therefore, earnestly suggest that this bill be amended to exempt those corporations whose shares in whole or substantial part are owned by residents of the State of its incorporation from the provisions of this bill or, in the alternative, that the compliance test set forth on page 6 be raised so that it will apply only to companies with assets in the range of $15 to $20 million and 1,500 to 2,000 shareholders, or more.

Mr. MURPHY. I would like to make a brief summary of it because time is getting late.

My name as will be noticed from my statement is Dennis E. Murphy. I am an executive vice president of The Ohio Co. of Columbus, which is an investment banking firm engaged in the underwriting of securities on both the National and State levels.

We are not directly affected by this bill except insofar as its general provisions are concerned. But we do have some comments to make on some of the provisions of the bill which affect small companies.

I have appeared at the various hearings in the Senate regarding this and revious bills going back over a period of many years and our primary objection has been to the provisions relating to the registration requirements for small companies.

We feel it is unnecessary from a practical standpoint and would be unduly burdensome to the many thousands of small businesses throughout the country.

When one of the previous bills was before the Senate, the committee that heard the bills over there, as a result of testimony from myself and others along this particular line, agreed to and did amend the bill which was then before that committee to raise the limitations from $2 million of assets to $10 million of assets and 1,000 shareholders. While that did not gas far as we thought it should, it did go quite a ways toward meeting the objections which we had to that bill.

Now I think, from my reading of testimony which has been presented at various hearings, that this legislation is based largely on the assumption that only certain large corporations make full and complete reports to their shareholders.

However, our experience has been that many of these small companies make just as complete and just as accurate reports as many of the larger ones do. In fact, the report which the Securities and

Exchange Commission itself made a few years ago on some 1,100 corporations indicated that the corporations which reported to the SEC and those which did not report had about the same degree of compliance with the accounting procedures of the SEC with one exception which related to sales and cost of sales which many of the smaller companies do not report.

We do not believe in the withholding of information to shareholders but there are occasions when management may feel justified in withholding certain types of information.

More important, it seems to us, is the protection of these small companies from their big competitors.

Many States have recognized the danger inherent in the public distribution of such information by providing corporations and their shareholders protection against disclosure of such information for unreasonable and improper purposes.

It is not unreasonable, in my opinion, to classify such reports as I have referred to; that is, where the omission of sales and cost of sales is missing, as and if those sales were adjusted, it would indicate that in the report which the Securities and Exchange Commission made that these companies that did not report to the SEC had a record of 96.6 percent compliance with their regulations, which I think is extremely good.

We have had considerable testimony on the question of regulations at the State level. In Ohio, for instance, the statutes provide that every shareholder is entitled to receive annual reports and that all books and records of accounts of operations are open to shareholders at all reasonable times except for unreasonable and improper purposes.

It is my judgment, therefore, that the State laws, particularly the ones we have in Ohio, give ample protection to investors in securities.

I might point out that many—not many but quite a few—issues which have been qualified and registered for sale by the SEC have not been qualified for sale in Ohio because they have had more strict provisions out there in the case of some issues than has been the case with respect to the SEC.

Now, our position is that the extension of Federal power to regulation of small companies on the State level, where information is already available or where adequate regulatory supervision is already provided and where there is no substantial market interest outside the State in which the securities are sold would seem to be an unnecessary and inadvisable invasion of the States right to regulate the securities industry within its own borders and would impose an uncalled for burden on the companies subjected to such regulations as well as upon the SEC.

A good deal has been said about the cost of registering securities with the SEC. We have had quite some experience in that respect in connection with small company financing in Ohio and we think that it would run approximately $25,000 per year for a small company.

When you relate that cost to the earnings of a small company, we think it gets to the point where it is almost prohibitive.

I would like to touch just a second on this intrastate exemption. The present Securities Act provides an exemption for companies whose securities are distributed entirely to residents in the State of

incorporation. I believe this is a desirable exemption, one which has operated to the satisfaction of all concerned and with entirely adequate protection to local interests at the State level.

In my judgment, any legislation of the character now proposed should provide a specific exemption for local companies which are substantially owned by local shareholders.

I therefore suggest that if this bill is favorably considered by this committee that an exemption be given any company whose shares are substantially owned by shareholders within the State of its incorporation similar to the exemption contained in the Securities Act of 1933 as of now.

In conclusion, I would like to say that we would suggest that this bill be amended to exempt those corporations whose shares are sold in whole or in substantial part to residents of the State in which the corporation is incorporated or, in the alternative, that the compliance tests set forth on page 6 be raised so that it will apply only to companies with assets in the $15 to $20 million range and 1,500 to 2,000 shareholders or more. This provision for 750 or 500 shareholders works out very peculiarly in some cases. Five hundred shareholders of a stock that is selling at $5 a share of course represents a much smaller investment than do 500 shareholders of stock selling at $50 a share.

We have made a survey of a number of companies out our way that have shares of stock outstanding. It is amazing how wide a variation you will find in asset value and number of shareholders. So we think that the suggestion we have made here with respect to raising those limitations to $15 or $20 million and 1,500 to 2,000 shareholders would be more practical than the one which has been included in the bill.

That is all I have to say, Mr. Chairman.

I thank you for this opportunity of appearing before you.

Mr. HARRIS. Thank you very much, Mr. Murphy.

Mr. Dingell, do you have any questions?

Mr. DINGELL. No questions.

Mr. HARRIS. We are glad to have your testimony.

Mr. MURPHY. Thank you, sir.

(Discussion off the record.)

Mr. HARRIS. Mr. Gerald S. Jeremias, president of the Empire Planning Corp., 570 Seventh Avenue, New York, N.Y. If Mr. Jeremias desires, he may submit a statement for the record at this point.

Mr. Stanley L. Schwartz. Your name is Stanley L. Schwartz, president of Technical Animations, Inc., 11 Sintsink Drive East, Port Washington, N.Y., is that right?

STATEMENT OF STANLEY L. SCHWARTZ, PRESIDENT, TECHNICAL ANIMATIONS, INC., PORT WASHINGTON, N.Y.

Mr. SCHWARTZ. Yes, sir.

Mr. HARRIS. I observe you have a statement.

Mr. SCHWARTZ. Yes, sir; I have a prepared statement which I have left with the committee.

I would like to take a very, very few moments, however, to explain the prime purpose of our mission to appear before the committee.

Mr. HARRIS. Let me get what you want in the record first, Mr. Schwartz. You have innumerable statements in here.

Here is what is apparently a statement by you as representing your organization. Is that what you wish to go into the record?

Mr. SCHWARTZ. Yes, sir.

Mr. HARRIS. Let it be included in the record at this point.

(The statement referred to follows:)

STATEMENT BY STANLEY L. SCHWARTZ, PRESIDENT, TECHNICAL ANIMATIONS, INC., PORT WASHINGTON, N.Y.

I appear before you today in an effort to clarify the record of the company which I head as president, Technical Animations, Inc., of Port Washington, N.Y., and to comment upon the inferences and implications made against my company in the SEC Study Group report.

At 12:30 p.m. on April 3, the following report was carried on the Dow-Jones news ticker:

"Washington: Dow-Jones—Among the recommendations that the Commission didn't specifically endorse were these:

"The study group's request for a law that would establish criminal sanctions and civil liabilities for—intentional or reckless dissemination of false and misleading statements including forecasts, of earnings, unwarranted by existing circumstances. The law would be aimed at press releases from corporations and at the activities of public relations concerns. In reaching this recommendation the study group said that while corporate publicity can be a valuable supplement to disclosures required by the securities laws, its investigation uncovered public relations, abuses, such as the use of press releases in deliberate attempts to falsify a company's financial position and prospects. The group mentioned five companies whose activities stood out as demonstrating specific practices or problems. The five are Avnet Electronics Corp., Barchris Construction Corp., Chemtree Corp., General Development Corp., and Technical Animations, Inc."

As soon thereafter as it was possible to obtain more detailed information on that section of the study group's report which concerned Technical Animations, Inc., and to make a comparison between the facts versus the inferences, implications, and omissions, I authorized the following statement to be issued to the financial editors of all wire services and the New York financial press:

"1. This statement is in answer to the press release from the SEC today in which Technical Animations, Inc., was named as one of the five companies that had deliberately used press releases in an attempt to falsify the company's financial position and prospects.

"2. Neither Technical Animations nor anyone authorized to represent the company has at any time ever issued a release that in any way attempted to falsify or distort the company's financial position or prospects.

"3. On April 28, 1961, Time magazine wrote a story relative to the annual meeting of American Machine & Foundry Co. At that meeting a Technamation display was shown to stockholders of that company.

"4. A reporter from Time magazine wrote a story relative to the company's products and sales. At that time (the third quarter of the company's fiscal year) sales were running at a $600,000 a year rate and the company was operating in the black as is mentioned in the Time story.

"5. During the fourth quarter of the company's fiscal year of 1961, the total volume of sales declined approximately 25 percent from the indicated gross volume.

"6. A complete reprint of the Time magazine feature is attached (exhibit A).

" 'We consider, without having had the opportunity of reading the complete report made by the study group, that this is a distortion of the company's position and furthermore that investigation would have certainly indicated to the study group that Technical Animations should never have been included in this broad indictment of public relations practices.' "

We took this action in an attempt to protect both our 2,500 stockholders and our repute in the business world, for we immediately realized that these charges were potentially destructive to us.

However, the sensational nature of the study group report, as it applied to the charges against Technical Animations, apparently outweighed the news value of our statement.

The following syndicated feature appeared within 24 hours in New York and cities from coast to coast (exhibits B and C).

So far as we can ascertain, the financial community accepted the sensational accusations contained in the April 3 news coverage of the study group's report as final and conclusive, insofar as it pertained to Technical Animations.

We thereupon prepared a report to our stockholders and forwarded same as quickly as it could be mechanically processed (exhibit D).

As a result of the study group report and the attendant publicity, certain real losses in our operation have occurred. We are not speaking of what we believe is but a temporary decline in the trading price of our stock, although the stockholders who have had occasion to convert their holdings during this period certainly suffered a real dollar loss. We are concerned more with potential loss of business and the weakening in our trade position.

Much of the business of Technical Animations, Inc., involves the development and manufacture of training aids and public informational material for the defense agencies and for companies of pronounced public character. We now feel that many requirements which normally would be referred to our company for solution through our unique research and design capabilities and the application of our Technamation process may be withheld because of a reluctance on the part of public or corporate users to employ the services of a company which was cited as a "horrible example" by the study group report. Additionally, we feel that today and in the future, a certain amount of essential information relating to the progress of our company may not be accepted by responsible publications because of the stigma now associated with our name.

The omissions and implications in that portion of the study group report covering Technical Animations seem inconsequential when compared to the scholarly and comprehensive accumulation of facts which makes up the total report. They are, nevertheless, extremely critical of our company's reputation. The essential omissions revolve mainly about the implied sale of stock by "insiders" of the corporation during the rise in the price of the stock following the appearance of the Time magazine story about our company. The study group report cites in detail the amount of stock sold by Mr. Purtell, Time business editor and his associates, indicating that they sold the bulk of their holdings (which they had purchased shortly before the article appeared) immediately after publication, at the height of the market. The report then goes on to state that "officers of the corporation sold 2,400 shares, and its public relations man sold 1,300 shares (acquired through the exercise of options)." What the report neglected to state was the fact that the corporate officers and directors held at that time approximately 200,000 shares, of which only about 1 percent was sold.

In fact, of the small amount of stock that was sold by "insiders," almost half, 1,100 shares, were sold on behalf of the estate (four minor children) of Jack Ballance, the deceased cofounder of the company. Nor did the report mention that the public relations man held a total of 25,000 shares on option, and that the proceeds of the relatively small proportion that he did sell went to defray heavy medical expenses then being incurred as a result of the hospitalization of his wife. In other words, the "insiders" did not use this stock rise as an opportunity to sell off their stock and held (as they still do) the great bulk of their equities because of their long-term faith in the future of the company. We feel that the report would have been more responsible if it had included these facts, instead of allowing the inferences to stand that our management had participated in a stock coup.

Secondly, and more important, the report implied that the Time magazine article was unduly favorable. Our company would have objected strongly to unduly favorable reporting of our operation, and we feel that facts will bear out our contention that the article was quite conservative. The Time article was primarily concerned with the process upon which most of the products and services of Technical Animations, Inc., are based. Time felt that the potential applications of this technique, which permits the addition of motion to almost any heretofore static medium of visual communications, were so far reaching and important as to merit editorial exposure to Time's broad readership. In the small and inconsequential reference to finances, the magazine merely reported that: "Sales have risen in 5 years from $7,000 to $600,000 this year. The company went into the black this year, but is spending its small profits in research." The fact is that spanning the 2-year period during which the article appeared, the company reported sales of $1,211,313 and showed a small profit, while indeed reinvesting its earnings in research and development. This was in accord with the figures as noted in the article. In any case, the difference between the "rate"

as noted and even the final figures for the first year was not such as to have affected the public demand for the stock.

The aspect of the Time article that did obviously tend to excite interest in the company had to do with the products existing and potential, and in his respect the article was definitely conservative.

The record would be incomplete without further comment, and full disclosures, of the data contained in the Time magazine story, relative to product development by Technical Animations—which the study group report characterizes as "unduly favorable."

So that you may better understand these comments, I have brought some examples of these products to show you.

Since the publication of the article, every projected development and application has been brought to fruition and some that were felt by us to be too far in the future to be mentioned have also been advanced to a state of industry acceptance.

In view of the facts as presented here today, we would like to propose for this committee's consideration that some regulation or procedure be established to insure fair and equitable control at the source over such situations as our company has encountered.

We know that literally thousands of American business enterprises, large and small, have experienced the disconcerting, and frequently damaging occurence of suddenly, with no advance warning of any kind, becoming the subjects of discrediting press releases issued by Washington regulatory bureaus.

These releases are often timed to make it almost impossible for the subjects to prepare adequate answers in time for editors to include their responses to these charges in the news coverage of the Government release.

Nor is it the policy of the bureaucratic press departments responsible for these releases to advise the subjects involved that there is to be a press release which may or may not have a vital effect on the company, its stockholders and its future existence.

Therefore, as a matter of basic justice and fairplay to American business and any concern or individual involved with such bureaus as the SEC, we believe that a mandatory procedure should be established so that:

1. Any involved concern or individual will be advised of the contents of any bureau press release before such press release is made public;

2. That the press departments of the regulatory bureaus should be compelled to take equal cognizance of both sides of any controversy, involving a concern or individual, and should relevant explanatory or informational material be made available by the named subject(s) to include both statements in any press releases; or

3. Bureau press departments should be forced to distribute, at the same time as their own release, any relevant accompanying material provided by the subject concerns or individuals involved.

As late as June 3, the same distorted story about technical animations as appeared originally on April 4, continued to appear from coast to coast (exhibits E and F).

It is particularly ironic to observe that the study group report requested a "law that would establish criminal sanctions and civil liabilities for intentional or reckless dissemination of false and misleading statements * * * aimed at press releases from corporations."

If such a law is considered, I suggest it should properly include all press releases, from Government regulatory bureaus as well as business enterprises.

(NOTE.—The exhibits were placed in the committee files.)

Mr. HARRIS. Now, did you have anything else you want to go in the record with it?

Mr. SCHWARTZ. No, sir; except the few comments that I would care to make at this time.

Mr. HARRIS. Very well.

Mr. SCHWARTZ. Briefly, the only position we wish to take on the legislation that is up for consideration at this time is that we would like the committee to take this opportunity to add a provision to the legislation which would effectively prevent a recurrence of the unfortunate happenings to our company which I have detailed in my statement.

When the study group of the Securities and Exchange Commission was investigating the over-the-counter market, they entered into an investigation and looked into a number of companies whose stocks had fluctuated rather erratically over a period of time in an attempt to determine whether this was the result of manipulation or other fraudulent business practices.

Among the stocks that they looked at because of this fluctuation was that of our company. They found rather quickly in their investigation that the cause of the fluctuation of our stock was the appearance in Time magazine of an article describing our company, its products, and the wide variety of uses of these products.

They also found, after considerable investigation of the company, that we as members of the organization and the company itself, had no part in instigating this article, that we had given out no false or misleading information, and in no way had we misrepresented our position.

Also they determined that we had personally not gained anything by the appearance of this article nor the fluctuation of the stock.

In other words, the Securities and Exchange Commission's position was that the wrongdoing, if any, here, was on the part of the business editor of Time magazine, whom they found had bought stock in our company prior to the issuance of the story because of his knowledge that the story would appear and because apparently he allegedly expected to have the stock rise. He then subsequently sold the stock after the story appeared.

This is what the Securities and Exchange Commission study group report indicated.

Our problem arose from the fact that when the study group report was ready for issuance, a press release was provided to the various members of the press. In this press release the SEC did not carefully distinguish between our company and other companies that were cited and did not explain that the inclusion of the name of our corporation was because we were, in effect, an innocent bystander, the tool of allegedly improper conduct on the part of the Time magazine business editor.

The result of this was that our company has suffered extremely serious harm. Our business has fallen off radically. We are just beginning to come out of it now after all the time since the report came out and the price of our securities has dropped very, very low and has stayed low.

I know that nothing I can do in appearing before this committee can change that situation. I am not interested in changing that situation by an appearance before the committee. We will do what we can to build up our company again and regain, we hope, our position in the financial and business field.

Mr. Cary was extremely concerned when the damage to our company took place. He had no intention whatsoever of harming our company. When the news reports first went out that did lump us with possibly guilty organizations and pointed us out as being perhaps guilty of something or other, we advised Mr. Cary and he quickly issued another press release which explained clearly the fact that our company was not at fault.

Further, very recently when we took occasion to point out to Mr. Loomis of the SEC that in addition to this poor publicity we had suffered serious business losses, he had the graciousness to write us a letter in which he made it very clear again that he never had any intention of impugning the honesty or integrity of the corporation or any of its members.

He also, in our discussions with the SEC, pointed out the fact that their press release was written quite circumspectly. It had been written carefully. If you read the press release as carefully as it had been written, it would have been difficult to jump to the conclusions that the press did. But the press could not have been expected to read the release with all the care required—they have deadlines to meet.

The point that we wish to raise here is this: With no intent to hurt the company at all, the company was harmed. In spite of all the good efforts on the part of SEC, the company was harmed. It was harmed not because of the Study Group Report or the investigation; it was harmed because of the press agent operation of the SEC.

In other words, what I am proposing to the committee today is some legislation to be added to the current bill which will regulate the public information officer function of a regulatory commission—and what that function is I am sure I don't know, but they always do issue press releases. I am asking for legislation which will prevent the broadside, widespread issuance of press releases which could be damaging to an individual or a company, without giving that individual or the company adequate warning of what is going to be released, and time to prepare a rebuttal or to at least suggest changes in the press release which would insure that the whole story is told.

Briefly, that is all I have to say. As I say, I am appearing in this case as an injured citizen.

I know that whatever is put into this bill will not affect our company but if it is written into the bill it will at least prevent the same thing happening to another company similar to ours or another individual in the future.

Mr. HARRIS. Mr. Schwartz, we are glad to have your testimony and your presentation here.

Thank you very much.

Mr. SCHWARTZ. Thank you, sir.

Mr. HARRIS. Mr. Burnside.

Do you wish to proceed with your statement now or just to include it in the record?

STATEMENT OF ROBERT A. BURNSIDE, NEW YORK, N.Y.

Mr. BURNSIDE. I would like to put my statement in the record; yes, sir.

Mr. HARRIS. Very well. You may come around.

Will you identify yourself for the record?

Mr. BURNSIDE. My name is Robert Burnside. I am from New York City. I have been active in the brokerage and underwriting business for the last 5 years.

Due to the shortness of time and at the request of Mr. Harris, I would respectfully request that my full statement to this subcommittee be included in the official record.

Mr. HARRIS. Let it be included in the record at this point.
(The statement referred to follows:)

FULL STATEMENT OF ROBERT BURNSIDE BEFORE THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, U.S. HOUSE OF REPRESENTATIVES, ON H.R. 6789

Mr. Chairman and members of the committee, my name is Robert Burnside. I have been active in the underwriting and brokerage business in New York City for some 5 years.

I am here today to testify on H.R. 6789, a bill embodying certain legislative recommendations of the Securities and Exchange Commission. I would like to divide my remarks into three general areas. In my preliminary general remarks, I will comment upon my reasons for being here today, as well as the general lack of criticism of the proposed legislation by other individuals in the securities industry. I will also comment upon the mechanical problems confronting those who might normally desire to testify.

In the second section of my remarks, I will devote myself to a point by point review of the substantive provisions of the proposed legislation, as well as the pertinent comments in the report of the Special Study of Securities Markets. My emphasis will be upon capital and other requirements as conditions of entry into this business, and the proposed extension of disclosure requirements to the issuers of additional publicly traded securities.

In the third section of these remarks, I will give my views concerning a pattern of behavior on the part of the SEC and various of its staff members that, I believe, should be called to the attention of this committee. That section will include a discussion of abuses of power by the SEC and its staff and the failure of the Commission and its staff to perform various tasks delegated by congressional mandate in the manner contemplated by the Congress. Also, I will discuss problems that are inherent in the nature of the regulatory process already established, as well as in that which is envisioned by the proposed legislation and various other recommendations of the Special Study.

I

I am willing to testify here today as an individual because I have completely severed my connections with the securities firm with which I have been associated in various capacities for the past 5 years. Were I still the underwriting manager of that firm, it would undoubtedly forbid me to testify here because of a justifiable fear of possible reprisal against the firm by the SEC. I am now engaged entirely in the field of private placement, which is outside the jurisdiction of the SEC.

I believe it is the fear of reprisal which has kept many reputable experts in the securities industry and industry generally from testifying against objectionable features of this proposed legislation. Such reprisals can and do take the form of harassment of broker-dealers by many means, including unusually frequent examinations of books, records, and procedures, and questioning of personnel and customers. Also, announcements of "investigations" are made with the usual effect of depressing the market prices of particular issues that may have been sponsored by the "offending" firm. In addition, businesses seeking new capital can be ruined by the simple but effective technique of holding up clearance for new issues.

Prospective witnesses before this committee have also faced mechanical problems. While Members of the Congress have had available advance copies of the massive Special Study Report, it is only recently that interested persons could obtain printed copies from the Government Printing Office. This study, which is admittedly monumental in scope and detail, and which is the background from which the proposed legislation has emerged, took a large staff of full-time employees some 2 years to complete—in fact, the congressionally established timetable for completion was completely ignored. And yet, the interested members of the securities industry and industry generally are expected to master its contents (over 3,000 pages), analyze the proposed legislation, and prepare testimony, all within a few short weeks of the first general availability of the complete report. Gentlemen, I respectfully submit that these hearings are as premature as the report itself was tardy.

II

The following comments are made with respect to the proposed legislation in the order in which the topics are covered in the proposed amendments. (Page references are to the printed version of the bill, dated June 4, 1963.)

1. No objection can reasonably be taken to the material on pages 1 through 5.

2. The proposal (on p. 6) to amend section 12 of the Securities Exchange Act of 1934 by the addition of subsection (g) (1) is most objectionable. This subsection (which provides for registration), together with subsequent proposed additions, would make firms whose securities are traded over the counter subject to reporting requirements similar to those required of firms whose securities are listed on a national securities exchange, for those firms having total assets in excess of $1 million and security holders of a given class of equity securities in excess of 750 (to be reduced to 500, 2 years after passage of the amendment).

3. This proposed change is onerous on several counts. In the first place, using a test of total assets of $1 million will tend to work a great hardship on many firms whose net worth is of very modest proportions relative to total assets. This will be equally true of those firms having a net worth of $1 million or more. The reason is that the amount of time and cost that will be required to adequately prepare the proposed reports to the satisfaction of the SEC will be prohibitive. Most small firms—and quite obviously, the impact of this proposed legislation will fall most heavily on small business—lack the financial and legal sophistication within their own staffs to prepare the required annual, semiannual, and monthly reports, without expensive outside assistance. Many firms having complicated financial situations and organizations in a state of flux will find that their managements are spending a disproportionately large proportion of their time assisting in the preparation of these reports. Total cost of preparing such reports can easily approximate $25,000 a year for a great many small firms that can ill afford such cost. Mr. James J. Saxon, Controller of the Currency, on June 6, 1963, expressed the fear that such registration and reporting requirements would impose a "substantial additional burden" on banks. If that is so in the case of banks, it would be even more so in the case of other kinds of commercial enterprises lacking the resources and the experience in such reporting of banks. In his letter of transmittal accompanying the first segment of the report of the Special Study, Chairman William L. Cary stated that one of the functions of the proposed changes was to facilitate "* * * the free flow of capital into the markets * * *" However, free flow is in fact impeded where available choice for investment is limited, and many a small but sound corporation will forgo the chance to expand through raising public funds because of an understandable reluctance to subject itself to the contemplated administrative burden. If a total asset test must be used, it should be raised to a meaningful $10 million.

4. The test based on the number of security holders is not a sound one. The mere fact that 750 people may own the equity securities of a given small business in no way indicates that such security is actively traded in the over-the-counter market and is the subject of great interest by the investment community. Very often, an old established family controlled business may have a great many securities holders as a result of the gradual dispersion of ownership as estates are settled successively through several generations. Also, a firm might have a situation where many, if not all, employees are equity owners. As in the case of the descendants of original founders, employee holders are not often active participants in a trading market. The amount of public interest frequently is relatively slight. At any rate, the number of mere security holders is relatively less important than the number of holders of 100 shares or more. If any numerical test is to be used, it should be at least 1,000 holders of 100 shares each, exclusive of employees. Also, consideration ought to be given to the possibility of adding the jurisdictional requirement that at least 100 transfers of 100 shares each must have occurred in each of the 2 calendar years immediately preceding the year in which the Commission seeks to require registration.

5. The burden placed upon a small business, especially a marginal company, by the proposed reporting requirements, can easily be the difference between a profitable and an unprofitable year. The interests of the securities holders of these companies are adequately protected by existing legislation and judicial precedence on the State level—the very States whose creatures these corporations are.

6. These companies might never within many decades past, have had a public offering. They might never have had any intention of becoming publicly owned

or doing anything that would subject them to the additional burden which the SEC here seeks to impose. And yet, because of events completely outside of the control of management, e.g., dispersion of ownership through testamentary disposition and/or gifts, the Commission would treat them as some new issuer with a substantial public ownership and following.

7. Where a company is new, or has had a period of adversity, it might well have substantially more than $1 million in total assets and many times 750 stockholders. And yet, such a corporation might be unable to raise the money necessary to pay for the independent audit required in order to submit the instant forms.

8. The Commission and the report of the Special Study of Securities Markets would have us believe that the sole objective of this part of the bill is to protect the investing public and, presumably, to promote and encourage the free flow of new investment capital into American industry. However, the American investing public is already perfectly free to put its investment funds into listed securities where the dubious safeguards provided by the filing of reports such as are here under discussion are already available. Nothing compels the investor to invest anew or to maintain an investment in securities traded over the counter. (I refer to those securities traded over the counter which are not obligated to file reports as though they were listed companies.) And, of course, for new issues the investor is adequately protected by the information contained in the registration statement.

9. The protections afforded by the filing of these reports are at best dubious. The Special Study Group itself commented upon the lack of ready availability of the information contained in these reports to the general investing public. At present, few indeed are the investors who would be willing and able to travel to Washington, D.C., and spend time in a cramped public reference room waiting for the file on the company in which the investor had an interest to become available. It is obvious that the Commission staff is far too limited to adequately process, let alone summarize for public use, these reports in anything like an efficient manner. Hence, the Commission is really seeking merely to impose an additional burden upon a segment of industry that is already beset to too great a degree by the heavy hand of Government bureaucracy—probably as a preliminary to a later request for expansion of Commission staff and increase in Commission budget for the purpose of processing the new flood of reports. The administrative unworkableness of regulation in this area is demonstrated by the proposal contained in section 10 of the bill to repeal existing law (sec. 32(b) of the Exchange Act) providing for fines for those corporations that fail to file the required reports.

10. The Commission position regarding the flow of new investment capital into industry is that such flow will be facilitated by the availability of this information. That position is nonsense. The reason is that the over-the-counter trading market is just that, a trading market. Not one penny invested in over-the-counter securities in regular brokerage transactions finds its way into the coffers of the corporate issuers. It is at the registration statement and new offerings level that the Commission can justly point to giving that level of information to prospective investors that will help to enhance the chances of a continued flow of new investment capital into American industry.

11. The proposed amendment provides that the reports (actually, registration statements) shall become effective 60 days after filing with the Commission. This is analogous to the provision of the Securities Act of 1933 that says that registration statements and new offerings shall become effective within 20 days after filing with the Commission. What will happen to currently traded securities if the Commission stalls, as in the case of registration of new securities, so that the effective date may be postponed as long as a year or more from filing date? Will the Commission attempt to suspend all trading in these securities—to the irreparable harm of countless small, innocent, and helpless securities holders?

12. The Commission's proposed legislation would exempt from such registration requirements the general run of securities issued by foreign issuers. The advantage gained by such issuers through not having to bear the positive cost and effort burden carried by otherwise similarly situated American firms may well serve to encourage the distribution of foreign securities in the United States. This, of course, could have a deleterious effect on our already serious balance-of-payments problem.

13. The proposed legislation provides in section 12, subsection (g)(3) that registration shall terminate when the number of holders falls below 300. If the entire concept registration above discussed is actually adopted, this subsection is an absolutely required minimal saving grace. However, the cutoff point should be raised substantially above 300, perhaps to within 10 percent of the original figure on which the requirement of registration is based.

14. The proposed revised section 14(a) of the 1934 act constitutes an undesirable grab for power by the SEC. Investors who choose to invest in over-the-counter-traded securities do so knowing that such securities are not subject to the various "protections" afforded by securities listed on national securities exchanges. Hence, they may be said to willingly undertake whatever additional degree of investment risk may be involved. Their remedies are still available under applicable State law. Again, it is for the State of incorporation, the governmental entity whose creature the corporation is to say what proxy rules shall govern. The cost burden of complying with SEC rules can be prohibitive for both a small firm and a large firm in financial straits.

15. By compelling those corporations which do not solicit proxies to file information statements with the Commission, this proposed legislation would again be tampering with the electoral essence of the creatures (corporations) of the various States.

16. The proposed amendment to section 15(a) of the 1934 act (p. 13) is absolutely intolerable, in that it makes use of the use of mails jurisdictional tack to eliminate the exemption from Federal registration presently available to securities firms doing an exclusively intrastate business. In addition, it compels membership in the NASD, inasmuch as that organization is presently the only registered securities association. The brokerage firm doing an intrastate local business is generally a small firm serving locally felt needs. Admittedly, it may lack both the professional sophistication and capital resources of many of the large brokerage firms doing a regular interstate business. However, that is no reason to impose the dual burden of Federal regulation and membership cost in the NASD. The impact on the overall economy of the country of intrastate brokerage firms is, at most minuscule. Existing State regulation is certainly adequate and often far more stringent and demanding than either existing or proposed Federal regulations. Mr. Cary recently remarked before this committee that the SEC wants all local brokers to register because, to track down fraudulent ones, "We need first to know who they are." It would seem that such information is already readily available from the State regulatory authorities.

18. The proposed amendment to section 15(b) of the 1934 act (particularly as set forth in lines 14 through 23 of page 16) contains a vicious back-door grab for jurisdictional power by the SEC. First, the proposed legislation would bring all brokers using the mails under the Commission's jurisdiction. Then, the instant paragraph would make all acts of all registered brokers subject to the jurisdiction of the Commission even though the individual acts in and of themselves had no jurisdictional tie to the Commission and might be perfectly permissible under applicable State law. In other words, the Commission is saying that acts legally done by nonregistrants might now become offenses if done by registrants.

19. The proposed amendment of section 15(b) of the 1934 act (as particularly set forth in subsection (2) on page 17) provides for denial of registration and other penalties for broker's for various reasons, including having associates with undesirable backgrounds. However, no provision is made for exempting brokers from such penalty if they did not have knowledge of the background of their associates, said lack of knowledge not being based upon a failure to make a reasonable attempt to find out the facts of such background. This omission in the proposed legislation is highlighted by the fact that an analogous situation in the same subsection provides that no person shall be deemed to have failed reasonably to supervise any person if certain reasonable procedures are followed (see line 19 of page 18 through line 9 of page 19). On the other hand, the grounds for denial set forth in this subsection should be expanded to include all felonies.

20. The proposed amendment to subsection (3) (p. 20) is a welcome and needed addition to the Commission's powers, in that for the first time it gives the Commission some direct control over the individual registered representatives, et al.

21. If the proposed legislation extending reporting requirements to firms whose securities are traded over the counter is passed, then, in such case

proposed waiver of such reports for companies whose securities holders fall below a given number is indeed a most desirable provision (proposed amendment to section 15(d) of the 1934 act, page 22). However, here again, the cut-off point for the waiver to go into effect might well be raised substantially from the proposed 300.

22. The proposal to insert a new paragraph (5) (p. 26) in section 15A(b) of the 1934 act provides for requirements with respect to training, experience, other qualifications, and financial responsibility of those seeking to join or work for a member of, a registered national securities association. As a condition for entry into the industry, no one will argue with requirements relating to ability, which would be measured by either examination or, in the alternative, experience and/or education. Likewise, local character committees similar to those screening applicants for admission to the bar in the various States would seem desirable. But in both cases, either specific standards or standards within which the Commission might set detailed rules should be carefully set forth in the legislation.

23. With respect to setting standards of financial responsibility, we come to the single most dangerous aspect of the proposed legislation. Mr. Cary, on the one hand, states that the purpose of the proposed legislation is to facilitate the free flow of capital into industry. But by destroying freedom of entry for the small underwriter (as the financial requirements urged by the Special Study surely would), he would destroy one of the prime available sources of new capital for small, new, and/or speculative enterprises. These are the underwriters that often specialize in best efforts financings which the major, more mature firms in the underwriting business would ignore, to the harm of small business and the economy, which would lose the flow of new job-creating capital.

24. While it is true that the fundamental conditions of 20th century American industrial life militate in favor of an increasing concentration of resources in the hands of a decreasing number of organizations in almost all fields of economic endeavor, it is still strong, and sound, congressional policy to encourage free entry into (though not to guarantee success in) all areas of private enterprise. The stimulating competition of new firms is desired. The helping hand of Government is, and for a long time has been, extended to small business organizations. New, and even untried, ideas, in terms of product and processes, are encouraged at all levels, starting with the Constitution and running the gamut of such statutory aids as special consideration in Government contract awards, special advisory service, special borrowing privileges, etc.

25. When a new, and hence speculative, enterprise proposes to commence operation, it cannot turn to the giants of the financial community for underwriting assistance. Simple overhead economics prohibits most of the large underwriting firms from even considering small deals. To preclude the sponsors of new, and admittedly untried, ideas from attempting to obtain the necessary capital resources with which to test their ideas in the marketplace may well be to deprive the economy in general, and the defense effort in particular, of very worthwhile contributions. The report of the Special Study states that the speculative first new issues in recent years have largely been underwritten by the relatively small underwriting houses. The study fails to explain just why an onus should attach to lack of size and newness of an enterprise that seeks public funds for development. There is nothing dishonest or profane about admitting that one does not have the funds with which to launch a new enterprise, or that one would prefer to transfer a substantial part, or even all, of the incidence of risk, from the shoulders of sponsoring management to a willing public. Congress, almost a third of a century ago, wisely established as the foundation of our Federal regulatory system in the securities industry, the principle of full disclosure. So long as this test is met, and a willing public can be found, why should the public be deprived of the opportunity to speculate (this word is used without embarrassment) and management not be allowed to raise funds with which to try new ideas? Since it is obvious that most new and small enterprises that are financed through public offerings are offered on a best efforts basis, it is equally obvious that they are likely to be offered to the public investment market through the small underwriter, who himself might be seeking to create a reputation through sponsorship of a worthwhile speculation.

26. It must be recognized that there are only a certain limited number of free investment dollars available in the hands of the investing public at any given time. By precluding the entry into the industry of those firms that would offer competing investment situations (speculations), Congress would be guilty of

unwittingly compelling the investing public to channel its investments through the established large firms in the securities industry.

27. Likewise, there is the possibility that issuers attempting to sell their own issues might be precluded from doing so because to do so would compel them to register as broker-dealers under the requirements of various States (a present reality) and might have a similar result in terms of SEC interpretation. Admittedly, some issuers could not meet the minimum financial requirements to qualify as a broker-dealer under the proposed legislation. What the proposed legislation really does is to penalize groups with small capital but with courage, ideas, and ambition. It creates a preserve for vested interests both in the underwriting function and in business generally. There is obviously nothing wrong with mere small size and modest resources. Implicit in the theory behind the proposed legislation is the insidious assumption that neither underwriting firms nor industrial companies can grow from small beginnings.

28. Commissioner Cary has said that the right of free entry has resulted in a "high incidence" of inexperience in the securities business on the part of principals of new firms. This begs the question, as it is natural for new firms to be inexperienced. Lawyers pass academic examinations and then commence practice without actual experience. Likewise, lawyers need not commence their practice with large, well-furnished offices. By all means, test the competence of new entrants—but do not require undue experience or financial resources that would bar fresh new blood to an industry that so desperately needs creative approaches.

29. The study group argues that underwriters and other broker-dealers with substantial amounts of capital at stake will pay more careful attention to rules than will firms that no not have a substantial cash investment to lose, and thus are more or less judgment proof. The report emphasizes potential liabilities arising out of underwriting activities. This line of reasoning is, at best, weak. Were the same line of reasoning followed elsewhere, rules would be established to bar all but the rich (at least in jurisdictions without mandatory insurance coverage) from driving automobiles or flying planes. Actually, the reverse reasoning would seem more likely to depict the true situation. The well-to-do, whether automobile drivers or underwriters, can afford to risk judgments and fines for violations. They do not have to feel that a single negligent act resulting in a judgment will put them into an insolvent position. On the other hand, the automobile driver, underwriter, or broker-dealer of limited means will assay prospective risks involved in a given situation a lot more carefully before undertaking them. In his case, one act of negligence which could result in a substantial recovery against him might serve to preclude his continuance in the business (by reason of lack of adequate cash resources). In addition, if the industry rule was that one such failure based on inability to meet financial obligations would serve to preclude continuance in, or future reentry into the securities industry, the broker-dealer of limited resources, serious purpose, and legitimate aspirations would hold himself to the highest possible standards of care.

30. The study states that the workings of the financial community require that all members be able to rely upon the financial soundness of their fellow broker-dealers. However, in addition to the fact that the mere successful meeting of initial entry requirements by a given broker-dealer offers no continuing guarantee of ability to meet commitments to anyone dealing with such a broker-dealer, there would seem to be no need to set up a minimum capital requirement for entry. As soon as a broker-dealer gives the first indication of financial weakness or irresponsibility, the other members of the financial community will protect themselves by refusing to rely upon the weak member to meet its obligations.

31. The study equates cash resources with seriousness of purpose. This is senseless. A dedicated man of integrity with meager resources would fail to qualify for entry. An unconvicted hoodlum might qualify. Certainly, mere sizable capital assets would be no protection against either fraudulent intent or a casual disregard of industry ethics. Broker-dealers can just as easily run away with a large sum as with a small sum. Minimum capital requirements would eliminate the possibility of starting from "scratch" and growing as character and ability are demonstrated to an ever-widening circle of satisfied customers and observers.

32. However, if there must be some test of financial responsibility, the test should vary with the nature of the function the proposed entrant expects to fulfill; e.g., those limiting themselves to best efforts underwriting would seem to

need less capital than those planning to engage in active market trading and maintenance. It is, of course, ridiculous to attempt to point out that statutory contingent liabilities assumed by all in the underwriting business make for higher capital requirements, inasmuch as the amounts suggested by the Special Study would still be far less than adequate to insure the purchasers of even a small regulation A offering.

33. The proposed amendment to section 15A(g), to provide for the stay of disciplinary action by any registered securities association when such disciplinary action is under review by the Commission, is a very desirable procedural protecton.

III

The history of the performance of the staff of the SEC, coupled with the nature of its legislative recommendations and admitted areas for further discussion, together form a recognizable pattern of behavior. Simply stated, I believe that the ever-spreading reach of the SEC is more than what Mr. James J. Saxon has chosen to refer to as the extension of "the reach of the bureaucratic hand"; rather, it is evidentiary of the ultimate goal of a significant element within the staff of the SEC to have the SEC and its staff become the absolute arbiters of the flow of American investment capital. The proposed legislation unquestionably would increase the already existing tendency on the part of the Commission to operate as though its congressionally granted powers were truly dictatorial in scope. The initial congressional grant of power to the SEC and its staff was admittedly broad, but few among the legislators responsible could have visualized ways in which the Commission and its staff have arrogated unto themselves new and broader powers, while using the powers specifically granted in ways never foreseen or intended by Congress.

Congress intended, in the Securities Act of 1933, that issuers would be able to complete the registration process within a 20-day period. However, it is an almost unheard of happening in the securities industries today for a firm to complete the registration process of an issue of securities within 20 days. Many cases are on record where the process took longer than 1 year. In fact, the staff of the Commission for some time past has had as its usual routine the practice of not even sending an initial letter of comment to the filing issuer within the statutory 20-day period. The usual practice has been for the staff to avoid the expiration of the 20-day waiting period by compelling filing registrants to amend their filing to extend the waiting period for successive periods of 20 days. It would be interesting if the Commission would make available statistics in this area. I think that this committee would be amazed at the small number of firms that have even received a letter of comment, much less completed registration, within 20 days. Also, it would be enlightening to know the average number of days spent in registration by the various issuers, as well as the average number of days before the first definitive letter of comment (often called a deficiency letter) is issued by the Commission.

This problem is not merely one of mechanics, where an overburdened staff is just physically unable to cope with the volume of its work. As particular industrial groups, or sponsoring promoters, fall out of favor with the Commission or its staff, there can be detected a lengthening of the processing period for particular kinds of filings. For some time it has been extremely difficult to get any kind of offering by a small mining company through the registration procedure in a reasonable time. Likewise, more recently, real estate offerings have fallen out of favor with the staff, and now are processed in the most painfully slow manner imaginable.

In short, the staff uses as a club its administratively conceived power to hold up clearance for particular issues to dissuade many a prospective issuer from filing. Promoters have come to recognize that they cannot reasonably anticipate becoming free to offer a particular security according to any particular time schedule. Hence, where funds are needed for a particular project in order to meet contractual commitments, industry is more and more frequently turning to private placement, thus limiting, in effect, the investing public's freedom of choice. It might be observed that the economic and social impact on the country of this developing trend (toward private placement) was not even touched upon by the otherwise comprehensive report of the Special Study.

In addition to showing a clearly discernible favoritism in administrative treatment among generic types of issuers, the staff has also moved to a substantive consideration of the economic merits of a proposed undertaking. No longer is the staff satisfied with a mere full disclosure of all relevant information. The

staff now looks to the economic soundness of a particular proposed operation and puts the registrant in the position of having to either justify the economic soundness of the venture or so emasculate the prospectus with uncalled for disclaimers and ridiculously negative statements that a fair sales presentation is no longer possible.

Let me turn to certain other recommendations of the Special Study that may well appear before this committee in future proposed legislation.

Commissioner Cary has indicated that the Commission will recommend to the Congress that operators of quotations systems be required to register with the Commission and adopt and enforce rules of fair practice in the use of their systems, just as is presently the case with the self-regulatory agencies. While no one will quarrel with the basic desideratum behind Chairman Cary's thinking, it must be remembered that the real place to regulate the integrity of quotations is with those from whom they emanate. Quotations systems do not deal directly with the public. They are an information medium. A watchful Congress is urged to prevent the reaching arm of the SEC from impinging upon the constitutionally guaranteed freedom of the press.

The Special Study's recommendations in the area of suitability of investment recommendations are supported by the Commission. Here we must be careful, lest we impose a heavier burden on the broker than that which is imposed on even such professional groups as lawyers. Any attempt to develop a ritualistic approach to determining how closely a particular recommendation dovetails with the economic circumstances and the aspirations of a customer will be to completely preclude the use of a pure technical (chartist) approach to market interpretation. Likewise, the investor's spectrum of choice for his investment dollar will be limited by the fear of those who make recommendations that a particular recommendation might subsequently be held to have been too speculative for the particular investor. The concept of suitability toward which the Commission seems to be aiming could make us a nation of investors in nothing but municipals and utilities.

On the other hand, no one will argue against the Special Study's recommendation that reckless dissemination of written investment advice should be expressly prohibited. However, any such prohibition will have to have a precise definition of "reckless," perhaps along the lines of that accorded "gross negligence" in the law of torts.

The Special Study, in recommending the abolition of floor trading privileges on registered securities exchanges, takes the position that any operative institution that has legitimately evolved through the years must continually demonstrate anew its positive social desirability in order to be permitted to continue. Ours is not a social order which operates by permissive grace. Our traditions are rooted in the belief that, unless some positive and demonstrable harm can be shown to flow from a particular activity, with such harm outweighing the beneficial results, such activity shall be immune from regulation and restriction. Such would seem to be the case with floor trading. I am not prepared to argue that it contributes substantially to the health of the national economy. However, there is no positive harm done by this institution, and it should not be singled out in such discriminatory fashion.

Mr. Chairman and members of the committee, a proper respect for the time of this committee does not permit me to attempt a lengthy summary at this point. I would like to express my appreciation for your courtesy and for the privilege of having been able to thus address you and to file with you a somewhat longer written version of my views on the vital subject matter of your deliberations. Thank you.

Mr. BURNSIDE. Thank you very much, Mr. Chairman, for this opportunity.

Mr. HARRIS. We are glad to have your statement, Mr. Burnside, which will be analyzed and studied and given consideration with this problem.

I am advised that Mr. Henry C. Schmidt wishes to appear. Will you come around, Mr. Schmidt?

Mr. Schmidt, will you identify yourself for the record?

STATEMENT OF HENRY C. SCHMIDT, COLLINGSWOOD, N.J.

Mr. SCHMIDT. Yes; my name is Henry C. Schmidt. I am a stock broker, registered with the Securities and Exchange Commission.

Mr. HARRIS. Will you give your address?

Mr. SCHMIDT. Yes; my address is 618 Park Avenue, Collingswood, N.J.

Mr. HARRIS. I understand you have a statement which you wish to file with the committee.

Mr. SCHMIDT. Yes, I have.

Mr. HARRIS. The committee will receive it. It has not had an opportunity to go over it to determine whether it should be received for the file or for the record.

Mr. SCHMIDT. I have gone over this act and the various ratios and I have worked them out. I have found that many of these do not actually work out when put into figures, worked out especially with the total assets and the number of stockholders of record, et cetera, does not work out to positive figures, that they are completely meaningless.

Mr. HARRIS. Thank you for your appearance.

Mr. SCHMIDT. Thank you, Mr. Chairman.

Mr. HARRIS. Mr. Robinson, would it be agreeable, then, to reschedule your appearance at a later date?

Mr. ROBINSON. It will be perfectly agreeable, Mr. Chairman. I will suit the convenience of the chairman and the committee.

Mr. HARRIS. We will let you know.

This concludes all of the other witnesses who were scheduled to testify today.

There are a number of people who wish to testify regarding this problem and who have asked for an opportunity at a later period.

The Chair is going to schedule another week of hearings on this early in January. I am making this announcement at this time to put everybody on notice that we are going to have 1 more week's hearings, giving those who could not be ready, or at least said they could not be ready at this time, an opportunity to present such information as they desire to the committee.

Following that 1-week schedule, which will either be the second or third week in January, we are going to conclude the hearings and move on to the consideration of this legislation. So an announcement will be made at the proper time depending on the program of the new session as to when it will convene.

The committee will adjourn, then, until further announcement.

(Whereupon, at 12:20 p.m., the subcommittee adjourned, subject to the call of the Chair.)

INVESTOR PROTECTION

TUESDAY, JANUARY 21, 1964

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE OF THE
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to call, in room 1334, Longworth Building, Hon. Harley O. Staggers (chairman of the subcommittee) presiding.

Mr. STAGGERS. The committee will come to order and we will continue our hearings on the bills 6793 and 6789. We will have as our first witness this morning Mr. Lawrence H. Taylor, chairman of the National Stock Exchange.

Mr. Taylor, will you take the chair, please? Give your name, and affiliation, and your address, if you would please, and start right in with your presentation. We are glad to have you with us.

STATEMENT OF LAWRENCE H. TAYLOR, CHAIRMAN OF THE NATIONAL STOCK EXCHANGE

Mr. TAYLOR. Thank you, Mr. Chairman. My name is Lawrence Taylor and I am from New York City, 6 Harrison Street, care of the National Stock Exchange. I brought with me a copy of the prepared statement that I sent to your committee a few days ago.

I want to thank you for your courtesy and interest in having me come before you. With respect to the extension of 1934 act reporting provisions to unlisted companies as presently recommended, I wholly concur with the extension, but believe that the threshold may be too high and that it could well be made to apply to companies with over 400 stockholders and $400,000 net worth to include more of the smaller companies especially needing to report.

The public should be encouraged to support small industry through protective legislative which provides active current information for stockholders through the year to enable them to better gage their proportionate continuing interest to sell, hold, or buy more; thus all companies being made to report equally, none could find economic advantage by a secrecy policy.

Companies of this size should have financial statements (10–K and 9–K) at least twice a year, and one of these should be verified by an outside independent accounting firm. If any event of importance (8–K), good or bad, occurs during the year, the stockholders should be informed.

The insiders should report their trading in corporate stock and not be allowed to take short-term profits to the disadvantage of other less

well informed stockholders. Certainly, too, the stockholders are entitled to know the main subjects for vote at the annual or other special meetings and the essential facts through proper proxy statements.

Other testimony notwithstanding, such reporting and auditing, when done in conjunction with other corporate work, represents a very, very, minor annual expense, though many company managements, wishing to avoid such further disclosure to stockholders, may, almost to a man in nonreporting companies, be expected to describe such projected costs possibly as extreme.

If big businesses, which are much more stable, need good audit control, then it is imperative for small companies to have good accounting with perhaps less executive staff and at a more volatile point in their existence. The small companies are far more likely to run into trouble for lack of proper figures than because this reporting expense is preventing their staying in the profit column. It is just when a small company has trouble turning a profit that good and frequent figures can be of the most help in locating and stopping excessive areas of capital drain.

Certainly public disclosure, beyond the obvious dictates of sound business procedure and the evidence of management's good moral intention to keep their public partners informed, serves the public stockholders especially well as a most effective deterrent to any possible chicanery that might tempt some management group in a given situation which might not otherwise be revealed when no detailed reporting is required.

If the public knew that the smaller companies were required to keep better records and to keep stockholders informed, there should be proportionately more investment interest in these companies and a consequent facilitation of the problem of these companies in continuing to find new capital for growth without going the present merger and acquisition route so popular today, since the new issue market for small companies ground to a halt in May of 1962. There are many fine small companies with excellent records and almost no public support today.

It is important to note here that, when the May 1962 break occurred, the profits and/or capital invested in the smaller companies was, to a significant extent, taken out of this small company market to protect the blue chip shares. Thus, the over-the-counter market was really a safety cushion for the blue chip stocks.

When the next big market break occurs, which is usually after a period of new highs and unwarranted price earnings ratios, the low price stock cushion is presently quite deflated and such another sharp crack in the blue chip prices could this time have far more serious consequences than the last 1962 break without the secondary market cushion.

Basically, what I am saying is that the public investment dollar is unwisely too concentrated in too limited a number of blue chip stocks because the investment arteries of this country have grown up to feed certain major markets at the neglect of others and because the smaller companies do not presently publicly offer, as a group, the same information and markets as the blue chips. The smaller companies require thoughtful attention here because they alone can pro-

vide the only means for broadening the national investment base and thus limiting the potential damage of future blue chip market breaks.

On this point, we have in the last decade developed a new investment pattern with hundreds of millions monthly flowing into the market from mutuals, union pension plans, retirement funds, et cetera. This makes for a dynamically unstable market, if such funds are too concentrated, because these fixed investment patterns cause unrealistic highs, in blue chips especially, not based on earnings or growth.

When such buying at some overdue point may be channeled elsewhere, there is a sudden vacuum on the support side of the market and a rush or need to conserve capital, and/or profits in a declining market. An ideal and dangerous built-in cyclical device based on too limited a national investment base.

Substantial amounts of investment funds—estates of minors, certain trusts, reserve funds, et cetera—in this country may not, by various State laws or by long-established investment policy, be invested in other-than-listed securities.

This, therefore, continues to channel such large and regular funds into certain blue chip stocks listed on major exchanges where the investment arteries lead from every smallest town in any part of the country at the end of one or another news and/or ticker wire system.

Thus, the "listed" security market should be broadened in the national interest by bringing possibly several thousand of the stronger but smaller companies into exchanges throughout the country where the public might then enjoy the benefits of a public auction market and where the best bid and offer from any point in the country could be shown to the investing customer interested in one or more of the sound but smaller companies.

As a matter of background here, the only reason that our national investment base, in my opinion, is so dangerously narrow is that the architects of the basic Securities and Exchange legislation, in their efforts to control stock speculation after the 1929 break, introduced the present 12–B rule into the 1934 act to prevent the exchanges at that time from taking any additional companies onto their trading list without causing that company to make its essential affairs public. There was no intention to create the over-the-counter market or preserve it.

This single rule then created the sprawling tumult of today's over-the-counter market with its vices and vicissitudes so sharply delineated in the special Securities and Exchange Commission report on unregulated trading in unlisted securities in an unreported market, requiring no corporate disclosure, and where the trading is by secret negotiation and the broker and/or dealer wears two hats alternately where, by definition, it is to his best, and the customer's worst—within limits—advantage.

In the over-the-counter market, the broker is theoretically the customer's champion, getting the best price possible for the customer and earning his commission for his loyalty and service. As the dealer, in contrast, however, he must trade for a profit wherever and whenever possible, and naturally for the best profit possible—using inside and outside market prices—with the other party, the customer providing this profit.

In no other business I know of will businessmen tolerate a broker who is a dealer at will; they want a broker who is loyal all the time

as a broker, or a dealer who is willing to trade as a dealer, but they do want to know where they stand all the time and to trade at the inside market price at all times.

Where people's security and perhaps their life's savings may be at stake, guarded so carefully by various laws through regulation of insurance companies, trusts, savings and loan associations, et cetera, it is odd that we placidly countenance a double-standard security market both in the securities themselves and in the trading of these securities.

This is why we so urgently need the contemplated extension of the 1934 act disclosure provisions and we equally need to open the registered national securities exchanges to the many companies whose securities under these new reporting provisions might then be more equably represented to the public through the medium of a Securities and Exchange Commission supervised public auction market as conducted on a registered national securities exchange.

Each segment of the security industry must naturally protect itself and its revenues to the best of its ability; therefore, the repeal of the 12–B rule as discussed before the companies of their choice without restriction, the volume of exchange dealings might then be expected to increase sharply unless the over-the-counter dealers could themselves offer better or equal markets compared with the exchanges. There are already large over-the-counter markets in listed securities where volume and dealer interest is warranted but the exchange markets set prices.

The section of the present bill proposing the repeal of 12(F)(3) would protect the special privilege of the over-the counter market in allowing them to make markets without control of any kind in any company and then by preventing registered exchanges from doing the same by listing and making an exchange market in any companies of their choice though such companies might be required in all other ways to meet the reporting requirements of the 1934 act. Thus, if an exchange wishes to list a qualified company, it might not do so without the company's permission.

Many companies may be strongly influenced in such matters by their underwriter's representative on the board. Certainly, over-the-counter dealers do not naturally wish to surrender their more profitable trading stocks, in which they may make markets, to any exchange where their earnings thus may be proportionately reduced, all matters of public interest or service notwithstanding.

The same volume of trading on an exchange with a close market, published prices, etcetera, does not usually generate the same net revenue for the broker as if the customers' orders were filled by a broker-dealer over-the-counter in a private negotiation market, with widespread prices and no public figures.

In the public interest, therefore, it is recommended that 12(F)(3) be amended instead of repealed to permit registered national securities exchanges to apply for trading privileges in domestic unlisted securities when the number of shares public, number of stockholders, and net worth meet the minimum reporting requirements for this contemplated 1934 act extension, and when the company shall meet the other indexes required for listing on that particular exchange.

Foreign company shares or ADR's, American depository receipts,

should be exempted from any change in 12(F)(3) as they are when listed companies, now already exempt from the 1934 act proxy, insider, and standard financial reporting provisions and are clearly better traded with exchange supervision than without such supervision and control.

The Securities and Exchange Commission here has the power presently, through its power to regulate exchange affairs, to indicate what type of listing standards seem appropriate for each specific exchange and thus prevent abuse of any privileges extended to exchanges in the present act. This is not the time to curtail the role of exchanges and their police efforts in the securities industry in terms of their record to date under the 1934 act versus the over-the-counter market and its record.

Certainly in terms of Government economy alone far greater supervision can be given for the same budget on exchange trading with detailed records of every trade and the exchange giving close supervision under Securities and Exchange Commission control than the unreported, unrecorded private negotiation over-the-counter market.

The position of the major exchanges in any question of broadening the national investment base, for selfish reasons alone, cannot readily be supposed to be one that would encourage the over-the-counter broker-dealers to move onto the secondary exchanges following the better over-the-counter companies as their stocks would become exchange-traded stocks rather than over-the-counter stocks. Competition, however small at first, is never welcome, especially if the growth potential is dynamic.

The major over-the-counter firms collaterally should find the comparative freedom and better markup of their present operations more attractive than doing the same volume of business on an exchange; otherwise, they might have joined an exchange by now.

Thus, we find a highly compatible viewpoint logical between the major segments of the present security industry: the exchange groups preferring not to have the secondary exchanges expand to a real competitive level, and the over-the-counter group to keep its companies, privileges and profits as it.

The National Stock Exchange has a special position in this proposed bill by virtue of the fact that its role is not to make secondary regional marekts in the major exchange issues, either on local odd lots or after-hours trading, and bases its growing trading volume on original or primary listings because it is located in New York City and cannot, therefore, make effective secondary markets in such close competition to the major exchanges figuratively down the street. They too do not trade each other's listings for practical reasons.

It will be apparent to this committee that while the extension of the 1934 act reporting provisions may be of immense value to the National in its program of new listings that the repeal of the 12(B) rule would change the character of the National almost completely from a small growing exchange to a large active market for hundreds of hitherto unlisted securities.

As the first new exchange in the history of the Securities and Exchange Commission in nearly a third of a century, the National, at its outset, realized that possibly one of the prime reasons for the

exchange population of the United States being frozen for all these years was that the 12(B) rule had fenced in what was almost a private preserve for exchanges and created such a valuable outside market that the economic forces might well be so strong as to perpetuate this double standard security system, however illogical it might, over the years, appear to become.

The belief that exchange trading must again grow with the thousands of new, young, strong companies coming into being each decade was what carried the National forward in its effort to find its place in the security industry though for a time perhaps wedged between the giants of the industry.

As the major exchanges have increased their listing requirement minimums, naturally the horizons of the National have expanded and certainly it does seem the place here to say that it would seem illogical indeed that Congress would now turn its powers to the restriction of exchange markets in favor of the over-the-counter system, especially when such a fine and clear exposition of exchange versus over-the-counter trading has just been completed by the Securities and Exchange Commission with such sweeping changes implied in over-the-counter practices to bring these markets to the level of exchange practice. At least that is my opinion.

It seems wise and fair to allow the process of free competition in markets to bring about the desired improvement in security trading service offered to the U.S. public.

The 12(F)(3) amendments as recommended above are, therefore, urgently called to the attention of this committee though I well realize that our recommendations may have to stand largely upon the force of logic and long-range public welfare rather than upon numerical support, as the major exchanges cannot reasonably support our viewpoint; nor can their satellite exchanges, so dependent for business upon their major markets and firms, be also prudently expected to join our viewpoint.

For obvious reasons, the over-the-counter spokesmen cannot wisely support our recommendations. Our only area of support might well be public if we were rich enough, and adept enough to bring this complex issue clearly before the public and provide a means for them to voice their plea in their own behalf.

You gentlemen, as impartial public representatives of good will, are the closest we can come to placing our recommendations and case before the U.S. investor who has so much to gain or lose by your decision, which may also have such far-reaching effects creating regional capital markets, and in providing full growth opportunity to the industries now struggling for growth and capital in every corner of the land.

Last, but not least, your interest to broaden the capital investment base of the United States, through bringing more smaller companies' securities into the sun, can do much to place our economy on a sounder basis and to protect us from the incalculable losses of unwarranted inflation and depression cycles encouraged by a too-restricted investment capital market.

Thank you.

Mr. STAGGERS. Thank you very much, Mr. Taylor. You represent the National Stock Exchange?

Mr. TAYLOR. Yes, sir.

Mr. STAGGERS. Is that carried in the papers' listings across the country?

Mr. TAYLOR. Yes, it is carried by the Associated Press and by United Press, most of the wire services, and it is run by various papers. There is of course no consistent policy by which papers may carry them or not carry them, but it is carried by a good number of papers throughout the country.

Mr. STAGGERS. Does the Washington Post or Evening Star carry the quotations?

Mr. TAYLOR. I believe they have carried them. Whether they do at the moment I couldn't say. The financial section, as you are aware, sir, has a tendency somewhat to vary with the amount of advertising that is done of a financial nature.

Mr. STAGGERS. How many stocks do you have listed on your exchange?

Mr. TAYLOR. We have 12 now.

Mr. STAGGERS. I believe the essence of your testimony is to lower, as you say, the threshold of coverage.

Mr. TAYLOR. Yes, sir; that is correct; to bring in the smaller companies that have less than a million in assets.

Mr. STAGGERS. Would you compare that with the proposals made here?

Mr. TAYLOR. I feel that all that is proposed is excellent with regard to extension of the 1934 act requirements. I think the threshold should be lowered to include more companies and smaller companies, because I think it would bring all of these people to the universal auditing and reporting practices which I think these companies need even more than the bigger ones because their capital is more volatile. Their affairs need closer supervision and I think it would certainly be in the best interest of the public stockholders and of the companies themselves.

Mr. STAGGERS. I might say there are some who will agree with you, and some who disagree.

Mr. TAYLOR. I rather anticipated that, sir.

Mr. STAGGERS. Going just a little bit further, I notice you have a great deal to do with the over-the-counter markets in your testimony.

Mr. TAYLOR. Yes, sir; that is correct. Our listings come from the over-the-counter market. Our listings are all primary listings and the securities that we have listed and that we will list in the future will be, by and large, companies who have been traded over the counter prior to the time of coming on our exchange.

Mr. STAGGERS. I notice you talk about the insiders trading information.

Mr. TAYLOR. I think it is very desirable that this kind of information be made public on a universal basis so that there could be no difference for one firm versus another, and by the time they have $400,000 or $500,000 net worth rather than assets, I feel that this is the real key to the size of the company, not the assets.

A company can have $1 million in assets and could have $1,100,000 in liabilities and thus actually have a deficit of $100,000, but if they had $400,000 or $500,000 of net worth, I feel that that size company should start reporting if it has 400 stockholders.

Mr. STAGGERS. Some place in your testimony I heard the words "curtail exchanges" and I just don't know what you mean there. I don't know where it was, but something about curtailing exchanges.

Mr. TAYLOR. I am delighted with that question, Mr. Staggers. Actually this is the key question that I would have asked, if I could have, to have someone bring up. As you bring these companies under the 1934 act reporting provisions, you then cause them to file their annual reports and you cover their insider trading, and their proxy, and so forth. There is a section of the present 1934 act called 12(F)(3) and that 12(F)(3) as it presently exists would make it possible for us or any other registered national securities exchange to initiate unlisted trading in those securities because they would in all ways be reporting on an equivalent footing with the listed companies because the listed companies now only voluntarily sign themselves under the 1934 act.

Now this legislation would automatically put them under the 1934 act, so these additional companies would all meet, in effect, the listing standards on reporting, provided the exchanges, of course, would give supervision to a third area, that is, of morality, competence, and so forth that can't be spelled out precisely in the law.

By removing the 12(F)(3) provision it would prevent the exchanges then from the various privileges which were originally given under the 1934 act, and which are very important to them; that is, that of being able to make an exchange market in these securities, but it would, however, allow the over-the-counter people to make any market they chose, and I believe that the registered national securities exchanges should have at least the same latitude to make a market in a security as any over-the-counter firm, especially because a man could go out in some States with as little as $2,500 and open a market in a security. An exchange operating under the most careful supervision on reporting and audit control if 12(F)(3) is repealed would not be allowed to do the same thing as any over-the-counter firm. It would seem to be only wise and fair that, if any small over-the-counter firm would have certain privileges to make markets, that these same privileges not be withdrawn from the exchanges. I think there are many that will say that the public auction market of exchanges with published prices and exchange supervision provides a much better public market that is offered over the counter by telephone without any record of transactions.

That is the crux of my remarks. I believe that that 12(F)(3) should be amended so that the exchange would be able to apply to the SEC or notify the SEC, saying, "subject to your approval, we would like to initiate trading in the stock of XYZ and company," which is now under the 1934 act reporting provisions so that the public information that it sends out is equivalent in all ways to a listed company.

I think that any exchange should have the privilege of making a market in the securities of its selection. I have researched this particular aspect, and 12(B) and the 12(F)(3) in terms of interviewing the architects of the original legislation and this is largely what they had in mind. They didn't envision that a monster over-the-counter market would grow out of the 12(B) rule. They had no idea that this would be the result of it. There is much legislation that has been

passed, I am sure, where the result has been nothing like what the intended result should be.

In this case the possible closing of the door to exchanges at this point in their making exchange markets in selected securities I don't feel is consistent with the findings and the record to date.

Mr. STAGGERS. I was trying to get at what your theory was, but I will forgo that right now and come back possibly later.

Mr. Long?

Mr. LONG. Mr. Taylor, you give us a little of the background of the formation of the National Stock Exchange and the economic factors that brought it into existence. I think that you might give us a little more of your thinking on this.

Mr. TAYLOR. Yes. The National Stock Exchange had its inception, or conception, in 1958, in May 1958. I advanced the idea to the directors of the New York Mercantile Exchange and a survey was undertaken, and the reasoning behind bringing the National Stock Exchange into being was that we had a burgeoning securities industry.

We had more companies going public. We had more stockholders numerically. We had more trading. We had more shares public. The whole industry was in a period of dynamic expansion and our exchange facilities had not changed literally since the 1920's, and we felt that the existing exchange facilities were not going to be wholly adequate for this tremendous number of thousands of companies in the future, and that, as the bigger exchanges began to fill, there would be need for additional national exchange facilities to take care of the additional companies as they came along, the smaller companies and the newer companies, because the big exchanges would raise their minimum listing requirements, for very obvious reasons.

They found that it was desirable and necessary to do so, and we have the less speculative exposure on our exchange by virtue of the fact that we don't have 7,000 tickers or 4,000 of them. We have less speculative leverage. We therefore could trade a smaller company with the same degree of safety that a larger exchange would have to have for a larger company. The surveys that we made and the studies that we did on the subject led us to the conclusion that there was a market to be served and that if we went about it earnestly and sturdily we might be successful in creating it.

So far, we have opened the National, and we are growing. We have grown 50 percent since we have opened or maybe better. Statistics of course are always misleading, but we are a growing exchange and we have a lot of good people and trained people and we hope that our growth will be geometric rather than arithmetic from here on out.

Mr. LONG. How many companies do you have listed on the exchange?

Mr. TAYLOR. We now have 12. We had eight when we opened.

Mr. LONG. What is the size of those companies in, say, annual dollar volume?

Mr. TAYLOR. I would rather give you the net worth figures from memory, but I would say that they probably run from half a million to 6 million with maybe an average size company in the million dollar net worth area probably, in that general area.

Mr. LONG. You would hope if the appropriate changes were made in these rules and regulations that your exchange, being typical of

these in being and also those being started, could list a substantial number of companies of a comparable size within a relatively short period of time?

Mr. TAYLOR. Yes, sir. If I may qualify that word "list," the 12(B) rule says that you may not list a security of a company unless they apply for listing. The 12(F)(3) rule or section says that you may trade the shares of a company of your selection on an exchange, on an unlisted basis the same as, for instance, you have seen on the American Stock Exchange unlisted trading; provided that company meets all the requirements of the 1934 act.

You are now about to extend the protection of the 1934 act to a much broader group of companies and if you do not repeal the 12(F)(3) provision we will then be able to make exchange markets in these companies of our selection and at our option.

Mr. LONG. Could you give in concise terms the result of the survey and study that you have made on the application of the rules and how it came to create the large over-the-counter market which you say was not, in your opinion, their intention at the time.

Be as specific as you can as to how this rule came about.

Mr. TAYLOR. Yes. The 12(B) rule, if we look just at the simple wording of it, says that an exchange may not list a security unless that company voluntarily registers itself under the 1934 act and meets obviously the reporting requirements and thus also meets most of the exchange requirements.

This 12(B) rule therefore prevented the exchanges for the first time in history from taking the securities of any good growing company and creating a market for them on an exchange.

Mr. LONG. This goes back to the use that I made of the word "list" in the first question I asked you?

Mr. TAYLOR. Yes, sir. That is correct.

Mr. LONG. If in the act they had said rather than list, or in the regulations they had said rather than list, say, the words "trade in" then the result would have been completely different, as you see it?

Mr. TAYLOR. Well, there is another provision. You can't just list a company and then trade it because of 12(B) and you also can't trade it unlisted on an exchange under 12(F)(3) under the present 1934 act, unless it meets the 1934 act reporting requirements, which means that the companies are completely free of any exchange trading possibility and that no exchange may step in and make a market in their securities, unless they so choose. This is the way in which the over-the-counter market came into existence, because any company is completely at liberty to avoid reporting and exchange markets, if it doesn't sign itself under the 1934 act. If it doesn't choose, as an unlisted company, to meet the reporting requirements of the 1934 act it may then do whatever it chooses in the over-the-counter market free of exchange supervision and the officers can have insider trading without public knowledge and the company may be free of proxy rules.

The companies don't have to put out audited reports. They don't have to put out 6-month figures. They have complete latitude, so again, and this is just a personal opinion and I will not make it as professional, I think that the very vicissitudes that had plagued the exchanges in the 1929 boom had a tendency to be recreated in the over-the-counter market and I think that at the time that we created the 1933

and 1934 acts we felt that the exchanges were the only place that this type of trading latitude would occur; so we tried to get very firm control of the exchanges, which we did, but never realized of course that the very vicissitudes which we had thought to control on the exchanges would simply move outside of the exchanges to a new free market and set up shop on the telephone, as the over-the-counter market is conducted today.

Mr. LONG. It killed it in one place and created it in another.

Mr. TAYLOR. Yes, sir; and it rests on that one rule just as sharply as you might balance a bridge on a diamond. That one rule, if it were shot out from underneath the over-the-counter market, would change the entire security industry almost overnight and would put it in far better position for real public service, in my opinion, would put the industry under a much more economical form of Government supervision and a much more effective one.

Mr. LONG. One other question. In your paragraph number 18 you speak of the fact that:

> There are already large over-the-counter markets in listed securities where volume and dealer interest is warranted but the exchange markets set prices.

What are the economic facts that cause this? I have noted over the years how over-the-counter houses do a great deal of trading in certain listed stocks, and I assume that is what you are referring to there.

Mr. TAYLOR. Yes, sir.

Mr. LONG. How does this come about? What causes this?

Mr. TAYLOR. This is a very interestingly expanding trend for large blocks and small blocks to be traded this way and a tremendous volume of trading of listed securities of major companies is being now done over the counter and it is done without the restrictions on trading practice or commission and there is a great deal of latitude there. This is the unsupervised area of our securities industry if you want to trade net or you want to trade one way or another, this is one of the reasons it is growing so tremendously. You can step up and they will take 10, 20, or 30,000 shares of a very well-known stock, but usually it is trade against the last exchange price because the exchange price is, in effect, the national price. It is the price which is showing all over the country, so this is the most acceptable price.

If you were to trade it at any other price you wouldn't be personally happy with the fact that you had received approximately whatever the market was, as you would want to know the exact price, that is, the exchange price.

As you get the less active major issues you will find that the over-the-counter market varies materially. In other words, you go from the "blue chip" market which is right within a very small tick of the big board prices until you get way down to the smaller issues and the less active issues where the compatibility between the over-the-counter price at any given instant and the exchange market price becomes proportionately less until finally these prices may bear almost no relationship because the spread between bid and asked is so wide.

Mr. LONG. Thank you, very much.

Mr. STAGGERS. Mr. Glenn?

Mr. GLENN. I have no questions, Mr. Chairman.

Mr. STAGGERS. Mr. Keith?

Mr. KEITH. Thank you, Mr. Chairman. How many employees do you have full time with the National Stock Exchange?

Mr. TAYLOR. In the National Stock Exchange, Mr. Keith, if I may put a little different phraseology in my answer to the direct question you asked me, we share employees with the New York Mercantile Exchange, so we have a vice president who is in charge of member firms and member lists who had a similar responsibility with the New York Stock Exchange, and we have a vice president in charge of clearing and trading who was formerly a senior auditor and supervising accountant for Ernst & Ernst, and we have a floor supervisor who was formerly of the floor trading department of the New York Stock Exchange.

Then we have board boys, and clerical help, and secretaries, and so forth. Probably on a busy day we might have six or eight working on our affairs. On a quiet day the same number wouldn't be helping as on a busy day.

Mr. KEITH. Let me put it in a different way. What is your total operating budget?

Mr. TAYLOR. Our total operating budget would be difficult to give you from memory, accurate figures on that, for the reason that our budget is involved with the Mercantile Exchange which is our sponsor.

For instance, we pay no rent, so again if I give you our budget it is less the rent figure, and less the heat figure, and less the light figure and so forth. This is part of a combined budget that both exchanges have.

Mr. KEITH. Roughly what is the cost of your operation?

Mr. TAYLOR. Well, I would say that salarywise we are probably running less than $50,000 a year for our total operating expenses. Of course, again, we have revenue that comes in as well as expenditures which are made.

Mr. KEITH. Thank you, Mr. Chairman.

Mr. STAGGERS. Mr. Curtin?

Mr. CURTIN. Thank you, Mr. Chairman. Mr. Taylor, I have just listened to your statement with great interest and it seems that you have confined your statement to a rather limited section of this proposed legislation.

How do you feel about the legislation as a whole? Are you generally in favor of these proposed bills, or are you opposed to them?

Mr. TAYLOR. I am very much in favor of them. I feel that this is a constructive, worthwhile approach to extend the reporting provisions of the 1934 act. I think it is something that could have been done 10 years ago very beneficially or 5 years ago or this week. I think it is very desirable. My area of true concern is that at the same time that we take such a great step forward in bringing these companies into a reporting position because they have the public's money, I think we shouldn't close the door to an exchange market in these securities.

I don't think we should do so. I feel that an exchange market is a public auction market. It is a desirable form of market, and I don't feel that any over-the-counter dealer wherever he may be, with whatever degree of State, Federal, or other supervision should be in the position where he can go out and make the market any way he wants to, but where there is a registered national securities exchange under the control of the Government with statistical information that they are enjoined from doing so.

I don't feel that this is fair to the exchanges, and I feel that it is particularly important to the National as well as to the other exchanges because of the fact that we are dealing in prime listings.

Our listings are our listings alone. We may share one occasionally. The other exchanges throughout the country do a great deal of their business as an overflow from the major exchanges. We don't do any overflow business. We don't do odd lots locally. We don't do after-hours business locally.

We are a prime exchange doing our own business, on our own listings, and endeavoring to grow with the size companies that we feel we can serve best, and as you put these companies under this reporting provision I feel that we should have the same opportunity to trade these freely that any over-the-counter man may have who has $500 in the bank and the will to render a service.

Mr. CURTIN. Have you any reservations as to any provisions of this proposed legislation?

Mr. TAYLOR. The earlier point I made. I would like to see the threshold of the bill lowered and I believe that it would be wise if the term "million dollars in assets" was better defined than it is because I feel that this is something that could be subject to a considerable amount of professional discussion once the legislation is passed.

I deal a good deal with accountants and I think that some element of net worth as determined in the SX form by the SEC would be a very useful distinction.

Then we could at least go to a known tested index rather than to use a new phrase.

Mr. CURTIN. How do you and your members feel about the compulsory membership provision?

Mr. TAYLOR. I feel that more regulation has been required in the securities industry. I feel that every time we have had regulations in the securities industry it has increased the public's confidence to to invest in securities and I feel that the growth of this country is very strongly dependent upon the small companies, the medium-sized companies, being able to get capital.

I see a great many of them. My area is small companies. I probably see $100 or $200 million a year worth of small companies and they are all fighting a capital battle.

Anything that will give them greater standing will enable that company to grow where it is. In other words, that company may be in Bangor, Maine, it may be in Nashville, Tenn. It is away from the capital market and it is difficult for that man there to go out and get the capital that he wants and everything that is done to upgrade that company in terms of the public acceptance, such as putting it under the 1934 act and doing all these things, which are very nominal in cost, will make the public thereafter able to put more of its money in the secondary market and thus accomplish what I set forth here in broadening the investment base in this country, which I feel is dangerously narrow because of the channels and the arteries that are now set up for investment money, and in the direction of our fixed investment dollar so many million dollars a day into the blue chip market every day. This fixed investment fund plan is a new element in the industry and I think that money should be spread over a broader base and I think that this legislation that you are considering will do so.

Mr. CURTIN. Does that mean that you are in favor or against the compulsory membership?

Mr. TAYLOR. I am in favor of the compulsory membership, sir.

Mr. CURTIN. That is all, Mr. Chairman. Thank you.

Mr. STAGGERS. Thank you, Mr. Taylor, for your remarks.

Mr. TAYLOR. Thank you, Mr. Staggers, and thank you, gentlemen.

Mr. STAGGERS. Our next witness will be Mr. Arthur V. Toupin, general counsel, Insurance Securities, Inc., San Francisco, Calif.

Will you take the chair and give your name, and your connection, and your address please?

STATEMENT OF ARTHUR V. TOUPIN, GENERAL COUNSEL, INSURANCE SECURITIES, INC., SAN FRANCISCO, CALIF.

Mr. TOUPIN. Thank you, Mr. Chairman and members of the committee. My name is Arthur V. Toupin. I am an attorney, a member of the bar in the State of California, and general counsel for Insurance Securities, Inc., located at 100 California Street, San Francisco.

I am delighted to come to this beautiful Washington weather. It was raining cats and dogs when I left San Francisco.

Insurance Securities, Inc., which I am going to call ISI for convenience, is a California corporation organized in 1938 with its principal offices, as I mentioned, in San Francisco. The principal business of ISI is the management, administration, and underwriting of an open-end investment company called Insurance Securities Trust Fund, which I will call the trust fund.

As principal underwriter, ISI is the sole distributor of investors' participation in the trust fund. ISI is registered with the Securities and Exchange Commission as a broker-dealer under the Securities Exchange Act of 1934. In its selling activities as principal underwriter, ISI currently maintains a force of 670 sales representatives, almost all of whom are full-time representatives. All of these sales representatives are licensed under the Corporate Securities Act of the State of California with the California commissioner of corporations.

The trust fund, organized in 1938, is an open-end investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940. Because of this, both the trust fund and ISI are subject to the detailed regulations called for by the 1940 act. The trust fund is also sold under a permit from the California commissioner of corporations. The trust fund is currently either the fourth or fifth largest open-end investment company in the United States and is the largest fund in the United States which specializes in the securities of a single industry.

The trust fund portfolio is invested completely in life, fire, and casualty insurance company stocks. The net asset value of the trust fund as of January 14, 1964, was in excess of $1.2 billion. There are currently more than 228,000 outstanding trust fund accounts. The trust fund and ISI operate exclusively in the State of California.

Those of us who have worked with the trust fund and ISI are proud of the success both have had and of the fact that we have untold thousands of investors who tell us they are pleased with their investment.

I want to relate my remarks to only a few sections of the Securities Acts Amendments of 1963 represented by bills now being considered by your subcommittee—S. 1642, H.R. 6789, and H.R. 6793, and for convenience I will make reference to the section numbers in S. 1642.

Principally my comments will be directed toward section 6(a) of S. 1642 which would amend section 15(a) of the Exchange Act to compel a broker or dealer such as ISI to become a member of a national securities association or, in the alternative, to go out of business.

Although, as I mentioned, ISI is registered with the Commission as a broker-dealer and, I may add, is registered as a broker under the Corporate Securities Act of the State of California, it has never chosen to become a member of the National Association of Securities Dealers.

Because of the nature of ISI's business, there has never been any economic inducement for the company to become a member of NASD, and we have exercised our right under the law not to be a member.

Not being a member of NASD, however, did not relieve ISI from regulation, because as I mentioned, our selling activities are already regulated by the Commission under the Exchange Act and the Investment Company Act of 1940 and by the California commissioner of corporations under the State's Corporate Securities Act.

However, if one of these bills should become law, we, along with some estimated 200 other brokers and dealers, will be compelled to join the NASD or some newly created national securities association. It is to this kind of legislative compulsion that we are strongly opposed.

Section 15A of the Securities Exchange Act of 1934 as it would be amended by this bill would give to a national securities association immense power over its members. Under section 7(a)(5) of the bill, the association would have the power to determine the standards required for membership and to refuse membership to anyone who did not meet those standards.

Under section 7(a) (2) and (4) of the bill, the association would be authorized to expel an existing member. Since the bill requires that a firm must be a member before it can engage in business, the power to deny membership and to expel from membership is obviously the power to destroy the member's business.

The association, then, is given the power to determine whether a firm shall commence or remain in business or shall close its doors—the power of business life or death. These powers are basically judicial in nature, in the sense that the association must make determinations of fact upon the basis of which it must judge a member, just as in a trial court.

In our opinion, the basic fallacy of this part of the bill is that the judges who are given the power to make these crucial decisions would, in all cases, be the competitors of the accused.

I think it is fair to say that if any individual or business firm in this country is to be subjected to judgment by any tribunal concerning its right to carry on a business, it should have the right to a disinterested and completely objective judge and jury.

The point I want to make is that this bill makes it absolutely impossible to hold the necessary hearing involving the right of a firm to do business before an impartial tribunal.

This is so, in my opinion, even though section 7(a)(5) of the bill provides the ordinary safeguards for a regulatory hearing and section 7(a)(6) provides for review by the Commission. No securities association could ever be equipped to assign disinterested persons to the task of hearing a charge made against one of its members for the simple reason that every member of the association represents a competitor of the accused.

As an illustration, if you gentlemen were the stockholders of a manufacturing company and had an important legal matter in a court presided over by a judge who, as a sideline, also manufactures a competing line of products, you would probably expect the judge to disqualify himself from your case, and if he did not, you undoubtedly would direct your counsel to seek to have him disqualified under judicial procedures. Why? Because, no matter how honorable the judge, you would not wish to take the chance that his self-interest in the case might overcome his good judgment. But there would be no such solution available to the member firm subject to association disciplinary action, because the only persons qualified to hear his case under this bill would be his competitors.

The concept that a so-called self-regulatory association composed exclusively of people who compete with one another can be set up as a tribunal to judge the right of members to commence or continue in business has few, if any precedents in American business life and certainly none in our judicial system.

It is not enough to say that an association is not a court of law, because the association would be making decisions under this bill of greater importance than many courts ever make. It is not enough to say that there is a right of appeal to the Commission. In the illustration I just gave you, you as stockholders of the manufacturing company would not be satisfied with your competitor as trial judge, even though you knew the appellate court panel contained no competitors.

Congress probably would not even seriously consider a bill which would compel membership in an association of manufacturers of automobiles composed, let us say, of Chrysler, General Motors, Ford Motor Co., and others, and which would give that association the power to determine, for instance, whether Chrysler could continue to manufacture Plymouths. Yet I think this illustrates precisely what this bill does. I believe one of the reasons that this compulsory feature of the bill has not been more widely discussed before is that the NASD has been in existence for a long, long time on a voluntary basis, and it is an easy, painless jump for the voluntary members to a compulsory association. But that doesn't alter what we consider to be the basic fallacy of the bill.

Under the existing Exchange Act, membership is voluntary and I can see nothing wrong in a broker or dealer voluntarily subjecting himself to judgment by his competitors. Under the existing law he can always withdraw from the association without being forced to go out of business. But so far as I know there is no precedent in the American tradition for compelling a businessman to subject the details of his business life to a tribunal composed entirely of self-interested competitors.

I recognize that some of these points have been made by others before this committee who have pointed out that the U.S. Supreme Court has on more than one occasion held that similar compulsory membership statutes are unconstitutional.

Although I agree with those who have stated that the proposed broad delegation of power to a semiprivate group is unconstitutional, what I am making here is not the constitutional argument. Rather, I would urge upon the Congress the basic principle that any law which it passes must assure fair play for those it regulates.

We believe there is at least one other basic fallacy involved in the concept of compelling membership in a national securities association. If section 6(a) of this bill becomes law, every broker and dealer may, from time to time, have to divulge, through the association, the details of his business operations to his competitors.

One of the time-honored concepts of competitive enterprise has been that any person who develops a superior method for conducting his business need not share his knowledge with competitors. This right to the exclusive use of your own trade practices has been one of the great incentives toward achieving excellence in American business.

Members of the association, being competitors, can be expected to act like competitors. And how are competitor-members likely to react to a member firm which is a front runner in their business? Is there not a real probability that competitive instincts would operate to use the power of the association to learn and use the front runner's methods? Or, in the alternative, to cut the front runner down to size?

If competitors act like competitors as members of an association, section 6(a) can operate as a serious impediment to and restraint of trade. Rather than promote free and open competition, enactment of section 6(a) will tend to standardize the operations of members and force them into the same mold. Instead of deterring combinations in restraint of trade, it would create such a combination with enormous authority to exact strict standardization of trade practices.

Even if there were no basic fallacies, problems or inequities involved in compulsory membership, there still would remain the question whether it has been demonstrated that by compelling a mutual fund selling organization to join an association we will thereby improve its sales practices. Has it been shown that firms distributing mutual funds who are members of the NASD maintain higher sales standards than nonmembers?

Before enacting section 6(a) would it not be reasonable to require a showing that firms which are members of NASD have a better record of performance than those who are regulated only by the Commission and the State securities commissions?

We believe that the kind of compulsion proposed here should be adopted, if at all, only in response to a showing of great need, which we do not believe has been made.

You are aware, I know, that the Midwest Securities Commissioners Association has indicated its strong opposition to section 6(a). Their reasons for opposition are different from those I have expressed, but are, I believe, compelling.

ISI is not opposed to reasonable expansion of the powers of the Commission in this area if the need for such additional authority is clearly demonstrated.

However, we believe the compulsory membership provision of section 6(a) is a basically unsound and unfair method of regulation and should not be enacted. If additional regulatory powers are to be granted, we urge that you give them to the Commission directly, not to an association of competitors.

In the context of any discussion about the need for additional legislation, it should be borne in mind that the securities industry is today one of the most heavily regulated of all industries, and that this is particularly so in regard to sales activities in the mutual fund area.

The Commission has direct authority over mutual fund sales under three Federal acts: the Investment Company Act of 1940, Securities Exchange Act of 1934, and the Securities Act of 1933. For a firm like ISI, the only advertising that can be used, unless we wish to use the text of the trust fund prospectus—29 pages—as the copy, is what is commonly referred to as the "tombstone ad." The term "tombstone" is appropriate—so much so that many firms, including ISI, do practically no advertising. All sales literature which we use must be submitted to the Commission and to the California Commissioner of Corporations and must conform to the statement of policy of the Commission.

At all times there must be an up-to-date prospectus approved by the Commission and given to each prospective investor before he purchases. All of the reports to investors relating to the activities of the trust fund are governed by Federal statute and by the Commission's statement of policy.

Under section 15 of the Securities Exchange Act, the Commission is given broad powers over brokers and dealers, whether they are members of a national securities association or not. Among these are the powers to prescribe means to prevent fraudulent, deceptive, and manipulative acts and practices and to promulgate rules in respect to financial responsibility.

It has the power, of course, to deny or revoke the registration of any broker or dealer. In addition, each mutual fund selling organization must comply with the laws of each State in which it distributes securities. Some such selling organizations operate in each of 50 States, and must comply with the securities laws of each. The Federal and State laws in many cases overlap and duplicate one another. The cost of compliance with all of these laws is very large indeed, and ever increasing.

Within the framework of this regulatory pattern there is really not much unregulated running room left for the mutual fund sales organization. There will always be the few who violate the laws and the regulations and make the headlines. But this does not necessarily indicate the need for new laws.

It is my belief that the laws now on the books grant sufficient authority to the Commission to deter and to punish the wrongdoer. Section 6(a) merely would shift the burden of initial enforcement from the Commission to a quasi-private association.

I would like to call the committee's attention to one further section of S. 1642 which I believe deserves consideration. Section 6(b) of the bill would amend section 15(b)(2) of the Securities Exchange Act of 1934. Under section 15(b)(2) the Commission is authorized, upon a hearing, to revoke the registration of a broker or dealer, to

censure or suspend him, or to deny him registration if any person associated with the broker or dealer at any time has done or does certain specified things. The power of the Commission to revoke, suspend, censure, or deny the registration of the broker or dealer is not dependent in any way upon the culpability or even the knowledge of the broker or dealer of the act of the person associated with him.

In other words, if a representative of the broker or dealer should have acted in any one of the proscribed ways, whether before or after he became associated with the broker or dealer, the Commission would have the power to revoke the registration of the broker or dealer, even though he had no knowledge of the act complained of. It is my understanding that in cases where the broker or dealer firm is not culpable, it would not ordinarily be the practice of the Commission to invoke this section against the firm.

As a matter of fact, in the report of the Committee on Banking and Currency, U.S. Senate, to accompany S. 1642 (S. Rept. 379) at page 77, the following explanation of the amendments to section 15(b)(2) is given:

> While the literal terms of section 15(b)(2) would empower the Commission to suspend, or deny or revoke, the registration of any broker or dealer for employing a person who had committed one of these offenses prior to his employment, the committee does not contemplate that so extreme a penalty would be reasonable or appropriate in cases where the broker or dealer acted in good faith without knowledge of the employee's past misconduct. It has never been the practice of the Commission, nor would it be consistent with our traditions, to punish innocent people for the conduct of another for which they had no responsibility and of which they had no knowledge.
>
> This, of course, does not relieve the broker or dealer from the responsibility to use reasonable care in determining that persons employed by him are not one of the classes of people which the act, for the protection of investors, seeks to preclude from engaging in the sale of securities.

It is my belief that section 15(b)(2) of the act should be amended to provide that the Commission's power to censure, deny registration to, suspend, or revoke the registration of a broker or dealer firm for the act of a person associated with it be limited to those cases in which the firm has actual knowledge that the act has been committed and thereafter permits the person who committed the act to continue to be associated with the firm.

Such a clarifying amendment in the act itself, it seems to me, would be far preferable to an explanation of the meaning of the act in the committee report.

It should be noted that in the original draft of the bill in the Senate there was a similar provision permitting the NASD to deny admission or expel a member upon a finding that a person associated with the member had committed certain specified acts. This power was not limited to situations where the broker or dealer firm was culpable in or had knowledge of the act complained of.

In the Senate, this section (sec. 7(a)(2) of S. 1642, amending sec. 15A(b)(4) of the Exchange Act) was changed to limit the authority of the NASD to cases where the person committing the act, "continues to be so associated after such broker or dealer knew or in the exercise of reasonable care should have known," that the associated person committed the act.

It is submitted that the ultimate power in the Commission to revoke the registration of a broker or dealer should be limited to cases where

the firm had actual knowledge of the act complained of. If failure on the part of the broker or dealer to exercise care to discover the act complained of is to be a basis for disciplinary action against the firm, it should, in my opinion, be limited to proceedings to suspend or censure the broker or dealer.

My main reason for coming here from San Francisco today is to urge the members of this committee to eliminate the compulsory membership aspects of section 6(a).

In our opinion, passage of this section would make it impossible for Congress to assure fair, disinterested, and unbiased treatment to the brokers and dealers who would be compelled to join a national securities association. The absence of a disinterested tribunal is built into this bill, and no matter how we might try to change human nature, we will never make competitors competent to judge one another with objectivity. Congress has a long history of insisting upon procedural due process in the laws it enacts, and I feel certain this bill will not be an exception.

Thank you.

Mr. STAGGERS. Thank you very kindly, Mr. Toupin. I think you have put together a very comprehensive statement here. I have no questions at this time, but I may have some later.

Mr. Long?

Mr. LONG. No questions, Mr. Chairman.

Mr. STAGGERS. Mr. Glenn?

Mr. GLENN. Mr. Toupin, you have given us a very fine exposition of probably the shortcomings, as you say, of section 6(a), of the bill.

How do you feel about the bill in general, the other sections?

Mr. TOUPIN. I think basically the other sections are very salutary and they certainly would meet no objections from us.

Mr. GLENN. So that your sole objection than is to section 6(a) of the bill?

Mr. TOUPIN. That is correct, together with the other two points I mentioned at the end of my testimony which are primarily technical.

Mr. GLENN. Thank you very much. That is all, Mr. Chairman.

Mr. STAGGERS. Mr. Keith?

Mr. KEITH. Thank you, Mr. Chairman.

Mr. Toupin, what happens when one moves out of the State? You say in your testimony that you operate exclusively in the State of California. I know there are a great number of people from other parts of the country moving into California, but don't people occasionally purchase your securities or adopt your plans, and then move to even more temperate climates.

Mr. TOUPIN. There are people, yes, who do leave California occasionally.

Mr. KEITH. Does that mean they have to drop out of your fund?

Mr. TOUPIN. No. If they are purchased in California they can take it with them, but our sales organization operates only in California with people located there.

Mr. KEITH. Don't you have monthly payment plans?

Mr. TOUPIN. We do, yes.

Mr. KEITH. And are they not allowed to keep these up after they leave the State?

Mr. TOUPIN. Yes, we permit them to do so if they purchased them originally in the State.

Mr. KEITH. Would that not automatically put you into interstate commerce?

Mr. TOUPIN. We are under all of the laws as though we were in interstate commerce whether we are or not. As you know, the 1940 act requires all investment companies to be registered with the Commission under the act. We also are registered as a broker-dealer under the 1934 act.

Mr. KEITH. I understand that, but the point I am trying to make is that you must, because of the substantial number of clients that you serve, have a rather substantial out-of-State followup on sales.

Mr. TOUPIN. There are a lot of people who have moved out of California and have our participating agreements, that is true, and I would say we are in interstate commerce, yes.

Mr. KEITH. I am looking at my notes on your statement here and many of the questions that were raised earlier in other portions of this testimony were answered later on. I have a note here that since the bill requires that a firm must be a member before it can engage in business, the power to deny membership and to expel from membership is the power to destroy the member's business.

Is there any precedent for this in any other area that you know of?

Mr. TOUPIN. There is none that I know of, except one I think was brought up in the Senate hearings by Chairman Cary when he mentioned the integrated bar of Michigan. There are, I believe, some bar associations which operate on this principal and that goes back a hundred years or more. It is a matter of history with the bar associations, but I don't know of any business-type organizations where membership is required by law and where the association has the power to determine whether a member can remain in business. Actually, I suppose lawyers don't really compete in the same sense that business firms that are in the selling end of business compete, so there is a substantial distinction.

Mr. KEITH. Is there any danger that in such an association there might be an agreed-upon commission fee that would be chargeable to the account and in that way almost establish a uniform sales cost?

Mr. TOUPIN. I wouldn't have any fear that an association of this kind would establish uniform prices or uniform fees. The 1934 act requires that an association maintain a free and open market and prohibits an association from imposing any schedule of prices.

Mr. KEITH. Is there in your view any constitutional question involved? You didn't refer to the Constitution as such in your testimony that I can recall, but it would seem to me that this compulsion might be in violation of the Constitution. I am not an attorney. Can you in lay language discuss that?

Mr. TOUPIN. Yes. I have not brought along the citations to the cases, but I know in at least two U.S. Supreme Court decisions the Court held that similar statutes, which required compulsory membership in trade organizations and then gave those trade organizations broad powers over the members, constituted a delegation of power to an unofficial body which had to be struck down under the Constitu-

tion, the concept being that if Congress is to delegate power to regulate business life it must do so by delegating it to a regular agency of the U.S. Government and not to an agency which is composed of competitors. I know in at least one of these cases the point which I made today was also made—that when you delegate the power over the business life of a member to an association of members who have adverse interests, you can't really expect to get impartial judgment.

Of course this is really our concern, that there be a statutory framework for regulation which can assure us that we will have objective treatment. When I say us, I am talking about brokers and dealers that would be compelled to join. I have no objection, if the Congress finds a real need to pass laws relating to the standards and qualifications for entry into the business, to giving that power to the Commission, which can administer it impartially. Nor am I suggesting that competitors are not wise, discreet, or honest, but rather that there is built right into this bill the fallacy that a competitor is equipped to render judgment on his fellow competitor objectively.

Mr. KEITH. It has been my experience in similar organizations where, incidentally, membership there is not a compulsory feature to join it that the boards which are established to deal with declining discipline tend to lean over backward to protect the reputation of the profession involved and your fears are ungrounded in that respect. But there might be more impartial and more effective protection of the public interest if the Securities and Exchange Commission did have the authority in the first instance. For example, in the insurance industry occasionally associations will rally back of someone who has absconded with the accounts of a client and will encourage the State authorities to relicense this man so that he may make good on the money that he owes the company. I don't think oftentimes it is in the public interest.

I think there are two sides to that coin and I don't think you have quite as much to worry about from your competitors as you might imagine.

Mr. TOUPIN. I have observed this, too, that competitors oftentimes because they all are in the same boat might, as you suggest, lean over backward to protect their fellow competitors because, Lord only knows, maybe next year they will be in the same place.

I think this is equally bad and it points up again the difficulty of a competitor reaching an objective conclusion, which really I think is what Congress has to try to seek when it gets into legislation of this kind.

Mr. KEITH. You indicated that there was an equally disturbing aspect to it.

Mr. TOUPIN. Yes.

Mr. KEITH. You say:

> If additional regulatory powers are to be granted, we urge that you give them to the Commission directly * * *.

As you know, we are in the midst of a lot of talk about economy, and if you gave these powers to the SEC would it not be a rather expensive additional chore?

Mr. TOUPIN. I assume that it would be the requirement of setting up standards and policing standards. However, it seems to me that there could be a bill which applies only to voluntary members of a

national securities association, under which the association would undertake to act on their behalf. So long as they volunteer to do this, there presumably can be no objection.

On the other hand, for those who do not wish to be compelled to join, the Commission very well might have similar authority.

Mr. KEITH. Would they have a users tax kind of approach to this, a levy on those who chose not to belong to a voluntary association, fees of which would be paid to the Federal Government and earmarked for the operation of this agency?

Mr. TOUPIN. There is precedent for that kind of approach, yes.

Mr. KEITH. What do you think about the regulations suggested in the bill for over-the-counter trading as it pertains to insurance companies? I understand we are going to hear later on from the National Association of Insurance Commissioners whom I believe don't look forward to the SEC assuming responsibility for the furnishing of information by the insurance companies to the SEC instead of to the States.

Mr. TOUPIN. As I mentioned, Mr. Keith, we are here to oppose other portions of the bill.

Mr. KEITH. Do you think this might be healthy for the insurance industry, or healthy for the policyholders, or both?

Mr. TOUPIN. I think probably this kind of legislation which requires over-the-counter companies to have the same proxy rules and disclosure requirements as listed companies is basically a sound thing, whether it applies to one industry or another. It is sound from the point of view of the investing public. We have been advised, however, that the National Association of Insurance Commissioners recently adopted a policy which was designed to meet the substantial purposes of these bills through State action. We have no information on the implementation of this policy, but believe that the Congress should carefully consider this action of the NAIC and the implementation of its policy to determine whether the public interest may be adequately protected without the unnecessary expense and duplication involved in including insurance companies under this bill.

I don't know that it makes a great deal of difference to the policyholder.

We really don't object to regulations, but merely to the method of accomplishing it.

Mr. KEITH. That is all, Mr. Chairman. Thank you.

(The following telegram was received for the record:)

[Telegram]

WASHINGTON, D.C., *January 22, 1964.*

HON. HARLEY O. STAGGERS,
Chairman, House Subcommittee on Commerce and Finance,
New House Office Building, Washington, D.C.

DEAR CHAIRMAN STAGGERS: In clarification of my response to Congressman Keith's inquiry at the close of my testimony today, concerning my views on the advisability of including insurance companies among the over-the-counter companies which would be required under the proposed legislation to follow the same reporting, insider trading, and proxy requirements as listed companies, it has come to my attention that the National Association of Insurance Commissioners has recently adopted a policy which would meet the substantial purposes of the proposd legislation. In other respects, it would appear to us that State

regulation is adequate. Under these circumstances the public interest will be adequately protected without the unnecessary expense and duplication involved in including the insurance companies under this bill.

ARTHUR V. TOUPIN,
General Counsel, Insurance Securities, Inc.

Mr. STAGGERS. I gather from your testimony, and sort of a summary of it, that your main point is that you are against compulsory registration then, especially of the mutual funds.

Mr. TOUPIN. That is correct. I think the principle that I rely upon would apply to everyone, but of course representing a mutual fund I would have specific interest in them.

Mr. STAGGERS. Certainly. You are interested in your own activity like everybody else. We have had the question brought up as to whether we are getting too much regulation by the Government. You are talking about Congress delegating these powers to the SEC and not self-regulations of private industry.

There are those who advocated in this bill when it came before us that we let the industry promulgate and enforce their own regulations. We are letting industry then control themselves without Government interference, so we have two sides to this.

Mr. TOUPIN. That is correct.

Mr. STAGGERS. That is always true or we wouldn't have a bill up here to make a law. I thought that Mr. Keith brought up a very interesting comment about the cost to the Federal Government. It is proposed in the bill that appropriate funds be appropriated, the amount to be collected from each member if he is to join in order to defray the costs of any policing, I believe. That would take the cost away from the Federal Government and leave it with the individuals, as proposed in the bill.

We talk about powers to interested parties and delegating these powers to those who could be the judge and jury, but have self-interest.

As you explain, it could work the other way. There could be more leniency, with one thinking that next year he might be the victim, or he could say, "I want to get rid of you," meaning the competitors.

Many of our different activities do have self-regulation. One of them is baseball. Presently, we have a conflict and a question which now must be decided, or has been decided—I don't know which—about Kansas City, or Kansas City moving to Louisville. That had been left with them almost entirely. Of course that is a different project.

Mr. TOUPIN. That again is a voluntary association.

Mr. STAGGERS. Yes, sir. I realize that. Each one of those who participated had a vote.

In the memorandum to the SEC, and we talked to you about delegating powers, the Congress and this committee appropriated and authorized $750,000 and then a couple of hundred thousand dollars more to investigate all the securities and exchanges.

Instead of getting outsiders to do this we turned it over to the SEC and they in turn, consulting with members of the industry, came up with a bill. I assume they consulted with your industry, or some segments of it. But what they were trying to do was to come together with people that would benefit all of the industry, and at the time I was doubtful whether this was right or not, but yet the Congress felt that they had to go to experts, men who knew this phase, and they in turn set up committees of their own connected with most all of

industry to make recommendations. So we often do have to get self-interested parties to make laws because if we did'nt have the experts to do it, we wouldn't come up with these regulations.

This is one of the points in this bill that will have to be resolved by the committee.

I might say to you that we are very thankful to you for coming and giving us the value of your comments. They will be taken into consideration when the bill is in its later stages, I can assure you. I thank you very kindly. I might say you are accompanied by very good counsel.

Mr. TOUPIN. Thank you, Mr. Staggers.

Mr. STAGGERS. The committee will stand adjourned until 2 o'clock this afternoon. We will try to get the permission of the House to sit this afternoon. We will resume hearings at 2 o'clock this afternoon and hear the other witnesses for today.

Thank you gentlemen.

The following correspondence was submitted for inclusion at this point in the record:)

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., February 8, 1964.

HON. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance, House Interstate and Foreign Commerce Committee.

DEAR CHAIRMAN STAGGERS: On January 21, 1964, Mr. Arthur V. Toupin, general counsel of Insurance Securities, Inc., appeared as a witness before the subcommittee on H.R. 6789.

At the conclusion of this testimony, there were two or three points which I would like to have had clarified, but, in view of the press of time, I did not pose the questions in the hearings. I subsequently wrote to Mr. Toupin, requesting such clarification, and have received his response.

I should like to request that my letter and his response be incorporated in the record, in order that his testimony on these points may be made clear.

Thank you for your consideration.

Sincerely yours,

HASTINGS KEITH, *Member of Congress.*

Enclosures.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., January 22, 1964.

ARTHUR V. TOUPIN,
General Counsel, Insurance Securities, Inc.,
San Francisco, Calif.

DEAR MR. TOUPIN: This refers to your testimony yesterday before the Commerce and Finance Subcommittee of the House Committee on Interstate and Foreign Commerce on H.R. 6789.

Regrettably, time did not permit me to pose certain additional questions to you concerning your testimony, therefore I should like to now ask if you would answer the following two questions in order that I may have your position clear in my mind:

1. Do you favor section 7(a)(3) of this bill, which would require a securities association to set standards with respect to training, experience, and other qualifications as the association finds necessary or desirable for employees of its members?

2. I understand that Chairman Cary has indicated that some broker-dealer firms may be exempted from compulsory membership in an association by Commission action. In your opinion, should a firm which is engaged in direct selling of securities receive such exemption?

In the course of your testimony, I asked you for your opinion on whether stock insurance companies' securities should be included under the registration and disclosure provisions of this bill with other over-the-counter securities. I believe that your answer was in the affirmative. In connection with this question, I am enclosing a copy of the supplemental information form that was adopted by the National Association of Insurance Commissioners at their meeting in December. As you will note, the form relates to information supplied by insurance companies to their stockholders. I would appreciate it if you would look the form over and give me your opinion as to the adequacy of the reporting requirements and whether it would be a satisfactory substitute to the requirements imposed by the SEC.

I would like to take this opportunity to thank you for your very clear presentation before the subcommittee yesterday. I'm sure you can appreciate the fact that this is a very complex and controversial area; therefore, your answers to the above questions will be of great assistance to me in my consideration of this legislation.

Very sincerely yours,

HASTINGS KEITH, *Member of Congress.*

Enclosures.

INSURANCE SECURITIES INC.,
San Francisco, Calif., February 3, 1964.

Hon. HASTINGS KEITH,
Member of Congress,
House Office Building,
Washington, D.C.

DEAR MR. KEITH: This is in response to your letter of January 22, 1964, in which you asked certain additional questions relating to my testimony before your subcommittee. I will respond to these questions in the order in which they were presented in your letter.

(1) Section 7(a)(3) of S. 1642 would require a national securities association to specify appropriate standards with respect to training, experience, and such other qualifications as the association finds necessary or desirable. No broker or dealer could become a member unless qualified under these standards nor could he hire any person who did not qualify under the association's standards. The association would also be required to develop standards relating to the financial responsibility of the broker and dealer members. Related to this is section 7(a)(6)(e) of S. 1642 which would amend section 15A(k)(2) of the Exchange Act to give the Commission power to change the rules of an association in relation to "the qualifications required for members or natural persons associated with members or any class thereof."

First, let me say that we are in favor of upgrading the standards and performance of people who engage in the securities business and our firm, along with many others I am sure, is constantly trying to improve standards within our sales organization. We certainly do not oppose any assist in this regard which may come from the specification of minimum standards under an act of Congress. It should be pointed out, however, that the above-mentioned amendments give the association and the Commission complete discretion to decide who can and who cannot engage in the securities business, without any statutory guideposts whatsoever. It is recognized that it would be extremely difficult to provide definitive statutory guideposts relating to qualifications for entering the brokerage business. However, if nothing more were done than to add the word "reasonable" in front of the language which grants these powers to the Commission and the association, some statutory restraint would be imported into the bill.

It should also be pointed out that section 7(a)(3) does not contain the usual "grandfather" clause which would protect against the retroactive application of this bill to persons already validly engaged in business. I feel confident that neither the Commission nor the Congress would intend to apply section 7(a)(3) retroactivity to persons who have been earning their livelihood in the securities business under existing law.

Chairman Cary, in his testimony in the Senate did state: "In establishing criteria, the NASD could adopt appropriate 'grandfather' clauses exempting existing members and their employees, either permanently or for a transition period, from some or all of the qualifications requird of new entrants."

In our opinion, such grandfather provisions should apply to all brokers and dealers and to persons associated with them who are validly in business under existing law, whether they are currently members of NASD or not and whether they join NASD or another association. Unless they do so apply, no broker or dealer would know, if this bill becomes law, whether he or any of his associates will be permitted to continue in business until the association or the Commission makes the fateful decision whether he qualifies under standards yet to be developed. Chairman Cary's above-quoted comment would seem to indicate that section 7(a)(3) should be applied retroactively to some (who are not now members of NASD) but not to others (who are). This we believe would be inequitable and unnecessary. Also, you will note that his comment is permissive, leaving it to NASD to select those firms or persons to which the legislation would be applied retroactively. We would urge the Congress, if it should enact the compulsory membership features of section 6(a), which we sincerely believe it should not do, to further amend section 7(a)(3) to provide that its application shall be prospective only. In the alternative, the report of your committee could make it clear that section 7(a)(3) is not to be applied retroactively so as to exclude from the securities business those who are now validly engaged in it.

(2) In your second question you stated that Chairman Cary has indicated that some broker-dealer firms may be exempted from compulsory membership in a national securities association by Commission action. You asked whether, in my opinion, a firm which is engaged in the direct selling of securities should receive such exemption.

There are a number of sales organizations like our own which engage exclusively in the sale of the securities of open-end investment companies. I believe that in connection with their selling activities these firms are subject to more Federal laws and regulations than are firms which sell other forms of securities. This is so because, in addition to being subject to the provisions and regulations of the Securities Act of 1933 and the Exchange Act, the sales activities of such firms also are governed by the provisions of and regulations issued under the Investment Company Act of 1940. I presume that if Congress or the Commission were trying to determine which firms ought to be relieved of compulsory membership, a most logical starting point would be to exempt those firms which already are subject to the most stringent laws and regulations.

However, we do not believe that the exclusion of some and the inclusion of other firms provides an answer to the basic regulatory problem. Congress is seeking a regulatory method which will improve sales practices in the securities industry. In accomplishing this, it seems to us, Congress first consideration must be to find a regulatory method which will assure fair and disinterested treatment to those who would be regulated. We have yet to discover anyone who contends that such treatment can be assured in a regulatory framework which would require competitors to be the judges of one another's conduct. If we are right in this concept, then the compulsory aspects of section 6(a) of S. 1642 are basically unsound as a regulatory method and should not be enacted.

With your letter you also enclosed a form entitled "Stockholder Information Supplement" recently adopted by the National Association of Insurance Commissioners. The information called for by the questions in the form is in substance the same kind of information that would be required of insurance companies under this bill. We are in favor of the basic concept of S. 1642 to cause additional information to be placed in the hands of shareholders of companies whose securities are traded in the over-the-counter markets. It would appear that the National Association of Insurance Commissioners is taking steps to cause such information to be provided to shareholders of insurance companies. We are not informed as to the methods of implementation available to and planned by the insurance commissioners in the various States. It would seem, however, that if these basic purposes of S. 1642 can be effectively accomplished through State action, it would then be unnecessary to go to the expense and duplication involved in including insurance companies under this bill.

I hope these answers will be helpful to you in your further deliberations of this bill.

Sincerely,

ARTHUR V. TOUPIN.

(Whereupon, at 12:08 p.m., the committee recessed to reconvene at 2 p.m., the same day.)

AFTERNOON SESSION

(The subcommittee reconvened at 2:30 p.m., Hon. Gillis W. Long presiding.)

Mr. LONG. The hearing will come to order.

The next witness is Mr. Edward F. Galotti.

Mr. Galotti, will you come forward, please?

STATEMENT OF EDWARD F. GALOTTI, ARLINGTON, MASS.

Mr. LONG. Welcome to the committee. Would you please identify yourself for the record and proceed in your own way?

Mr. GALOTTI. Mr. Chairman and members of the committee, my name is Edward F. Galotti. My residence is 76 Broadway, Arlington, Mass. I am a businessman, president and treasurer of Ambassador Aluminum Products, Inc.

I appreciate this opportunity to appear before your committee. I am here to testify this afternoon on S. 1642 and related bills which propose to amend the Securities Act of 1933 in order that disclosure requirements to the issuers of additional publicly traded securities may be extended and to provide for improved qualification and disciplinary procedures for registered brokers and dealers.

The philosophy underlying the passage of the 1933 act was a direct result of the debacle of 1929 which was caused, at least in part, by the unscrupulous activities of certain financial manipulators, who operating under the prevailing philosophy of caveat emptor, saw the public as only so many sheep ready for a fleecing.

It is my feeling that there has been no change which justifies a return to the old view that the investing public needs no more protection than his own good judgment. I think it is fair to say that the present view is that legislation is needed to protect the unwary from the unscrupulous.

I do not approach this subject in an academic way. Quite frankly, my acquaintance with the subject is direct and personal. Like the Scriptural man who rode down from Jerusalem to Jericho and fell among thieves, my experience has not been conducive toward a charitable view toward those who operate within a loophole in the law to fleece the public.

For this reason I am vitally concerned that the proposed legislation be amended in order that the investing public may be protected by legislation with teeth in it.

I would like to discuss loopholes in section 4 (1) and (2) of the Securities Act which in my opinion negate the purpose of the framers of this legislation who intended to replace the philosophy of let the buyer beware with a philosophy more suited to the modern marketplace, let the seller beware.

Specifically, let us consider a case where a corporation organized under the laws of one of the States issues two classes of stock. One class meets the registration requirements of the Securities Act, and the other does not. This latter stock is referred to as unqualified stock which is defined as stock which is to be issued with transfer restrictions limiting its sale to insiders. Insiders being defined as controlling persons, officers, directors, and key employees of the corporation.

In order to comply with the State's security regulations the public issue alone is qualified under the "blue sky" law.

If the corporation is successful, or appears so, the price of the stock issued to the public will, quite naturally, rise as demand increases. Naturally there will be a demand on the part of the general public for shares of the corporation's stock.

The public, however, is not as likely to understand the distinctions between the two classes of stock. The same is not true of the insiders, however. The insiders—the controlling persons, both officers and directors—are permitted, through exemption, to sell their stock to broker-dealers. The insiders continue to exercise their options, thereby receiving additional nonregistered, nonexempt, so-called restricted stock. If they should decide that they wish to cash in their profits they must merely tell the corporation counsel that their circumstances have changed since they originally agreed to the restrictions. Counsel will then notify the transfer agent to honor the transfer if it has not already done so before any notification.

Broker-dealers may legally use instrumentalities of interstate commerce in publicly distributing the restricted shares. The restrictions vanish at some point amid the original issuant, the corporation counsel, and the transfer agent. If the public should, by accident, learn that it has been sold and delivered a class of stock which is not qualified for public distribution, it has merely learned something new, but that is all. The public has no available remedy even though section (5) states that it is illegal or unlawful to sell securities unless a registration statement is filed or in effect.

The brokerage fraternity can take advantage of the situation in a unique fashion. The broker calls the underwriter for instructions as to what to do. The broker-dealers claim that they do not contact the SEC or the particular office which oversees the "blue sky" law, but that the underwriter is the more logical source. The underwriter then becomes the scapegoat.

At some point, some broker makes a mistake by inserting a quotation on the pink sheets specifying a particular class. At this point, the erring broker is advised not to be specific. It is suggested that less attention will be attracted if this stock is traded on an unspecified basis. In addition, the nonqualified class will not have to be sold at a lower price than the qualified class. Hence, the insiders, the broker-dealers, and the sophisticated, will be able to make more money.

Incidentally, the nonqualified stock sells for a lower price then the qualified.

The stock now is traded from broker to broker on an "unspecified" basis. This indicates to the broker that more than one class is outstanding. Incidentally, the public does not know this terminology and is not to be told same orally or by confirmation slips. If a typist should make an error and show "unspecified" on the customer's copy, and if the customer should question the brokerage house, he is told that this does not belong on his copy—disregard it.

Now to further confuse the customer, the broker will send him a delivery slip stating that the securities delivered are of the class which may be sold to the public. The certificates will, however, be of the other class. The brokers employ the exemption under existing section 4(2) of the Securities Act. This will prevent the public from

rescinding the transaction and getting his money returned. That is, should the public ever discover that the class of securities which it never ordered but was delivered is not qualified for public sale.

A sophisticated broker will never solicit an order from the public in an unregistered stock. He may stimulate the demand, then direct the person to another broker for execution of the order. This will prevent liability under the act of 1933.

If a member of the public should bring suit to recover under the "blue sky" statute against the selling broker and/or the agent broker, a unique defense will be presented. The selling broker will admit he was the principal but will allege he did not sell to the plaintiff, rather he sold to agent broker, not as agent but as principal. The alleged agent will uphold the selling broker's position. Both, then, will testify that: (1) this becomes an exempt broker's transaction; (2) "custom and practice" preempt any statute and an agent at the time of sale never discloses that he is acting as agent; (3) neither are concerned as to whether the stock is qualified under either law. This protects the selling principal. Subsequently, the buying broker will issue to the seller a confirmation slip stating that the purchase was for a third party—hence, an agency transaction. The selling broker simply disregards this because it is a postsale development.

The buying broker will testify that this will stimulate the market price. The customer is issued a confirmation slip stating it was an agency transaction. Some brokers will execute a transaction in a security having two classes on a temporary unspecified basis. If qualified stock is delivered, the broker, now not in need of exemption 4(2), will then issue a correction reading that the transaction should read "Specified." He will not respond to a customer's inquiry on this subject matter. To do so might expose this unique loophole which is detrimental to the public.

It is conceded that a shipping clerk who acquired a few shares of restricted stock through stock options should not be expected to spend thousands of dollars to register his stock after his employment has been terminated. He should be permitted to sell his stock to a broker-dealer, who purchases it for investment purposes only. The restrictions should not simply vanish. This loophole should be outlawed. The broker should not be allowed to publicly sell and distribute these shares, as is now done.

Brokerage people will move into dominating corporate positions as either or both directors and officers to augment the original group of high repute. They will take advantage of the loophole, and in so doing, will show the other officers, directors, and employees how to realize actual cash profits. Through skillful application of: changes in accounting procedures; dissemination of false and misleading information, both orally and otherwise; artificial market price stimulation; unique application of investment letters; issuance of the publicly held class at less than 50 percent of market value and not through stock options; cooperation of the registrar and transfer agent banks, both in improper dilution of stockholder equity and refinancing; officers and directors forming a brokerage firm and later issuing or causing to be issued market letters containing factually inaccurate and misleading statements for public distribution and consumption; causing other brokerage houses and investment advisers to aid in the

scheme; skillful reference to a former insider now a Presidential adviser; the public will be legally taken for millions of dollars.

A stock split will be affected. The management will then trespass the last sacred outpost which is available to the public. It will cause the independent auditors to forgo their independence by preparing and presenting audited financial statements which will be factually inaccurate and misleading. Omissions of items of materiality will shield the management from the public stockholders and the facts from the public.

In fact, the audited financial statements prepared by a reputable firm will only be correctly interpreted by another CPA if he has the treasurer at his elbow to unearth the true financial condition.

If I may, Mr. Chairman, I would like to insert something which is not contained in my printed statement, which appeared in this morning's Wall Street Journal. It is an article by Donald A. Moffett, entitled "Bookkeeping Battle, SEC Auditors Drive for More Uniformity in Corporate Reports, Varying Present Practices Spread Confusion Among Investors, Some Lenders."

I will quote from part of it:

> These variations, however, are drawing increasing criticism. Investors trying to decide which companies' stock to buy sometimes have trouble comparing the performance of one concern with a competitor whose accounting is different. Banks and other lenders who use corporate reports to judge the soundness of loans they are considering occasionally have similar difficulty. Even some accountants confess they get confused at times. "It's getting so bad you have to hire other experts to help you understand financial statements," says one of the country's leading certified public accountants.

Continuing inside on page 17, I would like to illustrate this point, if I may:

> A client company recently wanted to "capitalize heavy research costs." That is, rather than treating them as an expense to be deducted from profits. The company wanted to add them to the balance sheet as an addition to the value of its assets in about the way a company reports an outlay for a new factory, not as an expense but as an addition to the value of its plant and equipment. Auditors, however, usully will go along with such a treatment of research costs only when it can be demonstrated that they are bringing in some tangible return, and the research thus really is a kind of asset with some measurable value. In this case, the auditor ruled that the research had resulted in "little possibility of a marketable product," so he told the company he wouldn't let it capitalize the cost.

The management's comment was:

> We thought we would give it a try.

Although the financial statements do not indicate that the corporation is bankrupt at the balance sheet date, the treasurer after he has unloaded his restricted stock, subsequently says the balance sheet clearly indicated the then bankrupt condition. If these exemptions were unavailable to the insiders, broker-dealers and loaning banks would not be able to distribute nonqualified shares to the public. If full disclosure were required, those who were selling would not have found a gullible public.

I think, in conclusion, that this committee should consider carefully whether self-regulation is an adequate remedy for the condition which has existed. I submit that it is not, and cannot be an adequate remedy. What is needed is legislation which will insure the public that the

trust which they give to a stock broker, a trust inspired by the belief that the Government has remedied the fraudulent practices of a generation ago, is not misplaced.

The failure of the New York and American Stock Exchanges and the National Association of Securities Dealers to take action proves to my satisfaction that, if the situation is to be remedied, it is the Congress, and not those having a vested interest in the status quo, who must prescribe the remedy.

Thank you, Mr. Chairman.

Mr. LONG. Thank you, Mr. Galotti.

This seems to me, Mr. Galotti, very much like a documentary from personal experience. Is this true to a great extent?

Mr. GALOTTI. Yes, sir; it is, Mr. Chairman.

Mr. LONG. Also, it would appear to me that while the opportunity to begin this chain of events came from the exemptions to the Securities Act, included within the series of acts were many things that were without the law, that were, in fact, illegal.

Mr. GALOTTI. That is the impression that I have, sir.

Mr. LONG. I gathered from this, in your personal experiences, that you brought legal action to attempt to right the way you felt you had been wronged in this instance?

Mr. GALOTTI. Yes, sir, I did.

Mr. LONG. And that this also reflects the legal consequences of your effort to right these wrongs?

Mr. GALOTTI. Yes, sir; because the legislation existing presents no remedy for the public.

Mr. LONG. That is, legislation provides none in itself, but did you pursue the possibility of proceeding on the basis of the fact that you had been defrauded? I think it is a different question involved here than whether or not an exemption is available to a securities dealer or a securities broker or even to an issuer of securities and the question of whether or not you were defrauded.

Mr. GALOTTI. Mr. Chairman, I don't mean to be disrespectful to you. I am sure we are not trying to retry the case, as it were. I am sure that you would recognize that I felt I was in the competent legal hands and had representation. But it was the opinion of the trial judge as well as the counsel that that which the brokers had done here with respect to the sales and deliveries of that which was unregistered, forgetting for a moment the touting and what the insiders did, that the law was written in such a way that if a broker who owns the stock on inventory is acting as a principal and the customer, or myself in this case, calling another broker to buy stock, which I assume is legal to be sold to me—and there is a legal class but at this point I do not know, I am not sophisticated, but I would like to think today that I have become sophisticated as a result of this transaction—broker B goes to broker A and buys the stock.

At that particular time, broker A says he recognizes B as the buyer, that he is selling him on a principal basis. Broker B testified in court, "That is right, because the practice and custom of the trade is that we don't disclose that it is an agency transaction until it is all over."

A broker should only wear one hat. He is either acting as principal or agent. I think we both agree on that, or at least I hope we do. When he sends the confirmation slip out to the customer, he says, "We

are acting as your agent." This brings him under section 4(2) because it is a customers transaction, and I think that perhaps this may have been overlooked and maybe it takes practical experience, shall we say, or exposure, before you folks might be able to take another look at what may be going on.

Mr. LONG. Was a legal determination made as to whether or not, when the stock was sold to you as one class and was in fact another class, this constituted fraud?

Mr. GALOTTI. No, sir; there was not.

Mr. LONG. No legal determination made on that point?

Mr. GALOTTI. No, sir.

Mr. LONG. That is specifically the point I was getting to. It would appear to me that this would be fraud, and that the cause of action was based upon that as distinguished from the Securities Act. It might possibly have allowed recovery. Of course, it is impossible to practice law on an incomplete set of facts.

Mr. GALOTTI. Surely. Do you agree, Mr. Chairman, if I may ask you a question, that these things should not happen, and if there is this loophole, the loophole should not in fact be there?

Mr. LONG. Yes. I think frankly that the entire area of this type of trading needs some strengthening, and I think this is the purpose of the amendments of this act to a great extent. I am not willing to commit myself with respect to any particular part of it at this stage, because there is much to be learned.

Mr. Glenn?

Mr. GLENN. No questions, Mr. Chairman.

Mr. LONG. Thank you very much, Mr. Galotti. We appreciate your coming. We appreciate you as an individual citizen having enough interest in this to take it upon yourself and at your own expense, your own time, to prepare this statement and to come down and make your views known. You are to be complimented for doing it.

Mr. GALOTTI. Thank you, Mr. Chairman.

Mr. LONG. Mr. Charles Robinson, Jr., is the next witness.

STATEMENT OF CHARLES A. ROBINSON, JR., STAFF ENGINEER AND COUNSEL, NATIONAL RURAL ELECTRIC COOPERATIVE; ACCOMPANIED BY ROBERT D. PARTRIDGE, LEGISLATIVE REPRESENTATIVE, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION, WASHINGTON, D.C.

Mr. LONG. Mr. Robinson, would you identify yourself for the record and proceed in your own manner?

Mr. ROBINSON. Thank you, Mr. Chairman.

My name is Charles A. Robinson, Jr. I am staff engineer and staff counsel of the National Rural Electric Cooperative Association, which is the national service organization of REA-financed electric systems.

With leave of the Chair, I ask that Mr. Robert Partridge, of our staff, be allowed to accompany me at the witness table. Mr. Partridge is an expert in the field involving the organic operation and the organic structure of electric co-ops.

Our membership, Mr. Chairman, comprises over 90 percent of all REA electric-type borrowers, located in 46 States, including Alaska. There are, throughout the United States, nearly 1,000 rural electric

systems. They provide central station electric service to about 20 million people through approximately 5 million meters, largely in rural areas. In all cases REA-financed systems were developed to provide service available from no other source.

Mr. LONG. As I understand it, for my own clarification, yours is, in effect, a trade association of the co-ops.

Mr. ROBINSON. That is correct, Mr. Chairman. We are a voluntary membership organization to which about 90 percent or over of all REA borrowers belong; the electric-type borrowers.

Mr. LONG. Thank you.

Mr. ROBINSON. These rural electric systems have borrowed just over $5 billion from the U.S. Government for the purpose of constructing some 1.5 million miles of electric lines and appurtenant facilities. Their average consumer density is thus about 3.3 consumers per mile of line. The average consumer density for investor-owned companies throughout the United States is 33 consumers per mile of line.

The average rural electric system serves just under 5,000 consumers, operates 1,600 miles of distribution line, and has borrowed approximately $4 million from the Rural Electrification Administration.

During fiscal year 1962, rural electric systems throughout the United States sold approximately 30 billion kilowatt-hours of electrical energy, constituting 4 percent of total electric utility sales to 5 million consumers representing 8 percent of the national total. Our total sales were 4 percent in terms of kilowatt-hours and 8 percent in terms of consumers, of the industry total.

During the same period, REA-financed systems consumed 34.4 billion kilowatt-hours. Of this amount, approximately 40 percent was purchased from Federal power marketing agencies such as the TVA, and the Bureau of Reclamation. Approximately 40 percent was purchased from investor-owned utility companies. A small quantity was purchased from State government utilities and municipal electric systems. Only 16 percent of the energy which they used was generated in REA-financed plants. Such plants constitute less than 0.8 of 1 percent of the Nation's installed generating capacity.

At the end of 1962 only two REA borrowers were in arrears more than 30 days. The total amount of such arrears was $93,837.

Mr. LONG. This $93,837 reflects all that has, in the entire $5 billion, not been repaid as of the time it was due at the end of 1962?

Mr. ROBINSON. Yes, sir. That was the amount that was in arrears at the end of 1962.

Mr. LONG. Including any amount that might not have been repaid?

Mr. ROBINSON. Yes, sir; that is my understanding. Of the total $5 billion loan program, that is the total amount that has not been repaid or that is in arrears. It is due and not paid on time.

This, of course, has not been written off, and presumably a major portion of it will be repaid.

This means that of the total $5 billion REA loan program, less than two one-thousandths of 1 percent is in arrears.

The capital structure of REA-financed systems, the utilization and application of funds borrowed by them from the Government, the administration and management of reserve funds, and, in general, the entire organic management and administration of electric co-

operatives are closely supervised and regulated by the REA Administrator. REA-financed electric systems are organized under various types of State statutes. In Nebraska, for instance, they are political subdivisions of the State government. In some States they are organized under nonprofit corporation statutes. In still other States, special enabling acts have been passed which provide statutory vehicles of incorporation especially tailored to the needs of rural electric cooperatives. In each State, however, the corporate structure of the organization is regulated by State law.

Rural electric system membership meetings are held each year. At these meetings consumer members elect a board of directors in which ultimate managerial responsibility is vested. Rural electric systems, except for a few municipal and investor-owned REA borrowers, do not issue stock, bonds, debentures, or any other type of interest- or income-bearing paper except their 2-percent note to the United States. Their sole source of initial capitalization is the Rural Electrification Administration.

OUR INTEREST IN H.R. 6789

Our interest in H.R. 6789 arises from section 3(c) of the proposed legislation which begins at line 12 of page 6 of the bill.

As we understand the language, this section would require every issuer with assets of at least $1 million, and which is engaged in interstate commerce or which affects interstate commerce, both of which categories presumably include rural electric systems, to submit to SEC a complete registration filing on any outstanding "equity securities" held by 750 persons or more.

Rural electric systems do not issue stock certificates, bond certificates, debenture certificates, or any other interest-bearing evidence of equity or debt except the 2-percent notes to the United States. They do, however, issue two kinds of generally nontransferable, noninterest-bearing certificates to their member-consumers; membership certificates and capital credit certificates.

Rural electric cooperatives are not public utilities in the common law sense. They do not, in general, hold themselves out to serve the public nor in most cases are they under a legal obligation to serve the public. Except in special cases, they serve only members, and there is thus no diversity of interest between owner and consumer.

At the time a farm family or other prospective rural consumer seeks service, an application for membership in the cooperative is submitted. Upon acceptance of the application by the board of directors, the member is issued a certificate of membership as evidence of his right to cast a vote in managing corporate affairs and to receive central station service from his cooperative. Membership usually involves payment of a $5 fee. These membership certificates are as a rule not transferable at all. In a few cases they are transferable to a successor in occupancy of the premises held by the owner. In no cases do they bear interest.

It appears to us, however, that these membership certificates might subject rural electric systems to the provisions of section 3(c) of H.R. 6789 requiring submission of complete registration filings to the commission.

In addition to membership certificates, rural electric systems also issue capital credit certificates. Initially the entire capital structure of an REA-financed electric system consists of a loan from the Government. The Government advances 100 percent of the total cost of constructing the system and the cooperative issues to the Government its note for the amount secured by a first mortgage on all existing and after-acquired properties.

After the rural electric system becomes operational, it begins to repay this loan to the Government over the statutory 35-year period. The funds with which to repay the Government loan are derived from power sales revenue. In other words, the member-consumers of the cooperative contribute through their power bills to the repayment of the Government loan.

Therefore, as the proceeds from membership electric bills are used to repay the Government loan, the loan of the Government to the cooperative is progressively decreased, and the equity of the members substituted.

Rural electric system bylaws and the Rural Electrification Administration require that each system keep books of account which accurately reflect the increasing equity of the membership and the allocation of that equity among individual cooperative members.

As evidence of this equity in their cooperative, each member is customarily and periodically issued a capital credit certificate. This capital credit certificate is evidence of the magnitude of each consumer's equity in his cooperative. It is non-interest-bearing and nontransferable except to a successor in occupancy or interest of the premises held by the member.

As the cash position of the cooperative permits, and at the discretion of its board of directors, these capital credit certificates may be retired via a cash payment from the cooperative to the member-consumers. Thus, the equity is transferred from the member-consumer to the corporate entity. To the extent that these payments represent a return of capital contributed by a member-consumer who had used electricity for purely domestic purposes, they would be nontaxable. If, however, a member consumer had deducted his electricity bill as an expense necessary to a commercial operation, then, in that event the cash capital credit retirement payment would be proportionately taxable.

These capital credit certificates, we believe, might also fall within the provisions of section 3(c) of H.R. 6789, and, thereby, subject all rural electric systems to complete SEC registration filings on them.

INTENT OF THE SEC

We respectfully suggest to the subcommittee that it is probably not the desire of the Securities Exchange Commission to reach this type of issue. We further respectfully suggest that no public interest could be served by additional control through SEC of these generally nontransferable and non-interest-bearing certificates. A great many rural electric systems throughout the United States utilize only one or two or three nonspecialized clerical employees. The preparation of a complete SEC filing is a major task for skilled and specialized attorneys, accountants, and engineers. The requirement that each cooperative submit a registration statement would constitute a very

heavy financial burden and, we believe, is unwarranted by the circumstances.

On two occasions, representatives of the National Rural Electric Cooperative Association, including myself, and the SEC have discussed the relationship between the language of section 3(c) of H.R. 6789 and the rural electrification program. We are now advised that the Commission does not intend that either the membership certificates or capital credit certificates of rural electric systems should be subject to section 3(c) of the proposed legislation.

We specifically inquired of the Commission as to whether or not it would object to the inclusion in the proposed legislation of specific language exempting from its provisions these two types of certificates; that is, the membership certificates and the capital credit certificates issued by the rural electric systems.

We are advised by the Commission that it would not interpose objection to the inclusion of the following addition to subsection (g) (2) of section 3(c) of H.R. 6789:

( ) any security issued by a mutual or cooperative organization which supplies a commodity or operates not for pecuniary profit; provided the security is part of a class issuable only to persons who purchase commodities or service from the issuer, the security is transferable only to a successor in interest or occupancy of premises serviced or to be served by the issuer, and no dividends are payable to the holder of the security.

In the alternative, we respectfully suggest that the same objective would be served by including in the list of exempt classes of issuers and issues provided for, beginning with line 1 of page 7 of H.R. 6789, language such as:

membership certificates and certificates of capital credit issued by any REA-financed, nonprofit electric system.

Mr. Chairman, we do have the approval of the Securities and Exchange Commission of the longer language, the more involved language, which appears at the middle of page 7 of my statement. We do not have its approval for the shorter form which appears toward the bottom of my statement on page 7.

At this point, Mr. Chairman, I offer for inclusion in the record in substantiation of our assertion in this matter, copies of a letter dated November 18, 1963, addressed to Charles A. Robinson, Jr., staff engineer and staff counsel of the National Rural Electric Cooperative Association, on the letterhead of the Securities and Exchange Commission, and signed by its General Counsel, Philip A. Loomis, Jr., which, in essence, states the position of the Commission as not opposed to the inclusion of the aforementioned language.

Mr. LONG. Without objection, it will be inserted as part of the record.

(The letter referred to follows:)

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., November 18, 1963.

Re H.R. 6789, 88th Congress.

Mr. CHARLES A. ROBINSON, Jr.,
Staff Engineer and Staff Counsel, National Rural Electric Cooperative Association, Washington, D.C.

DEAR MR. ROBINSON: This is with reference to your suggestion that section 3(c) of this bill be amended to add certain securities of rural electric cooperatives to the class of securities exempted from proposed section 12(g) (1) of the Securities Exchange Act of 1934.

As I indicated to you, it was not our intention that these securities should be subject to subsection (g). The matter has been considered by the Commission and we would have no objection if your association wished to suggest that such a provision be included in order to clarify this matter. I have slightly revised the proposed draft which you submitted simply in order to make it conform a little more closely to the form we usually follow in similar provisions. The suggested language is as follows (suggested subparagraph to be added to subsection (g)(2) of section 3(c) of S. 1642, and to corresponding provision of H.R. 6789):

"( ) any security issued by a mutual or cooperative organization which supplies a commodity or service primarily for the benefit of its members and operates not for pecuniary profit; provided the security is part of a class issuable only to persons who purchase commodities or services from the issuer, the security is transferable only to a successor in interest or occupancy of premises serviced or to be served by the issuer, and no dividends are payable to the holder of the security."

Sincerely,

PHILIP A. LOOMIS, Jr.,
General Counsel.

Mr. ROBINSON. Under the language of section 3 of the proposed legislation, as it is found beginning at line 6 of page 10, the Commission may by rule or regulation, or upon the application of an interested person, and after notice and opportunity for hearing, exempt from its provision, by administrative procedures, such classes of issues or issuers as it deems appropriate. We submit, however, that if it is the coincident intent of the Commission and of Congress that a particular classification of issues or issuers be exempt from jurisdiction, the exemption is most effectively expressed by specific language in the basic statute.

The present controversy over the jurisdictional status of REA-financed electric systems before the Federal Power Commission is an excellent example of the problem. The Rural Electrification Act of 1936 and the Federal Power Act of 1935 were passed within a few months of each other. The Rural Electrification Act does not mention the Federal Power Act and the Federal Power Act does not mention the Rural Electrification Act.

The REA Administrator must certify the feasibility of each loan granted and the security interest of the United States represents the entire capital structure of nearly all rural electric systems. The Administrator, in addition, must supervise and approve the wholesale and retail rates of each system which he finances, the accounting practices thereof, the disposition of reserves, and, in general, their entire financial organizational and organic structure and operation.

For 27 years after passage of the Federal Power Act, no Federal Power Commission asserted general jurisdiction over REA-financed electric systems. It was widely assumed that such jurisdiction did not lie. Last July, however, the present Federal Power Commission issued "show cause" orders to three REA-financed systems for the purpose of initiating formal proceedings to determine its jurisdiction.

Thus far, over 400 rural electric systems have intervened in support of the three respondent systems which are resisting this assertion of jurisdiction by FPC. These intervenors have contributed over $50,000 for the purpose of retaining counsel, employing expert witnesses, and defraying other costs normally incident to such administrative and judicial proceedings Our lawyers estimate that even this amount is probably only 30 percent of ultimate total cost of defending

the action before the hearing examiner at the Commission, before the Commission itself and, on appeal, before the U.S. Circuit Court of Appeals and possibly the Supreme Court.

The Secretary of Agriculture, convinced that Federal Power Commission jurisdiction over REA-financed systems would conflict with and overlap and statutory responsibilities of the REA Administrator, has also intervened against this assertion of FPC jurisdiction.

The FPC staff, as evidenced by testimony already filed, contends that the Commission holds regulatory authority not only as to the rates and accounting practices of REA-financed electric systems, but also as to the issuance by such systems of their notes and mortgages to the United States. The latter contention, if successful, would create an area of clear and unambiguous conflict with the statutory powers of the Administrator.

It would also, by invoking applicability of the Federal Power Act, effectively grant a judicial appeal from decisions of the REA Administrator. This would reverse 25 years of precedent established by the Supreme Court of the United States in a long series of cases beginning with *Tennessee Electric Power Company* v. *Tennessee Valley Authority*, 306 U.S. 118 (1939); and including *Alabama Power Company* v. *Ickes*, 302 U.S. 464 (1938) and *Kansas City Power and Light Company* v. *McKay*, 96 U.S. App. D.C. 273, 225 F. 2d 924 (D.C. Cir. 1955) 350 U.S. 884 (1955).

It is, therefore, abundantly clear to us that where it is the intent of the regulatory authority involved, and of the Congress itself, to exempt from the applicability of a particular regulatory statute certain classes of business or securities, such exemption should be clearly spelled out in the basic enabling legislation if it is to be effective and independent of changing regulatory authority personnel and policy.

UNNECESSARY BURDEN ON RURAL ELECTRIC SYSTEMS

We respectfully emphasize, Mr. Chairman, that many rural electric distribution systems throughout the United States serve less than 1,000 consumers. Many more serve less than 3,000. The filing of SEC registration statements by such systems in connection with the distribution of membership certificates or capital credit certificates would constitute a burden which we feel is unwarranted by existing or potential damage to the public interest or by the interest of either the electric cooperative itself or its membership.

In view of the fact that REA-financed systems are thoroughly regulated and controlled by the REA Administrator, by State law, and by bylaws, in view of the fact that the United States of America holds the only security interest in nearly all such systems, in view of the fact that the only holders having equity interest in such systems are the members themselves, in view of the fact that there is no diversity of interest between owner and consumers, and in view of the fact that the Securities and Exchange Commission has expressly stated to us, that in sponsoring the instant legislation, it has no intention of regulating the membership certificate or capital credit certificates of REA-financed systems, we earnestly solicit the support of this subcommittee for inclusion in H.R. 6789 of specific exemption from the registration requirements of section 3 of the proposed legislation

for membership certificate and capital credit certificates distributed to member-consumers by REA-financed nonprofit electric systems.

Mr. Chairman, we very much appreciate the opportunity of presenting this statement. We think that in equity and in the light of commonsense it does not make sense for the SEC to regulate the membership certificates and capital credit certificates of these systems.

Mr. LONG. Mr. Robinson, thank you very much for your comprehensive statement. The language that you quoted on page 7 having been, in effect, cleared by the SEC, following that you said that the alternative that you set forth had not been cleared by the SEC. Have you discussed that approach to the problem with the Securities and Exchange Commission and have they turned it down, or have you just not discussed it with them?

Mr. ROBINSON. No, sir; I have not discussed it, Mr. Chairman. I thought that the Commission General Counsel had exhibited the utmost courtesy and consideration to use in clearing the longer language for our use and I did not want to attempt to press the Commission further.

Mr. LONG. To just let well enough alone, is that correct?

Mr. ROBINSON. That is well stated, Mr. Chairman.

Mr. LONG. Are there any of the rural electric co-ops that are converting themselves into private corporations, stockholder organizations?

Mr. ROBINSON. Not to my knowledge, Mr. Chairman; no, sir. I know of no such conversions being contemplated at the present time, nor do I know of any that have taken place.

Mr. Partridge advises me that he knows of none, either, and he was associated with REA for 15 or 16 years.

Mr. LONG. Mr. Staggers, have you any questions?

Mr. STAGGERS. No questions.

Mr. LONG. Mr. Glenn?

Mr. GLENN. Mr. Robinson, in the last paragraph on page 5 of your statement, you say that these capital credit certificates may be retired via a cash payment from the cooperative to the member consumer.

Can you tell us under what circumstances the board of directors would so act?

Mr. ROBINSON. I have never personally served on a board, Mr. Glenn. When I finish, I would like to have Mr. Partridge also answer the question. It is my understanding that the principal criterion upon which the board acts in deciding whether or not to fund these capital credit certificates is the cash position of the electric cooperative. If it has accumulated sufficient cash reserves to protect itself against sudden disaster, storms, ice storms, and heavy snow storms, things that destroy a major portion of the system, then in that event the board of directors might, upon recommendation of the manager, refund these capital credit certificates. Usually they are several years behind in refunding them. That is, a certificate issued for the year 1963 might not be funded for anywhere between 3 and 10 years.

Mr. GLENN. Isn't that, in effect, giving the member consumers a dividend?

Mr. ROBINSON. No, sir. It really isn't because it represents the amount he has paid. He has paid that amount in beforehand. I know it is a difficult concept to undertsand, but when the cooperative is first

started, all of the money is borrowed from the Government. In effect, nobody has any equity in it. It is all a debt relationship between the Government and the entity we call a cooperative. That loan must be repaid under the REA statute in 35 years. So the only way the cooperative can repay it is through the sale of electricity. It sells the electricity at a rate sufficient to cover not only the operating expenses but, in addition to that, an amount required to repay this loan.

As you or I connect to the rural electric system we pay a rate sufficient to pay back that loan to the Government. As the loan is repaid, an equity springs up in the cooperative.

Mr. GLENN. Wait a moment. Doesn't the member consumer get electricity in exchange for that money he is paying into the cooperative?

Mr. ROBINSON. Yes, he is getting electricity. But if he didn't have to repay that loan, he would get it a lot cheaper.

Mr. GLENN. All right, continue.

Mr. ROBINSON. In other words, he is not only paying all the cost of operating the system, but he is paying enough to repay the loan to the Government. It is a little bit like purchasing a house collectively, I assume, with a 100-percent mortgage. As you pay off the mortgage, you get an equity in it. The equity is not represented by any real money until you sell the house. In the case of the cooperative, he doesn't get any real money until the board of directors pays him some back. But when you sell your house, assuming you sell it for the same price as you bought it, it would not be income; it would be simply the realization of your equity in it.

Mr. GLENN. Then these capital credit certificates do have a value, don't they?

Mr. ROBINSON. I guess they have a value; yes, sir.

Mr. Partridge may want to add something to by explanation.

Mr. PARTRIDGE. I think you have explained it adequately.

Yes, Mr. Glenn, they do have a value. The value is not realized in cash, as Mr. Robinson pointed out, unless and until the board of directors takes action to pay off the accumulated capital credits. And as Mr. Robinson said, these usually run several years behind. That is, they will not be paying off current capital credits but, rather, will be paying off the oldest ones first, in the normal course of events. This repayment of capital credits normally doesn't occur until the cooperative has achieved a specified level of net worth, and in many of the cooperative bylaws the level specified is 40 percent net worth.

For some cooperatives, it is a smaller figure. The 40-percent level is about the level of equity capital in most electric utility systems.

Mr. GLENN. When a member consumer has had his capital credit certificate retired via a cash payment, does he still retain his membership in the cooperative?

Mr. PARTRIDGE. Yes, sir. The membership certificate remains outstanding and normally the member paid some small amount for that. It may have been $5, it may have been $10. Usually, in the early years of the REA program, the membership fee was $5. This remains on the book, remains outstanding and constitutes evidence of ownership and membership in the rural electric cooperative.

Mr. GLENN. Then he has two things, a membership certificate and also a capital credit certificate. Is that right?

Mr. PARTRIDGE. Yes, sir. I would say almost without exception he would have a membership certificate. He would have a capital credit certificate if and as, and when, of course, the cooperative achieves a net worth position. The net worth is reflected in capital credit to the member.

Mr. GLENN. When he is paying his electrical bill, he is not only paying for the electricity which he consumes, but he is also investing some funds in the cooperative which he may expect to have returned at some future date via the capital credit certificate redemption?

Mr. PARTRIDGE. Yes, sir; this is correct. In some cooperatives the amounts paid for the cost of current service is distinguished from the so-called amortization payment. I think this is particularly true in the Tennessee Valley area. So there, at least among those cooperatives, the amount which a consumer pays is divided into two parts. In other areas, they don't divide necessarily at the time he pays it, but it is divided on the books and any amount over and above the cost of service is credited to the member as a capital contribution.

Mr. GLENN. Thank you very much.

That is all, Mr. Chairman.

Mr. LONG. Thank you, gentlemen.

Mr. ROBINSON. Mr. Chairman, you asked me a little while ago whether or not any of these cooperatives were transforming themselves into private companies. You may have been referring to the situation which has arisen in Ohio, where the cooperatives are attempting to undertake construction of a generating plant without borrowing funds from REA, in close cooperation with the American Electric Power Co. system. That generating plant will be one of the largest in the country. The participation jointly by the cooperative and the company in it, although each will finance its own portion of it, constitutes a new concept in the REA program. It is something that has not yet been brought to fruition. Under the Ohio plan, the 30 cooperatives in Ohio have joined together to form a separate corporation which will borrow funds in the open money market for the purpose of participating in this generating plant.

In the exemption from the application of the proposed legislation which we have suggested, we have limited it strictly to capital credit certificates and membership certificates in electric cooperatives. So in the event that the cooperative transformed itself into some other type of entity or formed some other type of entity, the exemption would not apply. I don't want to convey the impression that we are attempting to get a blanket exemption for electric co-ops regardless of what they may do or regardless of that type of enterprise they may undertake. We are only trying to get it for these two particular non-interest-bearing types of paper which are not issued to the general public and which are confined to the cooperative members themselves.

Mr. LONG. I didn't have a specific instance in mind. But it appeared to me a logical step in the development of the co-ops, or at least a possible logical step in the development of the co-ops. In some instances we were nearing the date the loans will be repaid in their entirety. Consequently, the question arises as to whether or not the language as drawn here would exempt them from regulation in the event they did determine, by their own membership, to become private corporations. But I agree with you, in reading the language as set

forth, which you have discussed with the SEC, such would not be the case.

Mr. ROBINSON. No, sir. It would be limited strictly to these two very simple types of paper and not to any other type of security that might be issued at any time.

Mr. LONG. Thank you very much, Mr. Robinson.

If there is nothing further to come before the committee, we will adjourn until 10 a.m. tomorrow.

(Whereupon, at 3:25 p.m., the committee was recessed, to be reconvened at 10 a.m., Wednesday, January 22, 1964.)

INVESTOR PROTECTION

WEDNESDAY, JANUARY 22, 1964

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE OF THE
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to recess, in room 1334, Longworth Building, Hon. Harley O. Staggers (chairman of the subcommittee) presiding.

Mr. STAGGERS. The committee will come to order.

This is a continuation of our hearings on the Securities and Exchange Commission bills and our first witness will be Mr. Stafford Grady. I would like at this time to present Mr. Van Deerlin of California. I understand you are a constituent of his and I would like for him to present you to this committee and to make the formal introduction.

Mr. VAN DEERLIN. Mr. Chairman, thank you. I think the important point to be made about Mr. Grady is that, unlike myself, a native son, Mr. Grady is a Californian of only 12 years standing. This suggests that, whereas some of us were born there, Mr. Grady had the wit to get up and move there. Happily for the subject at hand, he has been on both sides of the fence, you might say.

Before becoming the insurance commissioner of California he was an attorney representing in many cases insurance companies. He is thus innately familiar with the reporting procedures that are required of them and is in an excellent position to judge the merits of the legislation that is proposed and now before this subcommittee.

I, therefore, with great confidence, as he appears on behalf of a number of State commissioners, introduce for his testimony the Honorable Stafford Grady, insurance commissioner of California.

Mr. STAGGERS. Mr. Grady, we are glad to have you and certainly with this distinguished introduction we will expect a great deal from you. I want to say that you have a distinguished representative from your area in Congressman Van Deerlin. He is a highly respected member of this committee. I would like to know if you want the men associated with you to come up and sit with you, Mr. Howell of New Jersey, Mr. Combs of Arkansas, Mr. Price of Texas, and Mr. Farnam of Massachusetts. Are they here with you? Would you like them to come sit with you?

STATEMENT OF STAFFORD R. GRADY, COMMISSIONER OF INSURANCE, STATE OF CALIFORNIA; ACCOMPANIED BY CHARLES R. HOWELL, COMMISSIONER OF INSURANCE, STATE OF NEW JERSEY; NED PRICE, CHAIRMAN OF THE STATE BOARD OF INSURANCE, STATE OF TEXAS; C. EUGENE FARNAM, COMMISSIONER OF INSURANCE, COMMONWEALTH OF MASSACHUSETTS; HARVEY G. COMBS, COMMISSIONER OF INSURANCE, STATE OF ARKANSAS; AND HAROLD BIDDLE, CHIEF ACTUARY, DEPARTMENT OF INSURANCE, STATE OF NEW JERSEY

Mr. GRADY. I wish that they may.

Mr. STAGGERS. We are glad to have them. It looks like you are surrounded by a complete battery of distinguished gentlemen.

Mr. GRADY. Thank you very much. I appreciate those kind words of introduction and also the welcome of this committee, and so that you will know who is here maybe I can identify these gentlemen in order.

Mr. STAGGERS. If you would, please.

Mr. GRADY. First of all, Mr. Ned Price, chairman of the Board of Insurance of the State of Texas, Mr. Harvey G. Combs, insurance commissioner of the State of Arkanas, and I apologize that his name is not on the printed statement, but we weren't sure that he was going to be here by the time we had to go to press yesterday; Mr. Charles Howell, commissioner of insurance, State of New Jersey; Mr. Eugene Farnam, commissioner of insurance of the Commonwealth of Massachusetts; and Mr. Harold Biddle of the Department of Insurance of the State of New Jersey who is the chief actuary in that State.

Mr. Chairman and members of the committee, as has already been indicated to you, my name is Stafford Grady. I am the insurance commissioner of the State of California, and I have already introduced to you the fellow commissioners who appear here with me. We all appear before you as a group representing the National Association of Insurance Commissioners. I have been asked to make this statement with regard to the position of the National Association of Insurance Commissioners in opposition to the inclusion of insurance companies under H.R. 6789, H.R. 6793, and S. 1642.

Each of us appears here also in his own individual capacity as a State regulator of insurance and I am sure that one or more of my fellow commissioners may wish to make some supplementary remarks of his own.

I would like to state at the outset that we appreciate the opportunity afforded us to present to you the views of the National Association of Insurance Commissioners.

It might be helpful if I could explain briefly the organization and functions of the NAIC. It is an organization composed of the insurance regulatory authorities of all of the 50 States of the United States plus the District of Columbia, Puerto Rico, the Virgin Islands, Guam, the Republic of the Philippines, and the Provinces of Canada.

As you are undoubtedly aware, the operations of insurance companies are not supervised by any Federal agency. For more than three-quarters of a century prior to 1944, the U.S. Supreme Court

consistently ruled that insurance was not commerce and therefore was subject to State rather than Federal regulation.

In the case of *United States* v. *Southeastern Underwriters Association* (322 U.S. 533 (1944)) the U.S. Supreme Court reversed this long-standing doctrine. Congress was then quick to enact Public Law 15, 79th Congress, in 1945. In the preamble of that law, it was stated that:

> Enactment of this bill will (1) remove existing doubts as to the right of the States to regulate and tax the business of insurance, and (2) secure more adequate regulation of such business.

The law itself states, in part as follows:

> AN ACT To express the intent of the Congress with reference to the regulation of the business of insurance
>
> *Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled*, That the Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.
>
> "SEC. 2. (a) The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business."

The National Association of Insurance Commissioners has been the body which has acted to make sure that the regulation of the business of insurance by the various States had a substantial degree of uniformity. There are some differences in the laws of the various States on several matters affecting the industry.

However, in the field of financial reporting, the National Association of Insurance Commissioners has prescribed what is commonly known as the convention form annual statement for both fire and casualty companies and life, accident, and health companies. These forms are required to be filed by insurers with the insurance regulatory authority of the domiciliary State and with the insurance regulatory authority in all other States in which they are admitted to do business. Many companies must file in all 50 States and the District of Columbia. These uniform statements are public information, available for examination and inspection by anyone who wants to see them.

These convention form annual statements require a more detailed financial accountability than is probably required from any other industry. Copies of the convention form annual statement required for the year 1963, as formulated by the NAIC, and as adopted and required by all the 50 State insurance regulatory authorities are available for your examination. I have given them to Mr. Williamson, the clerk of the committee, this morning. You will note in the first several pages there is required a detailed balance sheet and profit and loss statement.

Insurance accounting generally is somewhat more conservative than is required by the so-called generally accepted accounting principles. This is so because of the experience which the NAIC has had over a long period of time in dealing with the problems peculiar to an industry which is so permeated by the responsibilities of a public trust and which must be able to meet contract liabilities both now and in the long-term future.

Frankly, we commissioners are proud of the manner in which we have discharged our stewardship in regulating this vast industry, which in the year 1963 exceeded $33 billion in annual premiums.

However, we are also not unmindful of the fact that the very detailed study which has recently been made by the Securities and Exchange Commission, which study has in large measure been responsible for the inclusion of insurance companies under the proposed legislation which you are now considering, brought to light certain facts which require steps to be taken in order to assure a more complete disclosure of information to those who invest in insurance company stocks.

At this juncture, I would like to take this opportunity to commend the Securities and Exchange Commission and Commissioner Cary and his fellow commissioners, for the very excellent public service they have performed, in conducting the study and preparing and submitting the "Report of the Special Study of Securities Market of the Securities and Exchange Commission."

We insurance commissioners are mindful of the need to have as complete a disclosure of all information regarding insurance companies as is either necessary or desirable. I will deal shortly with the specific items called to attention by the report of the Securities and Exchange Commission, and will attempt to explain what action has been taken by the NAIC in an effort to require the additional disclosure which that report indicates would be desirable.

Soon after the SEC report was made public and the bills which you are considering were introduced, the NAIC appointed a committee to study the report and proposed legislation and make whatever recommendations it deemed necessary or desirable.

Unfortunately, S. 1642 was introduced in the U.S. Senate and considered by it and passed prior to the time when the subcommittee of the NAIC, appointed for the purpose of considering these bills and the SEC report has had an opportunity to complete its deliberations and make recommendations.

However, the deliberations of the subcommittee of the NAIC were completed and its recommendations were considered and adopted by the National Association of Insurance Commissioners at its semiannual meeting held in Phoenix, Ariz., during the first week of December 1963. The substance of the position of the National Association of Insurance Commissioners is stated in the resolutions adopted at the December meeting, and a copy of those resolutions is being submitted for the record. I would like to have it included in the record if there is no objection. It is atached to the printed statement that has been submitted.

Mr. STAGGERS. That is with your statement.

Mr. GRADY. Yes, it is , Mr. Chairman.

Mr. STAGGERS. Without objection it will be included in the record.

Mr. GRADY. I would like to attempt to explain the substance of what the NAIC has done. It adopted the recommendations of its special subcommittee which was formed to study the SEC report and required that for 1964 and subsequent years, a so-called stockholder information supplement should be filed with the domiciliary State as an addendum to and part of the filing of the convention form annual statement.

This supplement would be required of all stock companies with in excess of a certain number of shareholders—the exact number has not

yet been determined—and present thinking is that it will be required of all stock companies with in excess of 25 shareholders, and irrespective of whether they have more or less than $1 million in assets.

Thus the supplement will be required of many more stock insurance companies than are included within the requirements of S. 1642, which would require SEC registration by all stock companies with in excess of $1 million in assets and 750 shareholders. Indeed, the supplement will be required of virtually all companies in which it could be said there is a group of public investors.

In adopting the stockholder information supplement, the NAIC was cognizant of the facts which were disclosed by the SEC study and report. We commissioners throughly agree that, in the best interests and for the protection of those who invest in insurance company stocks, additional information should be required to be disclosed to stockholders in respect of the following matters:

(1) Annual reports: Setting forth a statement of assets and liabilities, a statement of operations reflecting profit or loss from both operations and investments, and a statement of the capital and surplus account.

(2) All proxy statements submitted to stockholders should contain the identification of nominees for directors, describe their principal occupation or employment, indicate the number of shares of the company's stock owned by each, indicate the amount of aggregate remuneration paid and certain other additional information.

(3) So-called insider transactions of all directors, the three highest paid officers and all shareholders who own in excess of 10 percent of the stock of the company.

In connection with the "insider" information to be required concerning the three highest paid officers, it is our present thinking that this information will be required in respect of such officers whose aggregate remuneration exceeds $20,000 per year. This is somewhat more stringent than the present SEC requirement, which is $30,000 per year.

Very frankly, these steps were taken by the NAIC in order to require disclosure of additional information of interest to investors which the SEC report indicates has been deficient in some instances. In fact, we modeled the stockholder information supplement in large measure after what we anticipated the SEC would require if this bill passed.

A copy of the stockholder information supplement as approved at the Phoenix meeting of the NAIC is being submitted with this statement and I ask that it be included in the record.

Mr. STAGGERS. It will be included in the record. Would you like it included at this point?

Mr. GRADY. No: it is attached to this statement, sir.

Mr. STAGGERS. It will be included at the completion of your statement.

Mr. GRADY. I would like to point out the current status of the supplement. At Phoenix, in December, the NAIC adopted the supplement and copies have been submitted to the insurance commissioners of the various States in sufficient quantity so that each commissioner can send a copy to each stock companw domiciled in his State. This will alert each of the companies to the fact that the supplement will be required as part of the 1964 convention form statement filing.

I have sent to each stock company domiciled in the State of California a letter dated January 15, 1964, with which I enclosed a copy of the supplement and advised them that it will be required henceforth. A copy of this letter is being submitted for the record, and I ask that it be included. It is attached to the printed statement.

Details regarding the final form of the stockholder information supplement will be resolved at the March meeting of the blanks committee. Also, at that time these following steps will be taken:

(1) Instructions to accompany the supplement will be prepared, to aid the companies in completely and accurately supplying the information.

(2) Instructions to be added in the Insurance Examiner's Handbook pointing out how best and most effectively to examine companies to assure that the requirement of the additional disclosures are met by the company being examined. As you know, each insurance company, as a matter of practice, is subject to very thorough examinations by the insurance departments of the various States.

Some explanation of the manner in which the NAIC stockholder information supplement is to be implemented is in order.

As an itegral part of the convention form annual statement, there is a section entitled "General Interrogatories." In the 1963 convention form, copies of which you have on your desk, for instance, there are 30 separate questions designed to elicit information concerning many aspects of the company's operations. As a result of the NAIC action, an additional interrogatory will be added to the 1964, and subsequent, convention forms. It will read in substance:

"If reporting company is a stock company, has it filed form ——— (stockholder information supplement) with the insurance department of its domiciliary State for the year covered by this annual statement? Answer ———."

And the answer, of course, would be either yes or no.

"If answer is 'No,' explain in detail."

We commissioners feel certain that as a result of asking of this question the companies will comply with the disclosure requirements and will disseminate the information to stockholders. We believe this for several reasons. First of all, the laws of the various States give the insurance regulatory authority the power to prescribe that the NAIC convention form annual statement be filed—and it has been so prescribed in all 50 States.

Secondly, we believe that the form of the stockholder information supplement by its very nature suggests the information which a company should disclose. In practice we have found that an interrogatory designed to indicate that a negative answer would be unacceptable results in the companies taking the desired course of action.

For instance, several years ago, the following question was added to the interrogatories:

> Has the company an established procedure for disclosure to its board of directors or trustees of any material interest or affiliation on the part of any of its officers, directors, trustees, or responsible employees which is in or is likely to conflict with the official duties of such person?

In no single instance to my knowledge, has an insurance examiner, who has examined a company since this question was added, failed to find that an established procedure designed to elicit conflicts of interest has been in effect.

Our insurance examiners have been instructed to study the procedure and include a description of it in the report of examination together with a list of reasons if the examiner considers the procedure inadequate in any way. The company is given a copy of this report and has an opportunity to correct any matters found to be in error or deficient. This system has worked quite effectively. We believe this is due in part to the fact that the insurance regulatory authorities in the various States have the right to publish these examination reports if they care to. Companies are understandably reluctant to have a critical report published. This would be disastrous competitively.

Needless to say, in view of the broad powers given the various insurance commissioners by the statutes of their respective States, no company would want to consciously refuse to make the disclosures indicated.

I would like to discuss for a moment the subject of the additional costs which would be involved if this legislation would pass in its present form—both to the insurance companies and to the Federal Government.

The insurance industry is highly competitive. Companies are constantly making efforts to keep costs at a minimum so that premium rates will not have to be increased. If insurance companies are to be required to register and file annually with the SEC, certainly some additional costs will be involved. None of us is prepared to give you an accurate estimate of the amount of these additional costs, but no matter what the amount, additional costs are to be avoided if possible.

Most insurance company personnel are oriented to filing detailed financial and other data with the insurance regulatory authorities of the various States. If these companies now are to be required to file information with the SEC, prepared to comply with its rules and regulations, they are confronted with a new and different problem. Experts familiar with SEC requirements will have to be employed to assure compliance. Obviously, this will involve additional expenses to these companies.

It is my understanding that the SEC estimates that additional appropriations amounting to several hundred thousand dollars annually will be required to finance the added responsibilities placed upon that agency by this legislation. I do not know what portion of this amount is attributable to the inclusion of insurance companies.

However, obviously, some portion of these added Federal expenditures could be avoided if insurance companies are excluded and they are allowed to continue their reporting to the States. We urge that the additional expenses to both the companies and the Federal Government are not justified.

To the extent that the information to be furnished to the SEC under this bill is the same as that already submitted to the various State regulatory authorities, it is merely an unnecessary duplication. To the extent that the SEC is given the power to require information different from or in addition to that submitted to the various States, two things occur:

(1) To that extent, the insurance industry is being subjected to dual regulation, that is, by the States and by the SEC.

(2) An area for confusion will develop. For instance, a person may get one picture regarding the financial condition from the company in which he is a policyholder, and an entirely different picture from the SEC required information if he is an investor in the same company.

We believe the additional expense, duplication, dual jurisdiction, and potential confusion should be avoided.

For the foregoing reasons, we object to insurers being included in the bills under consideration because it is our opinion that the regulation of the insurance industry is more properly the functions of the several States and because the NAIC has indicated both the willingness and the ability to correct any deficiencies found to exist.

We do not mean to imply that the steps we have taken are either perfect or complete. However, we do desire to leave with you the firm conviction that the NAIC and the commissioners of the various States are concerned equally with the Congress and the SEC with adequate disclosure to the end that investors in insurance company stocks will be fully informed and adequately protected.

Accordingly, we respectfully urge that the pending legislation be amended so as to exclude its applicability to insurers which are subject to the jurisdiction of the various States.

Again, we wish to thank this committee for the opportunity to present our views.

(Statements referred to follow:)

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

The subcommittee to study the SEC report on insurance company stocks met at 3:30 p.m. on Monday, December 2, 1963, in the Turquoise Room of the Hotel Westward Ho, Phoenix, Ariz. A quorum of the committee was at all times present. After extensive discussion, the subcommittee went into executive session.

Upon motion duly made, seconded, and unanimously carried, the following resolution was adopted:

1. Whereas the U.S. Senate has passed Senate bill 1642 which would extend various provisions of the Securities Exchange Act of 1934 to certain stock insurance companies, and would subject such companies to registration with, and regulation by, the Securities and Exchange Commission; and

Whereas said bill is presently pending before the House Commerce Committee and Financial Subcommittee of the Interstate and Foreign Commerce Committee of the House of Representatives; and

Whereas the 79th Congress has provided in Public Law 15 that: "The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business: and

Whereas the several States have been, and are, effectively regulating the business of insurance, and are able and willing to fulfill their responsibility to provide adequate protection for insurance company stockholders and are engaged in developing the most desirable and effective means of doing so; and

Whereas Senate bill 1642 represents precipitous Federal intrusion in the field of insurance regulation heretofore properly reserved to the several States by Public Law 15: Now, therefore, be it

Resolved, that—

1. The NAIC go on record as opposing the enactment of Senate bill 1642 in its present form.

2. The NAIC urges that Senate bill 1642 be amended by inserting after line 23 on page 8 of the bill the following:

"(F) Any security issued by an insurance corporation subject to regulation by the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or territory of the United States or the District of Columbia."

3. This resolution be forwarded to the chairman and members of the House committee, before which Senate bill 1642 is pending.

4. The president of the NAIC appoints a committee to deliver this resolution to the chairman of the House Committee on Interstate and Foreign Commerce, and direct such committee to convey to the chairman and/or members of the said committee the views of the NAIC with respect to Senate bill 1642.

RESOLUTION NO. 2

Commissioner Stafford R. Grady moved that the proposed stockholders information supplement, copy of which is attached hereto, be submitted to the blanks committee at its next meeting with the direction that the substance of the information sought to be elicited by said supplement be required to be provided by inclusion by appropriate inquiries in the convention form statement for 1964 and subsequent years, or in an appropriate supplement to such statement.

Motion was duly seconded and unanimously carried.

RESOLUTION NO. 3

Commissioner Ned Price moved to recommend to the parent committee that this subcommittee be continued for the purpose dealing with this problem until final disposition of the present legislation.

Motion was seconded by Commissioner Cantor and unanimously carried.

Hon. C. EUGENE FARNAM, *Chairman, Massachusetts.*
Hon. STAFFORD R. GRADY, *California.*

STATE OF CALIFORNIA,
DEPARTMENT OF INSURANCE,
San Francisco, Calif., January 15, 1964.

To: All domestic stock companies with 25 or more shareholders.
Subject: Stockholder information supplement.

At the December 1963 meeting of the National Association of Insurance Commissioners in Phoenix, Ariz., a stockholder information supplement (to be included as an integral part of the convention form annual statement for the year 1964 and subsequent years) was approved. A copy of the supplement in its present form is enclosed for your information and convenience.

The primary purposes of the supplement are threefold: first, to require the dissemination of complete and accurate financial information, including balance sheet, income, and expense items, and surplus to all shareholders; second, to require a disclosure of the names of proposed directors, their qualifications and other pertinent information when proxies are solicited from shareholders; and, third, to require the disclosure of information regarding insider transactions.

The supplement is not yet in final form; however, the substance of the information to be provided is indicated in the enclosed document. We are communicating this information to you at this juncture so that you will be in a position to answer the interrogatories and supply the information to be required in the 1964 convention form annual statement, which will include: whether financial information relating to 1963 was disseminated to shareholders during 1964; and whether proxy solicitations during 1964 were in accordance with the standards indicated; and requiring the disclosure of insider transactions which occurred during 1964.

We will transmit to you a copy of the final form of the stockholder information supplement soon after the March 1964 meeting of the NAIC blanks committee. It is anticipated that instructions will accompany the submission of the supplement to you in final form.

Very truly yours,

STAFFORD R. GRADY,
Insurance Commissioner.

Enclosure.

National Association of Insurance Commissioners Form No. ——— Stockholder Information Supplement Required by Question 10 General Interrogatories to Annual Statement of the _____ Company. To the Insurance Commissioner of the State of _____ for the Year Ended December 31, 19__

GENERAL INSTRUCTIONS

The information required to be contained in this supplement is to be furnished to the best of the knowledge of the company. Where appropriate, the company should obtain the required information, in writing, from its directors and officers and from any person known to the company to be the beneficial owner of more than 10 percent of any class of its equity securities.

DEFINITIONS

Officer: The term "officer" means a president, vice president, treasurer, secretary, controller, and any other person who performs for the company functions corresponding to those performed by the foregoing officers.

Beneficial Owner: _____.

(Additional definitions as required to be contained on this page.)

FINANCIAL REPORTING TO STOCKHOLDERS

1. Will the company distribute to its stockholders an annual report for the calendar year covered by this annual statement?

Answer: _____.

If answer is "No" explain in detail _____.

2. Did the company distribute to its stockholders an annual report for the prior calendar year?

Answer: _____. If answer is "Yes" attach copy.

If answer is "No" explain in detail _____.

3. If an annual report to stockholders was distributed for the prior year, did it contain the following financial statements (indicate answer in col. A); and were such financial statements prepared in substantially the form (individual or consolidated) required to be presented herein (indicate answer in col. B)?

	Col. A		Col. B	
	Yes	No	Yes	No
(A) To be answered by life companies:				
(a) Statement of assets, liabilities, surplus and other funds				
(b) Summary of operations				
(c) Surplus account				
(B) To be answered by fire and casualty companies:				
(a) Statement and assets, liabilities, surplus, and other funds				
(b) Statement of income—Underwriting and investment exhibit				
(c) Capital and surplus account				
(C) To be answered by title insurance companies:				
(a) Statement of assets, liabilities, surplus, and other funds				
(b) Statement of income—Operations and investment exhibit				
(c) Capital and surplus account				

SCHEDULE X.—*Information regarding management and directors*

(Furnish in the following schedule information on all directors and for each of the 3 highest paid officers whose aggregate remuneration exceeded $30,000) (for stock companies only).

Name	Principal occupation or employment	Served as director from—	Shares of each class of stock beneficially owned	Aggregate remuneration [1]	Retirement benefits accrued or set aside [1]	Estimated annual benefits upon retirement [1]
Compensation and retirement benefits accrued of all officers and directors as a group.				—	—	—
Answer "Yes" in each column if the information in that column was furnished to stockholders in a proxy statement or otherwise in the period covered by this statement.	—	—	—	—	—	—

[1] Necessary only for each director and the 3 highest paid officers whose compensation exceeded $30,000.

NOTE.—Did the shareholders have an opportunity to vote for or against the election of directors and also on other matters to be presented for a vote at any stockholders' meeting. Answer —.

Statement of beneficial ownership of securities (see instructions below)

(1) Name and title of director, officer, or owner of more than 10 percent	(2) Title of security	(3) Nature of ownership	Owned at beginning of year	(4) Number of shares		
				Acquired during year	Disposed of during year	Owned at end of year

INSTRUCTIONS FOR STATEMENT OF BENEFICIAL OWNERSHIP OF SECURITIES

Column 1.—Indicate relationship of the person to the company, for example, director, director and vice president, beneficial owner of more than 10 percent of the company's common stock, etc.

Column 2.—The statement of the title of a security should be such as clearly to identify the security, even though there may be only one class; for example, common stock, 4 percent convertible preferred stock, etc.

Column 3.—Under "nature of ownership," state whether ownership of securities is direct or indirect. If the ownership is indirect, i.e., through a partnership, corporation, trust, or other entity, indicate in a footnote or other appropriate manner the name or identity of the medium through which the securities are indirectly owned. The fact that securities are held in the name of a broker or other nominee does not of itself constitute indirect ownership. Securities owned indirectly shall be reported on separate lines from those owned directly and from those owned through a different type of indirect ownership.

Column 4.—In the case of securities owned indirectly, the entire amount of securities owned by the partnership, corporation, trust, or other entity shall be stated. There may also be indicated in a footnote or other appropriate manner the extent of the security holder's interest in such partnership, corporation, trust, or other entity.

If a transaction in securities of the company was with the company or one of its subsidiaries, so state. If it involved the purchase of securities through the exercise of options, so state. If any other purchase or sale was effected otherwise than in the open market, that fact shall be indicated. If the transaction was not a purchase or sale, indicate its character; for example, gift, stock dividend, etc., as the case may be. The foregoing information may be indicated in a footnote or other appropriate manner.

Any additional information or explanation deemed relevant by the company should be included in a footnote or other appropriate manner.

Suggested question to replace present question 10 on general interrogatory, page 13, of the convention form annual statement.

(10) If reporting company is a stock company, has it filed form ——— with the insurance department of its domiciliary State for the year covered by this annual statement?

Answer----------.

If answer is "No," explain in detail----------.

SUPPLEMENTAL (A4) BLANKS COMMITTEE REPORT

A special meeting of the blanks committee (A4) was held on December 4, 1963, in the Corral Room of the Westward Ho Hotel to consider the matter referred to it by Resolution No. 2 in the report of the Subcommittee To Study the SEC Report on Insurance Company Stocks (H2), after the adoption of this report by its Parent Committee on Laws and Legislation. This resolution directed the blanks committee to include in the association annual statement forms for 1964 and subsequent years, the substance of the stockholder information supplement attached to the subcommittee report. A quorum of the committee was present.

After considerable discussion during the open meeting of minor modifications in this proposed supplement which can be made at the time other changes in the form of the 1964 annual statements are adopted, the committee went into executive session.

Upon motion duly made, seconded, and unanimously carried, the change in the annual statement form and the stockholder information supplement recommended by the laws and legislation committee, as described above, were adopted for and as part of the 1964 annual statement forms.

Action was also taken to direct the chairman to work out a procedure to assure that a copy of this report together with that of the Subcommittee To Sudy the SEC Report on Insurance Company Stocks would be sent by each insurance department at an early date to each of its domestic stock insurance companies so that all companies affected by this change would have adequate notice of these additional requirements.

Hon. Charles R. Howell, chairman, New Jersey, by W. Harold Bittel; Hon. Stafford R. Grady, vice chairman, California, by Christy P. Armstrong; Hon. Alfred N. Premo, Connecticut, by Peter F. Kelly; Hon. J. Edwin Larson, Florida, by Frank de Veer; Hon. Harry E. McClain, Indiana, by Norman R. B. King; Hon. William E. Timmons, Iowa, by Vincent Nutt; Hon. J. Elliott Flanery, Kentucky, by Robert B. Evans; Hon. F. Douglass Sears, Maryland, by John H. Coppage; Hon. Frank J. Barrett, Nebraska, by Walter J. Madden; Hon. Samuel C. Cantor, New York, by Seymour Goodman; Hon. William R. Morris, Ohio, by L. Hayden Jones; Hon. T. Nelson Parker, Virginia, by John H. Parker; Hon. Lee I. Kueckelhan, Washington, by Jerome G. Bradley.

Mr. STAGGERS. Mr. Grady, I want to thank you for a very comprehensive report and one that I am certain that every insurance company in America would say is a very good statement of their views.

Mr. GRADY. Thank you, sir.

Mr. STAGGERS. I do not want to disagree with you, but I would like to ask you one or two questions.

Mr. GRADY. I would be happy to try to answer them.

Mr. STAGGERS. I think several members of the committee would like to do likewise. I notice that on page 7 you say that you have tried to comply with the SEC requirements in reporting to the States, such as your annual report setting forth a statement of assets and liabilities, a statement of operations, statement of the capital and surplus account, and also your proxy statements, as set forth in the SEC studies.

Mr. GRADY. Yes.

Mr. STAGGERS. Also so-called insider transactions. You recommended that they be reported to the State.

Mr. GRADY. Yes, sir.

Mr. STAGGERS. Now, in regard to that, you certainly come in complete agreement with 16(a) of the proposed law, but what about 16(b), the subsection which would give stockholders an opportunity to file derivative suits to enforce the act and require that recapture of excess profits be shown? How do you intend to enforce that under your provisions?

Mr. GRADY. Mr. Chairman, in our opinion that is the fundamental law of the various States.

Mr. STAGGERS. Then that would vary as to the 50 States in their respective State laws.

Mr. GRADY. Not necessarily. I think the laws in that respect are quite uniform. Corporation officers and directors cannot pocket insider transactions whether it is an insurance company or any other corporation. Once the facts are brought out any stockholder can bring a derivative suit in any State of the 50 States so far as I know, and this is so whether it is an SEC-regulated corporation or not.

Mr. STAGGERS. Would this be true with regard to your 6-months transactions of the SEC in securities?

Mr. GRADY. I am not sure I understand the question.

Mr. STAGGERS. Well, we have a 6-months transaction in the securities and exchange law, a time limit and so forth, that applies to certain transactions, and I just wondered if this would apply to your insurance companies too.

Mr. GRADY. I believe I understand your question now. It is my understanding that the SEC law does require a disgorging of insider transactions which have been realized by the sale of the company stock at a profit within 6 months. I doubt that the laws of the various States are that specific.

However, I think that any court construing the statutes protecting stockholders would certainly give a lot of weight to the fact that the SEC law uses a 6-month guideline.

Mr. STAGGERS. I might state this: I believe the McCarran Act says, in the different States you refer to here in the start of your statement, the business and so forth of the policyholders and everything would be regulated by the States and not the companies. Does this abrogate the Securities and Exchange Act of 1934 that has to do with stockholders across the Nation in these insurance companies? Does the State anywhere in any event supersede stockholder transactions?

Mr. GRADY. No, I don't think so, Mr. Chairman. I believe that it is public law 15 that intended to leave the regulations of insurance industry in the respective States.

Mr. STAGGERS. Yes; the regulations. But I am talking about stockholders now. Does it mention in any way transactions of the stockholders in the 50 States?

Mr. GRADY. We feel that if the insurance industry is going to be required to file information with the SEC, and be required to file financial information particularly, in accordance with the SEC rules and regulations, to the extent that those rules and regulations differ from the rules and regulations prescribed by the NAIC and the separate States, then we are being subjected to dual regulations and to that extent the dual regulations is inconsistent with the sense of public law 15.

Mr. STAGGERS. I would agree with you perhaps to the extent that it agrees with your policyholders and not stockholders, but I would say that you have said that you have prepared your recommendations almost in line with the SEC report. To me, until it is shown differently, perhaps the same statement that you file with your States would be sufficient for the SEC.

Mr. GRADY. We would hope that they would see it that way.

Mr. STAGGERS. That is what I say. We are talking about great expense accounts and everything. Perhaps what you have suggested here would be sufficient and then we would have a uniform control of the transactions as they related to stockholders across the Nation, because evidently in these insurance companies stockholders cross State lines.

Mr. GRADY. Oh, no question about it.

Mr. STAGGERS. And that is what the SEC first started to do: to see that the people who invest are protected. The public welfare here would be protected under the SEC and all they are trying to do, I believe, is to say that, "We want to protect stockholders, not to manipulate or say what the policy of an insurance company should be."

I am only bringing up some of the questions that have been raised.

Mr. GRADY. I understand, Mr. Chairman.

Mr. STAGGERS. Again I say to you you made a very good record for your organization.

Mr. GRADY. Thank you, Mr. Chairman. May I call this matter to your attention? Let's assume for the moment that you are a stockholder and a policyholder in the same insurance company. You have a life insurance policy or automobile insurance policy with the XYZ insurance company. You will receive a copy of the balance sheet and profit and loss statement of that company as a policyholder. That balance sheet and profit and loss statement is pursuant to the rules and regulations prescribed by the NAIC which are uniform throughout the 50 States.

Now, to the extent that the SEC is given any power in this statute to require financial reporting different from that that is prescribed by the NAIC, you as a stockholder or potential investor can very likely receive a different financial picture of that same company, and the reason for it is very simple.

Insurance accounting is much more conservative than is generally accepted accounting principles which I understand the SEC is attempting to apply, so you are going to get two sets of figures describing the same thing about the same company, and there is no con-

fusion in this industry now, but there will be then. This is to the detriment of a potential investor in my opinion.

Mr. STAGGERS. I would agree with you to this extent. What we are trying to do here is protect the stockholders in any company in America that crosses interstate lines. If we protect one it doesn't matter how many others are confused, I believe, and that is the sole purpose of the SEC—to protect the stockholders of the Nation. I believe this report of the Commission shows the weaknesses that were found.

Mr. GRADY. Yes, sir.

Mr. STAGGERS. And you have agreed in your report that there were weaknesses and you have tried to show some of them. Evidently then they were right, or your organization wouldn't have come along recommending some of these.

Mr. GRADY. That is correct, sir.

Mr. STAGGERS. Then all they are trying to do is to say, "Let the policyholder and the other things go to the States, but let us as a national organization just have a look-see so we know that everything is open and above board."

Mr. GRADY. There is presently plenty of look-see available in all 50 States.

Mr. STAGGERS. I am sure of that. Many of the stockholders that you know are not policyholders because a lot of people who invest certainly have their insurance companies made up for them and their balances in different ways and how they participate.

Mr. GRADY. But the point is, Mr. Chairman, now there is no confusion. If this bill passes there will be.

Mr. STAGGERS. I am sure of that, but in that confusion perhaps a few people will be protected.

Mr. GRADY. Mr. Chairman, they will now be protected by the action of the NAIC because this information will be furnished to stockholders in accordance with the rules prescribed by the NAIC.

Mr. STAGGERS. If we don't do anything else we will have done something to help policyholders.

Mr. GRADY. Yes, sir; no question about it.

Mr. STAGGERS. Those are all the questions I have.

Mr. Long?

Mr. LONG. No questions.

Mr. STAGGERS. Mr. Glenn.

Mr. GLENN. Mr. Grady, I am pleased to see that you have with you the Honorable Charles R. Howell, commissioner of insurance of my State of New Jersey and I would like to welcome Mr. Howell here because he is one of our ex-colleagues of this body, and I think he would still be with us if he hadn't perhaps unfortunately attempted to go over to the other body.

Mr. HOWELL. I made an error there, Mr. Glenn.

Mr. GLENN. Our loss has been the State of New Jersey's gain. He has been a very fine commissioner of banking and insurance and we are quite pleased with him in the State.

Mr. HOWELL. Thank you, sir.

Mr. GLENN. I noticed that you have a good portion of your statement based on this format which you are getting up as a result of a meeting in December called the stockholder information

supplement, and apparently from what you say this is still in process and I wonder just how mandatory this will be in the various States to make this a required procedure for all the companies who make their reports to the insurance commissioners of the States?

Mr. GRADY. Is your question addressed to me, Congressman?

Mr. GLENN. Yes, it is addressed to you.

Mr. GRADY. Sir, the substance of this form was adopted and approved at our Phoenix meeting. There are a couple of things that were left to be done, such as this: As you recall, the proposed bill provides that the new provisions will be applicable to all stock companies with more than 750 shareholders. We, the commissioners, believe that we will probably require our stockholder information supplement of all companies which have in excess of 25 shareholders.

We originally thought we would do it in respect of all companies despite the number of shareholders involved, but if you do that you get into situations where you have a wholly owned subsidiary of a big parent company and of course the stockholders would get the information from the parent company. We are going through this little, oh, kind of tightening up process in this form to just make sure that we are not imposing any useless burden on anybody and at the same time seeing to it that we are going to get all the information that is necessary.

Now, another example of this tightening up process is this: The SEC present rules and regulations require certain disclosures in connection with the officers who receive in excess of $30,000. We are going to lower that requirement. We think we are going to use $20,000, and one of the reasons for it is that it fits into present NAIC required reporting in connection with officers, information, so we are trying to tighten it up and make it conform and make it consistent with the rest of our reporting. These items, by the way, will finally be resolved at the blanks committee meeting of the NAIC which meets in March and it will then have final approval in its final form. We will prepare instructions which will go out to all the companies and we will also prepare instructions for our examiners to check these items.

In connection with its present status I mentioned during the course of my statement that sufficient copies have been sent to the commissioners in each State so that they have been in a position to send on to the companies involved in their own domiciliary States a copy of the supplement with a warning that it will be in the 1964 convention form, so we are in business, whereas the SEC doesn't have its law yet. We are moving. If you exclude insurance companies, this will apply much more rapidly than it would be if you passed this law and gave the SEC the power.

Mr. GLENN. I don't think you are following the subject of my question in that I want to know, with your association being a voluntary association, what mandatory requirement there will be on these companies to do this and how will the public be protected by a requirement that this information be given to the various insurance commissioners in the 50 States.

Mr. GRADY. Well, as I mentioned during the course of my statement, we feel that we have worded this interrogatory in such a way that an undesirable answer would be a negative one.

Thus we have indicated to companies that we want an affirmative answer and a compliance with this.

Mr. GLENN. What if a company doesn't desire to answer this and refuses to give the information? What then?

Mr. GRADY. They have to file the convention form annual statement with us and if they want to answer "No," and I can't conceive that they would want to answer "No," that they have not filed this information, the insurance commissioners of the various States have broad authority to deal with the subject.

For instance, in my own State of California, section 923 of the code says that—

> The commissioner shall cause to be prepared and shall furnish on demand to each of the insurers printed forms of the statements herein required. He may make such changes from time to time in the form and such statement and reports as seem to him best adopted to elicit from insurers a true exhibit of their condition.

These same forms must be furnished on demand to all insurers engaged in the same kind of buys. So I have the authority to prescribe the form. I have prescribed it. Every State has done likewise. It has prescribed this form. Section 844 of our company provides that—

> Every insurer authorized by the commissioner to sell securities shall thereafter at such times and in such form as he requires make and file in his office a report setting forth (*a*) the securities sold by it under the authority of the permit issued to him, (*b*) the proceeds derived therefrom, (*c*) the disposition of such proceeds, and (*d*)

and this is the critical one—

> such other information concerning its property, officers, or affairs and relating to or affecting the value of such securities as the commissioner may require.

So any commissioner can require that this information be filed.

Mr. GLENN. You are reading from your California law, are you not?

Mr. GRADY. Yes, I am, sir.

Mr. GLENN. Does every State in the Union have the same provision in its regulations?

Mr. GRADY. I will let my respective commissioners speak for their own States. I think I can answer generally that they may not be the exact same words, but they are very similar in application.

Mr. GLENN. What if the State itself would not see fit to make this requirement? Then how would you force these companies to do it?

Mr. GRADY. Well, every commissioner has prescribed the NAIC form. The form is uniform throughout the 50 States, so it is up to the commissioner now to see that this form is complied with.

Mr. GLENN. And if he didn't do it, there would be no compliance, right?

Mr. GRADY. Well, if he didn't do it it would be just like Commissioner Cary not performing his job either. There wouldn't be any compliance.

Mr. GLENN. The thing that is giving me some concern is that perhaps through the Securities and Exchange Commission this information can be obtained by a provision in the law which would make it punishable by fine or imprisonment not to furnish it, whereas under your association provisions it would have to go into the various 50

States and then the 50 States themselves would have to promulgate regulations and be responsible for the enforcement of these provisions, where maybe it could be covered by one provision in the Securities and Exchange Act.

Mr. GRADY. Congressman Glenn, I doubt that that is so because we feel from past experience in dealing with insurance companies that they will comply.

Now, we have broad powers. We can take away their certificate of authority for noncompliance.

Mr. GLENN. Who can?

Mr. GRADY. I can take it away.

Mr. GLENN. The commissioners?

Mr. GRADY. Yes, sir; so, therefore, we think that a company would be well advised to comply with our request; not only that, but this stockholder information supplement and the action that we have taken at Phoenix has been universally supported by the insurance industry. We haven't heard one dissenting voice. The whole industry, including all the commissioners, are against the inclusion under this SEC bill.

Mr. HOWELL. I just wanted to try to explain that this is a uniform blank of the blanks committee of the National Association of Insurance Commissioners. It puts questions on the blanks. They are put on the blanks of all the States. It is a very uniform procedure. If they want to ask something in addition to that they can do it, but I don't believe there has ever been an instance of any of the commissioners not placing on the annual statement the questions that the blanks committee prescribed.

Mr. GLENN. Sir, when Chairman Cary was before our committee he pointed out that State laws and regulations presently do not require timely disclosure of events of major importance, such a major acquisition of assets, significant litigation, which has taken place recently, or the issuance of substantial amounts of stock.

In contrast to that form 8–k in the Securities and Exchange procedure, the filing of which would be required by this bill, must be filed after the occurrence of these events.

Do you take into consideration that these things are of great importance and should be disclosed immediately on your form which you just mentioned makes such provision for these things?

Mr. GRADY. Of course, Congressman Glenn, I think those things are already disclosed to the States. For instance, mergers. They must be approved by the various State insurance commissioners before they are adopted, so that information is public information long before the SEC would get it under the 8–k filing. An 8–k filing as I understand it, is one that comes, I think, within 30 days after the event or within a month following the event. The insurance commissioners approve these things ahead of time.

In other words, two insurance companies cannot merge without the prior approval of the commissioners. The commissioners have hearings. The stockholders are informed of these things. Insurance company stockholders are not left as much in the dark as you have been led to believe. They are informed somewhat. We haven't had it uniformly so much as the SEC would like to have, but we do feel that the action we have taken at Phoenix will make it more uniform.

I would like to leave this thought with you. Here is an industry which for a hundred years has been regulated by the commissioners. Now, we have taken, we believe, long steps toward trying to cure whatever deficiencies the SEC found to exist. We don't think that we have necessarily gone all the way yet or that the actions we have taken are complete or perfect, but we would urge you, rather than change the status quo by enacting this law and subjecting us to duel regulations, that you would give us a little opportunity to see whether we cannot perform for you.

Mr. GLENN. Well, undoubtedly, sir, I think the insurance commissioners have done a splendid job in the protection of policyholders, but I think you can appreciate that what we are trying to do with this legislation is to see that all stockholders generally have the protection which they should have and which our laws have been a little neglectful in giving that protection in view of some of the things which have happened in the past several years.

I can recall in my own State of New Jersey back in the 1920's when we were having the boom period and two new companies were being formed, the formation of two companies, one an indemnity company and the other a fire insurance company, and unfortunately it was right before the stock market crash and these companies were taking the public's money and investment in their stock went down so fast that the stockholders didn't even have a chance to sell. They were insolvent before one could even call up the broker and tell him to sell. That too has been taken care of by the ensuing Securities and Exchange Acts to protect them from this sort of thing.

These things we are facing up to and, while policyholders have great protection now, I am concerned with protection that comes under the insurance field as well as the corporate field generally.

Mr. GRADY. Of course, no matter what we do, we are not going to eliminate all problems in the industry, but I think that the fact that these things did occur in the 1920's and have occurred on prior occasions is one which compels the NAIC to prescribe and follow a much more conservative method of accounting than the generally accepted accounting principles. We do not treat as admitted assets all things that other companies have as assets because we have found in the process of times of stress, process of liquidating companies, and that sort of thing, that some assets just are not worth what they are indicated on their books to be worth, so we have attempted to eliminate a lot of assets of that nature and they are called nonincluded assets.

If we are subjected to the SEC type of filing we will not have that conservative form of accounting which is being transmitted to stockholders. We think they should know what their insurance company is like as an insurance company because that is what it is.

Mr. GLENN. One last question. How old is the National Association of Insurance Commissioners?

Mr. GRADY. I am kind of a young member. I will have to ask one of my older colleagues.

Mr. HOWELL. One hundred-odd years.

Mr. GLENN. Thank you very much. That is all, Mr. Chairman.

Mr. STAGGERS. I notice Congressman Pool in the audience. Mr. Price, he is sitting there backing you up.

Mr. PRICE. Yes, sir.

Mr. STAGGERS. I didn't see him to start with, but I am certain he will have some comment to make for his fellow Texan. However, I see that he is backing you up there.

Mr. POOL. Thank you, Mr. Chairman.

Mr. STAGGERS. Mr. Van Deerlin?

Mr. VAN DEERLIN. Mr. Grady, roughly how many insurance companies are there in this land of ours?

Mr. GRADY. I think somewhere around 2,800 to 3,000, in that neighborhood, including life, casualty, and title companies.

Mr. VAN DEERLIN. Is it true or is just an idea that I have conjured up that there is an inordinate number of these companies which have been fathered in the State of Texas?

Mr. GRADY. I will let my colleague from the State of Texas answer that, if I may, Congressman Van Deerlin.

Mr. PRICE. There was a time, Mr. Van Deerlin, a few years back, when we had a problem. Let me say we have no problems at this time; no, sir.

Mr. VAN DEERLIN. The question was really put for Mr. Pool's benefit. Mr. Grady, are there any companies which have been formed exclusively within a single State; that is, all the stockholders residing within a single State, and which have all their policyholders within a single State?

Mr. GRADY. Yes, sir. We have several in the State of California and I am sure that each State has a number of them.

Mr. VAN DEERLIN. Which are not then in interstate commerce?

Mr. GRADY. That is correct.

Mr. VAN DEERLIN. This would be not a significant number, though; would it?

Mr. GRADY. I would say there probably would not be in excess of maybe 20 or 25 percent of the total number of companies.

Mr. VAN DEERLIN. That high? Would there be any very large companies in this category?

Mr. GRADY. No, most of the large companies are admitted in more than one State and have stockholders in more than one State.

Mr. VAN DEERLIN. Thank you, Mr. Chairman.

Mr. STAGGERS. Mr. Keith?

Mr. KEITH. Thank you, Mr. Chairman. As other colleagues have commented on the character and quality of the insurance commissioners I would like to point out that we have with us today the commissioner of the Commonwealth of Massachusetts, Eugene Farnam, who similarly tried to come to Washington at one time, and perhaps to his best interest and certainly in the best interest of the Commonwealth of Massachusetts he has now been made insurance commissioner instead of Congressman. I am certain that the policyholders and the stockholders in Massachusetts are safeguarded because of the quality of Eugene Farnam's service.

Mr. GRADY. In the SEC study they found that in the case of 36 elections of directors and insurance companies 28 of the proxy solicitations failed to state the names of the nominee. Does the NAIC form now require that these names be given?

Mr. GRADY. Yes, it does, Congressman.

Mr. KEITH. I note that the SEC study found that 50 percent of the companies studied failed to send their stockholders their profit and

loss statement. Does your new supplemental reporting form require that insurance companies send such a statement or its equivalent to stockholders?

Mr. GRADY. Yes, sir. I might add that will be required in 1964, whereas under the law that is before you it will not apply until 1965, as I understand it, of the SEC.

Mr. KEITH. Would you care to comment on the philosophical nature of this statement? Currently the SEC is responsible for the regulations applicable to a large number of insurance companies that come under the provisions of the 1933 act, and this is an extension of regulations to more than insurance companies because of a change in requirements, but after the same objectives as were contained in the 1933 act.

You are talking in your testimony about keeping things at the State level and implying that there is no real national need or purpose served that cannot be taken care of at the State level, but already we have a pattern of supervision by the SEC applicable to a very substantial amount of insurance companies.

Mr. GRADY. Yes, sir; I would like to comment on that, Congressman Keith. I believe Congress has indicated by the SEC Act of 1933 and 1934 that when a company goes to the public for funds it must register with the SEC and it then subjects itself to its requirements. Many companies have done that, although not as large a number of insurance companies as would first appear.

I think that certainly Congress has the power to prescribe that. The SEC has done an excellent job in regulating the submission of information to shareholders. I also feel that the insurance commissioners have indicated that they have a capacity to do an excellent job of regulation in the various States.

We now have also indicated by our action recently taken that we feel that probably the SEC's report showed that there were some deficiencies and we should require information to be submitted to shareholders. We have taken that action.

Now, from the philosophical aspect of it, my feeling is simply this: We have been at this business for a hundred years this way. We are taking some corrective action. Why not leave it in our hands for a little while and see if we can't adequately do the job, thereby eliminating the duplication which will be required if SEC gets in this picture.

If we find out that we cannot do it, then, philosophically or not, I think the SEC probably ought to take over and do it, but we think we can do it.

Mr. KEITH. I think the philosophy of the SEC approach is that any company of size and substance, size in number of stockholders, substance in the form of assets, comes pretty close to being public, interstate in ownership, and in the conduct of its business; and that as long as its regulations are limited to those which, in the normal course of events, might expect to have stockholders other than in one State, they feel they have a responsibility to make available in a central location the kind of information that might be required for a stockholder in another State other than where the company itself is located.

Mr. GRADY. I think that the SEC would not try and reach out for this additional authority if it were convinced that the insurance com-

missioners could do the job. I think that, unfortunately, this bill passed the Senate and we have been late in getting our position before you, but now that it is before you we wish you would consider it, and it is simply that we agree with you and we agree with the SEC that there should be a disclosure of information to stockholders and I don't know of any reason why the completeness of that disclosure couldn't be parallel to that that would be required by the SEC. Give us an opportunity to do this job ourselves. We think we can do it.

Mr. KEITH. Would you care to comment on the possibility of legislation requiring the States or the insurance companies to furnish to the SEC the information required by the form prescribed by the NAIC?

Mr. GRADY. That would be the worst position in which we would hope to come out of this situation. I don't know why the SEC would want that kind of information because if it is to supply only the information that is furnished to the domiciliary State, we can handle that ourselves and they don't need a statute to make a further disclosure.

In other words, if the information is filed with the States and our stockholder information supplemental works as we think it will, the information which SEC would require to be disseminated among the stockholders will have been disseminated by that very filing with the respective situation.

Mr. KEITH. Brokers dealing with over-the-counter stock issues would be more likely to turn for the information necessary for the solicitation of their accounts to the SEC rather than to the insurance commissioners because they are dealing in several different kinds of securities, one of which happens to be an insurance company.

Mr. GRADY. I understand. However, I am sure you are aware that there are trade journals and books that give tremendous coverage of insurance company stocks.

The Best Insurance Journal, for instance, covers life and fire and casualty companies throughout the whole United States. In that connection there was a matter which I read in the testimony which probably ought to be clarified.

While, I believe, Commissioner Cary was testifying, someone asked him about the information that is disclosed in these very accurate and authoritative reports, and the Best report was mentioned and I believe that Mr. Cary said that they felt all companies were not included, and this surprised me because Best is sort of like a bible in this industry. You can get all kinds of information about insurance companies out of that one filing, so I asked the Best Co. if they would tell me what companies are included, particularly in the fire and casualty line, and I have a letter dated January 17, 1964 from Alfred M. Best Co., Inc., Joseph P. Byrne, executive vice president, which I would like to read because it clarifies this matter and I think the record ought to have it.

Mr. KEITH. If you will just give us the essence of what is contained in the letter, perhaps the chairman will put it in the record and it will save time.

Mr. GRADY. Thank you. The substance of it is that individual company reports embrace all capital stock fire and casualty companies, except so-called captive or wholly owned companies engaged solely

in insuring the risks and properties of sponsors, which, of course, wouldn't involve the public at all.

Mr. STAGGERS. You may insert that in the record.

(Statement referred to follows:)

ALFRED M. BEST CO., INC.,
New York, N.Y., January 17, 1964.

HON. STAFFORD R. GRADY,
Insurance Commissioner of California,
Washington, D.C.

DEAR MR. GRADY: We have your inquiry about our annual Best's fire and casualty insurance reports, and the coverage in this publication of the capital stock fire and casualty companies domiciled and operating in the United States.

This annual volume includes comprehensive reports upon the financial position, history and transactions of over 1,400 insurance companies.

Individual company reports embrace all capital stock fire and casualty insurance companies except so-called captive or wholly owned companies engaged solely in insuring the risks and properties of sponsors.

Best's fire and casualty insurance reports places at the disposition of all interested most up to date, complete, reliable and valuable information about all capital stock fire and casualty carriers.

Reports are published on capital stock companies regardless of their relative financial importance.

Please turn to page 3 of the 1963 Best's fire and casualty insurance reports. There you will find a review of the position of Accredited Hospital and Life Insurance Co., St. Louis, Mo., which on December 31, 1962, listed total admitted assets of $713,409, capital paid up of $75,000 and net surplus of $91,007. On page 21 of the same book there is a report on the All Nation Insurance Co., which at the 1962 year end had capital paid up of $100,000, reported net surplus of $50,106 and total admitted assets of the company at the same date of $373,692. Its 1962 direct premium writings amounted to $406,141. There is also a report, page 630, on the Lamar Livestock Insurance Co., which on December 31, 1962, reported assets of $38,674, capital of $20,500 and net surplus of $9,012.

With these illustrations we confirm our complete coverage of all capital stock fire and casualty insurance companies.

Yours very truly,

JOSEPH P. BYRNE,
Executive Vice President.

Mr. GRADY. Thank you.

Mr. STAGGERS. I did not mention the fact that Mr. Farnam of Massachusetts and Mr. Howell of New Jersey were backed up by members of this committee, but the fact is self-evident. I want to tell both of you that you are backed up by two distinguished and dedicated public servants that are doing a job on a great committee; and, Mr. Combs, I would like to say that the next man you will hear from is the chairman of one of the most powerful and far-reaching committees in the Congress of the United States, a dedicated public servant, one who is respected here on Capitol Hill.

At this time I would like to call on Mr. Harris.

Mr. COMBS. I agree with you a hundred percent, Mr. Chairman.

Mr. HARRIS. Let that all be on the record, Mr. Chairman.

Thank you very much. I appreciate the very warm comments from the chairman, and let me say that I am glad to join other members in welcoming these distinguished gentlemen representing the State insurance commissioners throughout the States. I am especially pleased to see my, and I say this with affection, my old friend Harvey Combs, who has rendered such an outstanding public service in our State. One time he had a most active practice as an attorney down there, but in the last several years he has devoted his time and energy to this cause.

Harvey, I am glad to see you up here in this group. While we are passing out these expressions of friendship let me say that I join our

good friend, Mr. Glenn, in welcoming my former colleague, Charlie Howell, back here.

Mr. HOWELL. Thank you, sir.

Mr. HARRIS. We wish you well as you continue your public service, Charlie.

Mr. HOWELL. Thank you.

Mr. HARRIS. I would like to join in complimenting you, Mr. Grady, and your associates in your presentation of the views of your organization here today.

Mr. GRADY. Thank you, Mr. Harris.

Mr. HARRIS. I think the chairman commented appropriately a moment ago that apparently the consideration given to this problem over the last several months of last year has produced some belated but yet worthwhile activities in this field.

I think the States and the insurance companies conduct their responsibilities as well as the business of insurance companies, in a manner that would meet wide acceptance of this industry remaining under the supervision of State jurisdictions.

You mentioned the long tradition that has prevailed from the outset. You also mentioned that that tradition was upset by a Supreme Court decision in 1944. There is a tremendous responsibility in this problem of Federal and State relationships. It makes it very difficult sometimes, when interstate problems are involved, to draw the line or find out the point of demarcation. I know that there are great concerns where matters of jurisdiction are concerned. I know that is true not only in State and Federal relationships, but that is true in our competitive lives, in business, but that is also the thing, fundamentally speaking, that gives our system the spark that in my judgment that has made us strong in every respect, and that includes our economy, the free enterprise system.

I am glad to have our frank discussion of this problem. It seems to me that, as in the past, there are ways to resolve difficulties so long as what is desired and necessary in the interest of the public is kept in mind. I haven't seen many problems develop around here, certainly in this committee, that we haven't found some solution to, where there was a keen difference of opinion that existed, and I see no reason why there shouldn't be some way to resolve this one.

This committee decided about 3 years ago that something needed to be done in connection with the Securities and Exchange Acts in its responsibility and we directed a study to be made, which was the first time that any great undertaking was directed since the enactment of the acts.

There is a voluminous report, which you have mentioned in your statement, and out of that report came these proposals. I think the questions that have been asked here today of your statement get really to the heart of the matter, Mr. Grady.

There are about two things I want to try to develop for my own information. I hope to help to make the record.

Mr. Glenn endeavored to get some information from you. I would like to pursue that course just a moment. The NAIC has developed over the years, I suppose, out of association between commissioners of the various States.

Mr. GRADY. That is correct, sir.

Mr. HARRIS. What was the origin of the NAIC, if you know?

Mr. GRADY. I am not historically accurate enough to reply precisely.

Mr. HARRIS. Is it a voluntary organization?

Mr. GRADY. Yes, sir; it is.

Mr. HARRIS. Does it have any legal existence at all?

Mr. GRADY. No; it does not, so far as I know.

Mr. HARRIS. Does it have any authority legally?

Mr. GRADY. No, sir; only insofar as each commissioner enforces it in his own State.

Mr. HARRIS. Well, you were talking about the commissioners. I am talking about the organization.

Mr. GRADY. Yes; that is right. It is not a federalized statutory authority. It is just a voluntary association. It has its bylaws and its articles of incorporation. It has rules and regulations, extensive ones, pursuant to which it operates.

Mr. HARRIS. There is nothing binding on the part of any member of NAIC, is there? Morally, maybe; but legally?

Mr. GRADY. I think that is correct; yes, sir.

Mr. HARRIS. This is not a line of questions to imply that it isn't all right. We have other organizations similar to this that have been set up, voluntary groups, and that is rather traditional in this country, though just one comes to mind at the moment, and I might say that the Oil Compact Commission was set up under a Federal charter which legalized it, and it has been that kind of an organization in an endeavor to carry out its responsibilities and so forth.

Then do the State laws or any of the State laws—I wouldn't ask you to quote all State laws—insofar as you know recognize the existence of the NAIC?

Mr. GRADY. It is my understanding that some of them do, Mr. Chairman, in that they expressly prescribe in the statute that the NAIC form of annual statement, for instance, will be that required in that particular State, so there is some recognition of it expressly by statute in some States, but not all.

Mr. HARRIS. Do all States have included in their laws, insofar as you know, a requirement of what kind of statement will be filed?

Mr. GRADY. Yes, sir. Some States direct expressly that the NAIC convention form statement shall be filed and in other States the commissioner is given the authority to prescribe the form of statement and in each State he has prescribed the annual statement of the NAIC.

Mr. HARRIS. Are there any of the States where the laws of that State would conflict with the decision of NAIC as to the form of reporting?

Mr. GRADY. None to my knowledge, sir.

Mr. HARRIS. Were all of the States present at your meeting recently held in Phoenix?

Mr. GRADY. I don't believe Hawaii was there and one of the State commissioners died during the course of the meeting so he wasn't represented. Beyond that to my knowledge all other States were represented, sir.

Mr. HARRIS. Did all of the States represented subscribe to the decision of the NAIC?

Mr. GRADY. Well, I don't know whether I could say this "yes" specifically. We, as in the Congress, for instance, operate in some in-

stances by committees. The blanks committee is the committee which has the authority under the bylaws of the association to prescribe the very form that is going to be used and the blanks committee did prescribe the addition of the stockholder information supplement, and that action was approved in the plenary session of the NAIC.

Mr. HARRIS. What I am trying to say is, Mr. Grady, that sometimes I make the bold statement—and I am not by myself, other Members of Congress do it and members of the other organizations as groups do it—and I say I represent the Committee on Interstate and Foreign Commerce and so forth. When I say that I do not in any way fool my own self by saying that everybody on this committee is going to do exactly what I say is to be done and somebody very likely is going to have a different viewpoint. There is no particular damage done when that happens because we are talking about majorities ordinarily in this instance, and sometimes we are boasting a little bit. Human nature, you know, is the same in every group, but you are presenting today what you say is a program on behalf of the State insurance commissioners, and what I am trying to find out is just to what extent, as Mr. Glenn did a moment ago, are you representing the commissioners in a matter of this kind and how much weight does it carry?

This is no reflection whatsoever, because one or a dozen may disagree with you and, if so, that program insofar as you have presented it here does not meet the test or the need that has been described, and you would agree with that, wouldn't you?

Mr. GRADY. Yes, sir.

Mr. HARRIS. And what we are trying to find out is do you have the approval of all of the States of the program that you present here that you intend to inaugurate State by State?

Mr. GRADY. Mr. Chairman, about the only way I could answer that would be to say that we did go through the regular procedure that we have followed in the NAIC for years in considering matters in committee, having the committee action approved. I can say that the consideration of this supplement at the Phoenix meeting was attended by more commissioners I think than any other meeting that I have ever seen before.

Mr. HARRIS. That is commendable.

Mr. GRADY. And it also had one of the most lively discussions. It was a matter that had great concern at the meeting. It was adopted in due course by all the bodies that should adopt it in order to make it effective and I heard no dissenting vote from any commissioner.

Mr. HARRIS. That is not sufficient to answer the question I am trying to get at.

Mr. GRADY. I understand, sir, and I am trying to give you the only answer I can.

Mr. HARRIS. I know, but I am trying to get the information if you have it and if not I want to get your assistants to answer to see if we can't get the information, because what we are trying to do here—as I stated and other members, when Mr. Cary was here and others—is to really try to develop this record to find out what the need is and find out what should be done to meet that need.

Mr. GRADY. In other words, you would like a statement from each of the commissioners?

Mr. HARRIS. Here you have Texas, Arkansas, New Jersey, and so forth, and California, and I assume each one of you here subscribes to this statement. Is that true? Can we get that from each one of you?

Mr. GRADY. California subscribes, sir.

Mr. PRICE. Texas.

Mr. HOWELL. New Jersey.

Mr. FARNAM. Massachusetts.

Mr. COMBS. Arkansas.

Mr. HARRIS. Now we have that on the record. Now, can you get for this committee, to put in the record, a statement from those of each State so we will have information, when they come up here from this or that group or when SEC and we get together again, and we will have in this record a statement as to what we can depend upon?

Mr. GRADY. Yes, sir; I think so.

Mr. HARRIS. Could you get for us and include it in this record a statement as to whether or not each of the States subscribes, and if there are some who do not we would like to have that included in the record?

Mr. GRADY. Certainly.

Mr. HARRIS. May that be included in the record, Mr. Chairman?

Mr. STAGGERS. Yes, indeed.

Mr. GRADY. We will supply that.

(Letters from various States follow:)

STATE OF ALABAMA,
DEPARTMENT OF INSURANCE,
Montgomery, January 30, 1964

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR CONGRESSMAN HARRIS: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition I will send at an early date to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

WALTER S. HOUSEAL,
Superintendent of Insurance.

STATE OF ALASKA,
DEPARTMENT OF COMMERCE,
DIVISION OF BANKING, INSURANCE, AND SECURITIES,
Juneau, February 14, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR MR. HARRIS: The Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, has requested that we advise you on action taken in the matter of the stockholder information supplement

adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition we have sent to the stock insurance companies of Alaska a copy of the tentative form and the NAIC reports relating thereto which we understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Very truly yours,

A. W. LINGLE, *Director.*

INSURANCE DEPARTMENT OF ARIZONA,
Phoenix, February 11, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR SIR: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition I have sent to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Yours sincerely,

G. A. BUSHNELL,
Director of Insurance.

STATE OF ARKANSAS,
INSURANCE DEPARTMENT,
Little Rock, January 30, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR CONGRESSMAN: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition I have sent to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

HARVEY G. COMBS.
Insurance Commissioner.

STATE OF CALIFORNIA,
DEPARTMENT OF INSURANCE,
San Francisco, January 29, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee, House of Representatives, Washington, D.C.

DEAR MR. HARRIS: This letter is to advise you in respect of the position of the Insurance Department of the State of California regarding the following matters:

1. This department is in complete agreement with the action of the National Association of Insurance Commissioners in prescribing the stockholder information supplement to be included as a part of the 1964 and subsequent years convention form annual statements.

2. The convention form annual statement is required to be filed with this department by all insurers admitted to transact the business of insurance in the State of California.

3. It is our opinion that the statutes of the State of California give adequate authority to the insurance commissioner of this State to impose severe sanctions on any insurer which would refuse to supply the information requested in the supplement; accordingly, we do not anticipate that compliance will raise any problem.

4. On January 15 of this year this department addressed a letter to all stock insurers domiciled in the State of California with in excess of 25 shareholders enclosing a copy of the stockholder information supplement, as adopted by the NAIC at its December 1963 meeting in Phoenix, Ariz., and advised such carriers that the supplement would be required in 1964 and in subsequent convention form annual statement filings with this department.

Very truly yours,

STAFFORD R. GRADY, *Insurance Commissioner.*

STATE OF COLORADO,
OFFICE OF THE COMMISSIONER OF INSURANCE,
Denver, January 29, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

GREETINGS—CONGRESSMAN HARRIS: Insurance Commissioner Charles R. Howell, of New Jersey, has asked that I advise you of the action that the State of Colorado has taken in the matter of the stockholder information supplements. This is the special supplement that was adopted by the NAIC at our Phoenix meeting in December of 1963.

Congressman Harris, the stockholder information supplement was attached to and became a part of the various forms that we do furnish all insurance companies domiciled in the State of Colorado. These forms, along with the supplement, were distributed on or about January 6, 1964.

The information contained in the supplement, therefore, together with the detailed information contained in the annual statements, will be available to the public in the State of Colorado in most cases March 1 and not later than March 31 of this year, 1964.

Very truly yours,

SAM N. BEERY,
Commissioner of Insurance.

STATE OF CONNECTICUT,
INSURANCE DEPARTMENT,
Hartford, Conn., January 30, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee, House of Representatives, Washington, D.C.

SIR: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964

and subsequent years. The Connecticut Insurance Department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I have sent to the stock insurance companies of Connecticut a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

ALFRED N. PREMO, *Commissioner.*

STATE OF DELAWARE,
DEPARTMENT OF INSURANCE,
Dover, Del., February 7, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR MR. HARRIS: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I have sent, or will send, at an early date to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

ROBERT A. SHORT, *Insurance Commissioner.*

GOVERNMENT OF THE DISTRICT OF COLUMBIA,
DEPARTMENT OF INSURANCE,
Washington, D.C., January 31, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I have sent, or will send, at an early date to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

ALBERT F. JORDAN,
Superintendent of Insurance.

TREASURER'S OFFICE,
STATE OF FLORIDA,
Tallahassee, January 29, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR SIR: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I have sent to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

J. EDWIN LARSON,
State Treasurer and Insurance Commissioner.

STATE OF GEORGIA,
OFFICE OF COMPTROLLER GENERAL,
Atlanta, Ga., February 7, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR MR. HARRIS: Hon. Charles R. Howell, New Jersey Commissioner of Banking and Insurance, who is also chairman of the Committee on Blanks of the NAIC, has requested that I advise you of action taken by the Georgia Insurance Department in the matter of the stockholders information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., December 1963 as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years.

The Georgia Insurance Department requires the completion of the NAIC convention form—annual statement—by all domestic insurance companies. We propose and expect to follow all recommendations of the NAIC in the matter of the stockholders information supplement as it may be adopted by the NAIC as part of the annual statement form.

Furthermore, I am now forwarding to the stock insurance companies of this State a copy of the tentative form of the NAIC report relating thereto, which I understand was recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

The stockholder information supplement will be attached to and become a part of the annual statements required to be filed in this office on or before March 1, 1964, by all Georgia insurance companies, which statements are public records and available for inspection by anyone who might be interested in them.

Sincerely yours,

JAMES L. BENTLEY, *Insurance Commissioner.*

STATE OF HAWAII,
INSURANCE DIVISION,
DEPARTMENT OF REGULATORY AGENCIES,
Honolulu, February 4, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee, House of Representatives, Washington, D.C.

DEAR SIR: I have been asked by the Honorable Charles R. Howell, New Jersey Commissioner of Banking and Insurance and chairman of the committee on blanks of the National Association of Insurance Commissioners, to advise you of

the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I have sent, or will send, at an early date to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Very truly yours,

SIDNEY I. HASHIMOTO,
Insurance Commissioner.

STATE OF IDAHO,
DEPARTMENT OF INSURANCE,
Boise, January 31, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee, House of Representatives, Washington, D.C.

DEAR CHAIRMAN HARRIS: I have been asked by the Honorable Charles R. Howell, New Jersey Commissioner of Banking and Insurance and chairman of the committee on blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I have sent, or will send, at an early date to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

LEO O'CONNELL,
Commissioner of Insurance.

STATE OF ILLINOIS,
DEPARTMENT OF INSURANCE,
Springfield, February 5, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR REPRESENTATIVE: I have been asked by the Honorable Charles R. Howell, New Jersey Commissioner of Banking and Insurance and chairman of the committee on blanks of the National Association of Insurance Commissioners, to advise you of the action taken in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I have sent the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Very truly yours,

RICHARD G. HERSHEY,
Director of Insurance.

STATE OF INDIANA,
DEPARTMENT OF INSURANCE,
Indianapolis, January 30, 1964.

HON. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR CHAIRMAN HARRIS: We have been asked by the Honorable Charles R. Howell, New Jersey Commissioner of Banking and Insurance and chairman of the committee on blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963 as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

Such requirement by this department is based on the Indiana insurance laws, acts 1935, chapter 162, sections 20 and 269, wherein each company doing business in this State is required to file an annual statement which shall conform as nearly as may be to the form of statement from time to time adopted by the national convention of insurance commissioners.

In addition, we have sent to each domestic (Indiana) capital stock insurance company, under our cover letter of January 24, 1964 (copy attached), a copy of the tentative form and the NAIC reports relative thereto which we understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

HARRY E. MCCLAIN,
Insurance Commissioner.

Enclosure.

STATE OF INDIANA,
DEPARTMENT OF INSURANCE,
Indianapolis, January 24, 1964.

To: All Domestic Capital Stock Insurance Companies.
Re "Stockholder Information Supplement" To Be Incorporated in the Annual Statement Blank for 1964 and Subsequent Years.

At the December 1963 meeting of the National Association of Insurance Commissioners in Phoenix, Ariz., a Stockholder Information Supplement (to be included as an integral part of the annual statement for the year 1964 and subsequent years) was approved. A copy of the supplement in its present form is enclosed for your information and convenience.

The primary purposes of the supplement are threefold: First, to require the dissemination of complete and accurate financial information, including balance sheet, income and expense items, and surplus to all shareholders; second, to require a disclosure of the names of proposed directors, their qualifications and other pertinent information when proxies are solicited from shareholders; and, third, to require the disclosure of information regarding "insider transactions."

The supplement is not yet in final form; however, the substance of the information to be provided is indicated in the enclosed document. The enclosed material refers to a revised question 10 of the general interrogatories on page 13 of the fire and casualty blank but a similar question will appear in the general interrogatories of each type of blank (life and A. & H., title, fire and casualty, etc.) required to be filed.

We are communicating this information to you at this juncture so that you will be in a position to answer the interrogatories and supply the information to be required in the 1964 annual statement, which will include:

(1) Whether financial information relating to 1963 was disseminated to shareholders during 1964; and

(2) Whether proxy solicitations during 1964 were in accordance with the standards indicated; and

(3) The disclosure of "insider transactions" which occurred during 1964.

We will transmit to you a copy of the final form of the Stockholder Information Supplement after the spring meeting of the NAIC blanks committee. It is

anticipated that instructions will accompany the submission of the supplement to you in final form.

Please acknowledge receipt of this circular letter, addressing same to the attention of Norman R. B. King, Deputy Actuary, Department of Insurance, 509 State Office Building, Indianapolis, Ind. 46204.

Yours very truly,

HARRY E. MCCLAIN,
Insurance Commissioner, State of Indiana.

INSURANCE DEPARTMENT OF IOWA,
Des Moines, February 7, 1964.

HON. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee, House of Representatives, Washington, D.C.

DEAR MR. HARRIS: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the committee on blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the Stockholder Information Supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963 as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. Please be advised that this department has already circulated all stock companies in this State as prescribed in the proceedings of the December meeting and will accept and follow all recommendations of the NAIC in the matter of the Stockholder Information Supplement as it may be adopted by the NAIC as part of the annual statement form.

Our State is a particularly heavy mutual State and has a very small number of stock companies, however, we will abide by all of the actions of the NAIC in this matter.

Sincerely yours,

WILLIAM E. TIMMONS,
Commissioner of Insurance.

STATE OF KANSAS,
INSURANCE DEPARTMENT,
Topeka, February 3, 1964.

HON. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee, House of Representatives, Washington, D.C.

DEAR MR. HARRIS: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the committee on blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the Stockholder Information Supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the Stockholder Information Supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I have sent, or will send, at an early date to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

FRANK SULLIVAN,
Commissioner of Insurance.

COMMONWEALTH OF KENTUCKY,
DEPARTMENT OF INSURANCE,
Frankfort, Ky., January 13, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives,
Washington, D.C.

MY DEAR MR. HARRIS: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the committee on blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the National Association of Insurance Commissioners at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, we have already sent to all stock insurance companies of this State a copy of the tentative form and the NAIC reports relating thereto which, I am told, were submitted in behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

J. ELLIOTT FLANNERY, *Commissioner.*

STATE OF LOUISIANA,
COMMISSIONER OF INSURANCE,
Baton Rouge, January 30, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives,
Washington, D.C.

DEAR SIR: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the committee on blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I have sent to all the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

RUFUS D. HAYES,
Commissioner of Insurance.

STATE OF MAINE,
INSURANCE DEPARTMENT,
Augusta, February 12, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee, House of Representatives, Washington, D.C.

DEAR REPRESENTATIVE HARRIS: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken in the matter of the stockholder information supplement adopted by the NAIC at its regular meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years.

This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I have sent to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

GEORGE F. MAHONEY, *Commissioner.*

STATE OF MARYLAND,
OFFICE OF THE INSURANCE COMMISSIONER,
Baltimore, January 29, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee, House of Representatives, Washington, D.C.

DEAR CONGRESSMAN HARRIS: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I have recently sent to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

F. DOUGLASS SEARS, *Commissioner.*

THE COMMONWEALTH OF MASSACHUSETTS,
DEPARTMENT OF BANKING AND INSURANCE,
Boston, January 29, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR SIR: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Banks of the National Association of Insurance Commissioners, to advise you of the action taken in the matter of the stockholder information supplement, adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and

subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, on January 9 of this year I sent to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

C. EUGENE FARNAM,
Commissioner of Insurance.

STATE OF MICHIGAN,
DEPARTMENT OF INSURANCE,
Lansing, February 4, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR MR. HARRIS: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, at an early date I will send to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely,

ALLEN L. MAYERSON,
Commissioner of Insurance.

STATE OF MINNESOTA,
INSURANCE DIVISION,
Saint Paul, January 30, 1964.

Hon. OREN HARRIS,
Chairman, House of Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR MR. HARRIS: At the request of Hon. Charles R. Howell, New Jersey commissioner of insurance and banking and chairman of the committee on Blanks of the National Association of Insurance Commissioners, I have been asked to write you regarding the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963.

The Minnesota Insurance Department will require that the substance of the stockholder information supplement as adopted by the NAIC be included by each domestic stock insurance company as part of the prescribed NAIC annual statement form for the year 1964 and subsequent years.

On January 28, 1964, I released to all Minnesota stock insurance companies a transmittal letter and a copy of the tentative form with the NAIC reports relating thereto. If other recommendations are adopted by the NAIC regarding this matter, I will take the necessary actions for full participation to follow the recommendations.

Sincerely yours,

CYRUS E. MAGNUSSON,
Commissioner of Insurance.

INSURANCE DEPARTMENT, STATE OF MISSISSIPPI,
Jackson, February 17, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: I have been asked by the Honorable Charles R. Howell, New Jersey Commissioner of Banking and Insurance and chairman of the committee on blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963 as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I will send at an early date to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

WALTER DELL DAVIS,
Commissioner of Insurance.

JEFFERSON CITY MO., *February 14, 1964.*

Hon. CHARLES R. HOWELL,
Commissioner of Insurance,
Trenton, N.J.:

In accordance with the resolution adopted by the blanks committee at the NAIC meeting in December 1963, this division will require all domestic stock insurance companies to follow the recommendation by submitting stockholder information supplement in the form adopted and to be accepted as a part of the annual statement. This office will direct the above companies to comply with this request for the year 1964 and subsequent years.

RALPH H. DUGGINS,
Superintendent, Missouri Division of Insurance.

STATE OF MISSOURI,
DIVISION OF INSURANCE,
Jefferson City, Mo., February 13, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR SIR: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This division requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I have sent, or will send, at an early date, to the stock insurance companies of my State, a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Very truly yours,

RALPH H. DUGGINS, *Superintendent.*

STATE OF MONTANA,
OFFICE OF STATE AUDITOR,
Helena, Mont., January 30, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR SIR: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance, and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken by the Montana Insurance Department in the matter of the stockholder information supplement, adopted by the National Association of Insurance Commissioners at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964, and subsequent years. This department requires all Montana domiciled stock insurers to file the NAIC annual statement form and will accept and follow recommendations of the NAIC with respect to the stockholder information supplement, as may be adopted by the said NAIC as part of the annual statement form.

Please be further advised, I have sent to our domiciliary stock insurers a copy of the tentative stockholders information supplement form and the NAIC reports relating thereto, copies of which forms, I understand, were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

E. V. "SONNY" OMHOLT,
State Auditor and Ex Officio Commissioner of Insurance.

STATE OF NEBRASKA,
DEPARTMENT OF INSURANCE,
Lincoln, Nebr., January 29, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee, House of Representatives, Washington, D.C.

DEAR CONGRESSMAN HARRIS: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

Further, I have sent to all stock insurance companies in my State a copy of the tentative form (stockholder information supplement) and a copy of the NAIC reports which relate to this form.

It is my opinion that the NAIC and thus the States' approach to the problem of stockholder information is equal to or better than anything being suggested and urged by the Securities and Exchange Commission. For this reason, I respectfully request that your committee give consideration to our approach to this problem. If additional information is needed concerning Nebraska's position on this matter, please contact me.

Thank you.

Respectfully yours,

FRANK J. BARRETT,
Director of Insurance.

STATE OF NEVADA,
INSURANCE DEPARTMENT,
Carson City, Nev., January 30, 1963.

HON. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee, House of Representatives, Washington, D.C.

DEAR SIR: The Honorable Charles R. Howell, commissioner of insurance and banking of New Jersey and chairman of the National Association of Insurance Commissioners' Committee on Blanks, has requested that I advise you of the action taken, and to be taken, by Nevada relative to the stockholders' informational supplement adopted by the National Association of Insurance Commissioners at its meeting in Phoenix, Ariz., in December of 1963.

All of the insurance companies of this State have been advised that such supplement is mandatory, as will be any further changes or additions thereto.

Nevada Revised Statutes 686.090 make the use of the annual financial statement blank promulgated by the National Association of Insurance Commissioners mandatory not only for our domestic companies but for any company doing business in this State.

Sincerely yours,

PAUL A. HAMMEL,
Insurance Commissioner.

THE STATE OF NEW HAMPSHIRE,
INSURANCE DEPARTMENT,
Concord, January 29, 1964.

HON. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR SIR: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the Nationl Association of Insurance Commissioners, to advise you of the action taken in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition I have sent all the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

DONALD KNOWLTON,
Insurance Commissioner.

STATE OF NEW JERSEY,
DEPARTMENT OF BANKING AND INSURANCE,
Trenton, February 7, 1964.

HON. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR CHAIRMAN HARRIS: During the course of our appearance on behalf of the National Association of Insurance Commissioners before the Subcommittee on Commerce and Finance on January 22, 1964, you asked that a statement be obtained from each commissioner as to the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I have sent to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

CHARLES R. HOWELL, *Commissioner.*

STATE OF NEW MEXICO,
DEPARTMENT OF INSURANCE,
Santa Fe, February 6, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR CONGRESSMAN HARRIS: It has come to my attention that the Honorable Charles R. Howell, commissioner of banking and insurance for the State of New Jersey and chairman of the National Association of Insurance Commissioners Blanks Committee, is concerned with respect to the action in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as it pertains to the prescribed annual statement form for stock insurers for 1964 and subsequent years. Section 58–5–18 (NMSA, 1953 Comp.), provides that every company shall, as a prerequisite to the issuance of a license, on or before the first day of March of each year, file with the superintendent of insurance a financial statement for the year ending December 31 immediately preceding, on a form which shall be furnished by the superintendent of insurance and which shall conform as nearly as may be to the form of statement from time to time adopted by the National Convention of Insurance Commissioners.

Accordingly the superintendent will accept and follow all of the recommendations of the NAIC in the matter of the stockholder information supplement as it may be finally adopted by the NAIC as part of the annual statement form.

In addition I will send, at an early date, all stock insurance companies domesticated in my State a copy of the tentative provisional form and the NAIC reports relating thereto, which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Very truly yours,

R. F. APODACA,
Superintendent of Insurance.

STATE OF NEW YORK,
INSURANCE DEPARTMENT,
New York, January 31, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR CONGRESSMAN HARRIS: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department now requires the NAIC annual statement form to be filed by all domestic stock insurance companies. All recommendations of the NAIC requiring the furnishing of additional data in the stockholder information supplement as may be adopted by the NAIC as part of the annual statement form will be followed by this department.

In addition, I have sent to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

HENRY ROOT STERN, Jr.,
Superintendent of Insurance.

STATE OF NORTH CAROLINA,
INSURANCE DEPARTMENT,
Raleigh, February 11, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR SIR: It has come to my attention that your Subcommittee on Commerce and Finance of the House Interstate and Foreign Commerce Committee has under consideration Senate bill 1642 which, if enacted, would bring insurance companies under SEC regulations. We wish to inform you that this department does not feel that this legislation is necessary especially in light of the action taken by the Committee on Blanks of the National Association of Insurance Commissioners.

The Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the NAIC, has kept this department well informed in regard to the actions and plans of the Committee on Blanks of the NAIC. We wish to advise you that this department requires the NAIC annual statement form to be filed by all domestic stock insurance companies. We further wish to advise you that this department will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

We would also like for you to know that we have sent to the stock insurance companies of our State a copy of the tentative form and the NAIC reports relating thereto which we understand were reecntly submitted on behalf of the NAIC to your Subcommittee on Commerce and Finance.

If this department can assist you and your subcommittee with any further information regarding this important matter, we will be more than glad to furnish same at your request.

Sincerely yours,

EDWIN S. LANIER,
Commissioner of Insurance.

STATE OF NORTH DAKOTA,
DEPARTMENT OF INSURANCE,
Bismarck, February 17, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR SIR: I have been asked by the Honorable Charles R. Howell, New Jersey Commissioner of Banking and Insurance and chairman of the committee on blanks of the National Association of Insurance Commissioners, to advise you of the action taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963 as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I have sent to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

FRANK ALBERS,
Commissioner of Insurance, State of North Dakota.

STATE OF OHIO,
DEPARTMENT OF INSURANCE,
Columbus, February 10, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR CHAIRMAN HARRIS: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition I have sent at an early date to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

WILLIAM R. MORRIS,
Director of Insurance.

INSURANCE COMMISSIONER, STATE OF OKLAHOMA,
Oklahoma City, March 20, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR CHAIRMAN HARRIS: Hon. Charles R. Howell, New Jersey Commissioner of Banking and Insurance and chairman of the committee on blanks of the National Association of Insurance Commissioners, has asked me to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963 as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years.

This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, we have sent to the stock insurance companies of Oklahoma a copy of the tentative form and the NAIC reports relating thereto which were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Yours respectfully,

JOE B. HUNT,
Insurance Commissioner, State of Oklahoma.

STATE OF OREGON,
DEPARTMENT OF INSURANCE,
Salem, January 31, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR MR. HARRIS: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years.

This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition I have sent to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

WALTER G. KORLANN,
Insurance Commissioner.

COMMONWEALTH OF PENNSYLVANIA,
INSURANCE DEPARTMENT,
Harrisburg, February 3, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR CHAIRMAN HARRIS: The Honorable Charles R. Howell, commissioner of banking and insurance for the State of New Jersey, as chairman of the Blanks Committee of the National Association of Insurance Commissioners, has communicated with me as to your interest in the position of this department regarding the stockholders information supplement recommended for adoption by the National Association of Insurance Commissioners at the December 1963 meeting held in Phoenix, Ariz.

Copies of the aforementioned supplement and of the NAIC committee reports pertaining thereto, which reports I understand were recently presented on behalf of NAIC to the Subcommittee on Commerce and Finance have been mailed to all stock insurance companies organized in Pennsylvania in order that appropriate action can be taken to accumulate the information that will be needed to complete that supplement. The letter of transmittal also stated that certain minor modifications to the supplement were contemplated.

Stock insurance companies authorized to transact business in Pennsylvania are required to annually report their transactions for the year and their financial condition as of the year end using forms furnished by this department. The annual statement blanks and supplements thereto include those adopted by the Blanks Committee of the National Association of Insurance Commissioners.

Very truly yours,

AUDREY R. KELLY,
Insurance Commissioner.

STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS,
DEPARTMENT OF BUSINESS REGULATION,
Providence, January 30, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR SIR: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information

supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stock holder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition I have sent, or will send at an early date, to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

WARREN R. CAMPBELL,
Insurance Commissioner.

STATE OF SOUTH CAROLINA,
INSURANCE DEPARTMENT,
Columbia, February 4, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR SIR: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the position taken by this department in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years.

This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition I have sent to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which, I understand, were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Yours very truly,

WILLIAM F. AUSTIN,
Chief Insurance Commissioner.

STATE OF SOUTH DAKOTA,
DEPARTMENT OF INSURANCE,
Pierre, February 13, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR SIR: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition I have sent to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

J. R. MENNING,
Commissioner of Insurance.

STATE OF TENNESSEE,
DEPARTMENT OF INSURANCE AND BANKING,
Nashville, January 30, 1964.

HON. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR SIR: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition I have sent to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours.

ALBERT WILLIAMS, *Commissioner.*

STATE OF TEXAS,
STATE BOARD OF INSURANCE,
Austin, January 31, 1964.

HON. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR CONGRESSMAN HARRIS: On January 10, 1964, all stock insurance companies incorporated under Texas law were sent stockholder information supplement forms as adopted by the National Association of Insurance Commissioners at its December 1963 meeting in Phoenix, Ariz. The transmittal letter made clear that full compliance was to be required by the Texas board.

The Texas board requires use of the National Association of Insurance Commissioners statement forms and will accept and follow all recommendations of the National Association of Insurance Commissioners in the matter of the stockholder information supplements as they may be adopted by the National Association of Insurance Commissioners as part of such forms.

The Texas board has clear authority to enforce compliance by companies with its annual statement requirements, including stockholder information supplements:

"The board may make such changes in the forms of the annual statement * * * required of insurance companies * * * as shall seem to it best adapted to elicit a true exhibit of their condition and methods of transacting business" (art. 1.11, Texas Insurance Code).

"The board may inquire into the competence, fitness, and reputation of insurance company officers and directors and when found not worthy of the public confidence, revoke the certificate of authority of the company" (art. 1.14, sec. 3, Texas Insurance Code).

"The board may inquire of any insurance company as to its business condition * * * or any matter connected with its transactions which the board may deem necessary for the public good or for a proper discharge of its duties" (art. 1.24, Texas Insurance Code).

"The board is required to examine insurance companies every 6 months until 3 years old and every 2 years thereafter as to financial condition and compliance with the laws of Texas" (art. 1.15, Texas Insurance Code).

This letter is supplied as requested by the Honorable Charles R. Howell, chairman of the Committee on Blanks of the National Association of Insurance Commissioners.

Sincerely yours,

J. N. NUTT, *Commissioner of Insurance.*

THE STATE OF UTAH,
INSURANCE DEPARTMENT,
Salt Lake City, January 31, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR SIR: As commissioner of insurance of the State of Utah, I wish to advise you that the stockholder information supplement as adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, or such amendments to that supplement as may be hereafter adopted by the NAIC, will be required to be filed by all stock insurers doing business in this State for the year 1964 and subsequent years.

I will send, in the near future, a copy of the tentative information form and the NAIC reports relating thereto to each of the domestic stock insurers of this State, and I will advise such insurers that such reporting form, as now drafted or as may be amended, will be adopted by this department as a required annual statement supplement in exact conformity to any such form as has been or will be adopted by the NAIC.

Very truly yours,

E. VIRGIL NORTON, *Commissioner of Insurance.*

STATE OF VERMONT,
DEPARTMENT OF BANKING AND INSURANCE,
Montpelier, February 3, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR MR. HARRIS: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I have sent the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

ROBERT E. CUMMINGS, Jr.,
Commissioner of Banking and Insurance.

COMMONWEALTH OF VIRGINIA,
STATE CORPORATION COMMISSION,
BUREAU OF INSURANCE,
Richmond, January 29, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee, House of Representatives, Washington, D.C.

DEAR MR. HARRIS: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I have sent to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

T. NELSON PARKER, *Commissioner of Insurance.*

STATE OF WASHINGTON,
OFFICE OF INSURANCE COMMISSIONER,
Olympia, January 29, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee, House of Representatives, Washington, D.C.

DEAR REPRESENTATIVE HARRIS: The Honorable Charles R. Howell, New Jersey commissioner of banking and insurance, and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, has asked me to advise you of the action taken or to be taken by this State in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years.

This State, by statute, requires the NAIC annual statement form to be filed by all domestic stock insurance companies and we well accept and follow all of the recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted or subsequently changed by the NAIC as part of the annual statement form.

I wish to further advise that, on January 14, 1964, I sent to all stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto, which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

Sincerely yours,

LEE I. KUECKELHAN, *Insurance Commissioner.*

STATE OF WEST VIRGINIA,
INSURANCE DEPARTMENT,
Charleston, February 13, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is to advise that the plan of your committee to suggest to the congressional subcommittee that a full and complete report of stockholders' information be attached to and made a part of each stock insurance company's annual statement is a plan to which this department will subscribe. It is our opinion that since this office prescribes the annual report form which shows in complete detail the financial condition of all insurance companies under our jurisdiction that it will be possible for us to prescribe a supplement suggested or prepared by the National Association of Insurance Commissioners so that such information would be uniform in all States.

You are at liberty to suggest to such committee that West Virginia will participate to the fullest extent in any program suggested by Congress and expressed through proper legislation which is designed to have on file in the State where stockholders will have free and complete access to complete stockholders' information concerning any insurance company in which they may be financially interested.

Yours very truly,

HARLAN JUSTICE, *Insurance Commissioner.*

STATE OF WISCONSIN,
DEPARTMENT OF INSURANCE,
Madison, January 30, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR CHAIRMAN HARRIS: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I have sent, or will send, at an early date to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommittee on Commerce and Finance.

CHARLES MANSON, *Commissioner of Insurance.*

STATE OF WYOMING,
INSURANCE DEPARTMENT,
Cheyenne, January 30, 1964.

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House of Representatives,
Washington, D.C.

DEAR SIR: I have been asked by the Honorable Charles R. Howell, New Jersey commissioner of banking and insurance and chairman of the Committee on Blanks of the National Association of Insurance Commissioners, to advise you of the action taken, or to be taken, in the matter of the stockholder information supplement adopted by the NAIC at its meeting in Phoenix, Ariz., in December 1963, as part of the prescribed annual statement form for stock insurers for the year 1964 and subsequent years. This department requires the NAIC annual statement form to be filed by all domestic stock insurance companies and will accept and follow all recommendations of the NAIC in the matter of the stockholder information supplement as it may be adopted by the NAIC as part of the annual statement form.

In addition, I have sent, or will send, at an early date to the stock insurance companies of my State a copy of the tentative form and the NAIC reports relating thereto which I understand were recently submitted on behalf of the NAIC to the Subcommitte on Commerce and Finance.

Sincerely yours,

MARK DUNCAN, *Insurance Commissioner.*

Mr. HARRIS. The reason I want to get that is because you have explained, which has already been gone into and I am not going over it again, the very drastic action, which I say is drastic because I think it is, of requirements in the action taken at your Phoenix meeting recently and you have explained what you intend to require in the way of annual reports, proxy statements, and insider transactions, three problems that have been bothering a lot of people.

Traditionally the State commissioners have been interested in the protection of the policyholders. Isn't that true?

Mr. GRADY. Yes, sir.

Mr. HARRIS. And traditionally the administration of the program within your States has not given a great deal of thought or concern or consideration to the investors.

Mr. GRADY. I think the study would show that, yes, sir, and we would be inclined to agree that there has not been sufficient in that area.

Mr. HARRIS. You agree with the report of the study in that regard?

Mr. GRADY. Yes, sir.

Mr. HARRIS. And you agree that the investor should have protection insofar as he is entitled to have it as well as the policyholders?

Mr. GRADY. Yes, sir, we do.

Mr. HARRIS. And what you have done now in your efforts to meet this deficiency that was brought about, as I understood the record, is to extend your requirements to include that deficiency?

Mr. GRADY. That is correct, sir.

Mr. HARRIS. This gets right to the heart of the problem, and that is over-the-counter transactions. I don't know how familiar you are with stock transactions. I must say, very frankly, I am not very familiar with them so I can get in deep water pretty fast when I try to discuss matters of this kind, but from what little information that I have it does present quite a problem.

The 1934 act of course deals with only those companies listed on the exchanges. In other words, it does not include unlisted companies.

Mr. GRADY. That is correct.

Mr. HARRIS. And that is commonly referred to as over-the-counter transactions.

Mr. GRADY. Yes, sir.

Mr. HARRIS. And insurance companies come in that category?

Mr. GRADY. There may be a few that are listed on exchanges. I think there are one or two that are listed on exchanges, but not very many. By and large they are over-the-counter stocks, yes, sir.

Mr. HARRIS. That is true, but the 1933 act does include certain insurance companies.

Mr. GRADY. Yes, it does, those which go to the public for funds.

Mr. HARRIS. And that is about a third of the some 400 that would be brought in under this extension?

Mr. GRADY. I really don't have those figures in mind, but I think that is roughly so, sir.

Mr. HARRIS. I believe that is what Mr. Cary told us, that this would bring in about 400 insurance companies that would be included under the authority of the Commission here, and I am talking about insurance companies now. I think there are a total of 3,500 or 3,700 companies that would be involved.

Mr. GRADY. Yes, sir.

Mr. HARRIS. I understand about 400 of those, I think would be insurance companies. About a third of those 400 are already included under the 1933 act because they have had public issues of their stock.

Mr. GRADY. Yes, sir.

Mr. HARRIS. So you are talking about a little over 250 or 275 companies insofar as the practical application is concerned. I suppose that what you are fearful of is that, if the SEC is given authority over even this limited number within the field, the next step would be to move further.

Mr. GRADY. Yes, we are.

Mr. HARRIS. To set up these two different systems which they would like to and ultimately you are fearful that that encroachment would reach all the way.

Mr. GRADY. Well, we are concerned not only with that, sir, but also the matters which would be involved at present, and that is the additional cost and potential confusion that might result.

Mr. HARRIS. I know the matter of cost is important, but we have been told by those who seem to know what this would do that the cost as far as the companies involved would be rather insignificant. The confusion I wouldn't attempt to describe and to what extent there would be.

However, I have the feeling that the general proposition of over the counter is very well considered and what to do about it I simply dont't know. Here is a late issue of the Wall Street Journal. You, I am sure, observe this each day. It has a whole page of over-the-counter transactions——

Mr. GRADY. Yes, sir.

Mr. HARRIS (continuing). Involved with it. Of course, at the same time you have the New York Stock Exchange listed, the American Stock Exchange transactions, and so forth.

The securities laws were passed for the purpose of meeting a need, and back a good many years ago when they were enacted there was a great concern all over the country and in the industry about what would happen, but I don't believe you will find anybody today that has anything to do whatsoever with the securities business that would recommend the repeal of those acts of 1933 and 1934.

Mr. GRADY. Nor would we, sir.

Mr. HARRIS. That is exactly right, but I am reminding you that when these acts were passed—I wasn't here, but Speaker Rayburn told me about it time after time—there was a great concern expressed and vigorous opposition, but it has stabilized. I don't know enough about over-the-counter transactions myself to know whether or not there is any substantial business involved here that would require such protection. I simply don't know. I notice there are some pretty good business operations—insurance, banks, and a lot of others.

Mr. Chairman, I would suggest we recess for 5 minutes.

Mr. STAGGERS. We will recess for 5 minutes.

(A brief recess was taken.)

Mr. STAGGERS. The committee will come to order and we will continue our hearings.

Mr. HARRIS. Mr. Grady, with reference to annual reports, I believe I understood you to say a moment ago that you would see no objection to a certified copy of an annual report that the companies file with the State insurance commissions being filed with the SEC should they desire.

Mr. GRADY. I don't think I quite stated that. I said that that would be about the worst we wish would happen to us here. We would rather not even go that far.

Mr. HARRIS. Why?

Mr. GRADY. We think it is an unnecessary duplication, Mr. Chairman. The information is available.

Mr. HARRIS. Is it a duplication if that information is going to be made available to the stockholders?

Mr. GRADY. Yes; it is. It is a duplication of the information that would be made available to the stockholders and also the information that is on file in the domiciliary State in the insurance department and in the insurance department of every other State in which the company is licensed to do business, so in many instances this information will be available in 50 places, but it is required there now because those insurance departments have to examine the companies because they are doing business there.

Mr. HARRIS. There are a lot of people who don't like to go to 50 places in the country, though, in order to find out the information.

Mr. GRADY. I understand that, sir.

Mr. HARRIS. And what serious objection could there be to filing a certified copy with some central location?

Mr. GRADY. I don't think that it would be disastrous to the companies to do that. We would prefer not to do it.

Mr. HARRIS. How would that in any way encroach upon your progress as a State insurance commissioner?

Mr. GRADY. That is just what I was going to say, Mr. Chairman. So long as the SEC did not have the power to compel information in addition to or different from that filed with us I think that probably a lot of our objections to this legislation would be removed.

Mr. HARRIS. I should think myself if certain information were required to go in a certain place where it was easily accessible, regardless of whether or not there is authority for additional information, it would not have a burdensome effect. I simply, to save my life, can't see what objection there would be on the part of the insurance commissioners of the States or the insurance companies themselves if you really have in mind to do what is attempted here, and that is to bring about disclosures.

Mr. GRADY. We do have that in mind and this disclosure of course will be made by the companies to its shareholders. The information which you suggest might be filed with the SEC would, as I understand it, be the same thing that is filed with the domiciliary State; is that so?

Mr. HARRIS. That is about the only way that you could interpret it if it is a certified copy.

Mr. GRADY. I imagine we ought to understand what we are talking about specifically, though. I suppose you are talking about the stockholder information supplement and the annual report.

Mr. HARRIS. I am talking about anything that you require to be included in the annual report.

Mr. GRADY. Yes; things that are included in the annual report. There certainly wouldn't be any need, for instance, to file policy forms and all that sort of thing.

In other words from companies.

Mr. HARRIS. I am not saying that it would be a requirement on the State commissions to file this. We are talking about the companies who make the reports themselves. We are not talking about a responsibility of the State commissions. Of course the same would be applicable to proxy statements. Proxy statements are included in annual reports, are they not?

Mr. GRADY. Well, they have not been required to be included heretofore, Mr. Chairman. We are doing it now in this——

Mr. HARRIS. That is what you have in mind here?

Mr. GRADY. Yes, sir.

Mr. HARRIS. So the same principle would apply there.

Mr. GRADY. Yes, sir.

Mr. HARRIS. That would be a part of the annual report. The so-called insider transaction principle that you have explained I will compliment you on——

Mr. GRADY. Thank you, sir.

Mr. HARRIS (continuing). But the thing I am wondering about, as was heretofore mentioned, is what kind of enforcement do the States have with reference to insider transactions?

Mr. GRADY. I believe Chairman Staggers was alluding to that earlier My conception of that is that it is a matter which would be decided by a court of a State under the peculiar State laws that exist, wherever the transaction arose, and the fact that the SEC had a 6-month insider profit period, then their law I would think, would be considered by the court as a reasonable one and applied, so I think it would be under the laws of the various States that a shareholder or a company could go after and recover from an officer or director or who engaged in an insider transaction to the detriment of the company.

Mr. HARRIS. That is exactly the way I construe it and I think it would have to be considered in that light, and it seems to me that probably this has not been given a great deal of consideration to the point that it can be developed at this time, as to whether or not a given State, and if so how many, would have provisions in their State that would bring about the enforcement as provided in section 16(b) of the 1934 act. I believe you say that your group is going to have another meeting in March.

Mr. GRADY. Yes; we are, sir.

Mr. HARRIS. Would it be an encroachment of suggestions if I were to suggest that your committee and your group give consideration to developing just what the facts are with regard to this point?

Mr. GRADY. Not at all, sir; we are happy for the suggestion and we will do so.

Mr. HARRIS. Very well. If it isn't asking too much and it would be appropriate would you give us the benefit of your thinking on it after you have had an opportunity to consider it?

Mr. GRADY. We certainly will, sir.

(The following material was submitted for the record:)

STATE OF CALIFORNIA, DEPARTMENT OF INSURANCE,
Los Angeles, March 7, 1964.

In re H.R. 6789, H.R. 6793, and S. 1642 before the Subcommittee on Commerce and Finance of the House Interstate and Foreign Commerce Committee.

Hon. OREN HARRIS,
House Interstate and Foreign Commerce Committee,
House of Representatives,
House Office Building, Washington, D.C.

DEAR CONGRESSMAN HARRIS: I enclose herewith a copy of the letter that I have today written Congressman Staggers concerning the above subject. This letter is primarily to keep you current with the activities of the special committee of the National Association of Insurance Commissioners which has the responsibility of dealing with this matter.

I also wish to take this opportunity, however, of expressing to you and to your fellow committee members my own deep appreciation and that of my fellow commissioners for the opportunity you have afforded us of presenting our views. We hope that we can count on your supporting these views.

Sincerely,

STAFFORD R. GRADY,
Insurance Commissioner, State of California.

Enclosure.

STATE OF CALIFORNIA, DEPARTMENT OF INSURANCE,
Los Angeles, March 7, 1964.

In re H.R. 6789, H.R. 6793, and S. 1642 before the Subcommittee on Commerce and Finance of the House Interstate and Foreign Commerce Committee.

Hon. HARLEY O. STAGGERS,
House Interstate and Foreign Commerce Committee,
House of Representatives,
House Office Building, Washington, D.C.

DEAR CONGRESSMAN STAGGERS: This letter is primarily for the purpose of bringing you up to date on the activities of the special subcommittee of the National Association of Insurance Commissioners, which has been authorized to consider and recommend action in respect of the legislation referred to above, which your committee presently has under consideration.

The insider transaction matter.—A model bill which will require officers and directors and shareholders (who own 10 percent or more of an insurance company's stock) to report insider transactions to the insurance commissioner of the domiciliary State of each insurer within 10 days following the end of the month during which the transaction occurs, and creating a cause of action in favor of an insurer to itself recover short swing insider profit has been drafted. This model bill is substantially similar to the authority that the SEC has under existing legislation in respect of registrants. The bill has been introduced in the Legislature of the State of New York and it is anticipated that it will be enacted into law and signed by the Governor within the next 2 or 3 weeks. I propose to have the bill introduced in the Assembly of the State of California at its next session. Both the deputy superintendent of the State of New York and I have had numerous discussions with members of the insurance industry and we have been informed that the industry will support the adoption of this model legislation, not only in the States of New York and California but in all 50 States. The SEC subcommittee of the NAIC will at the semiannual meeting of NAIC (presently scheduled for the second week in June 1964) recommend that the model bill be adopted by the legislatures of all of the States.

Although we believe the insurance commissioners of the various States already have authority to require the disclosure of insider transaction information, we have gathered that it is the sense of your committee that legislation, such as that described above, would be deisrable in order to assure that the insurer would have a cause of action to recapture insider profits uniformly throughout the 50 States. With the support of the insurance commissioners of the various States and the industry, we perceive of no reason why this legislation should not be adopted in all of the States.

The Proxy Information Matter.—There is presently scheduled for Monday and Tuesday, March 23 and March 24, a meeting of commissioners in San Francisco, to review and further revise the stockholder information supplement with the view toward bringing its requirements more in line with those of the SEC The purpose of this meeting is so that a final draft of the stockholder information supplement will be ready for adoption by the Blanks Committee of the NAIC which will hold its meeting in New York during the week commencing Monday, April 6. I call these dates to your attention, not only for the purpose of keeping you advised—but also to correct what appears to be an erroneous impression that the NAIC Committee working on the supplement was to meet again on March 19.

Financial Reporting by Insurers.—You will recall that both the NAIC and the insurance industry have steadfastly opposed the pending legislation insofar as it would give to the SEC the authority to require any financial information different from or in addition to that which is filed with the insurance department of the insurer's domiciliary State. Basically, the reason for this opposition is to prevent the confusion which would result in the minds of investors as well

as policyholders in the event the SEC would be able to require the insurance industry to comply with so-called generally accepted accounting principles rather than the more conservative insurance accounting principles which have prevailed in the industry for over a hundred years. The public should not be confronted with two differing sets of figures regarding the financial condition of an insurance company. We still persist in this opposition and most earnestly urge that in no event should insurers be required to file with the SEC anything other than a certified copy of the financial information which is filed with the insurance department of an insurer's domiciliary State. This is necessary to prevent confusion and dual regulation.

Unanimity of State Insurance Commissioners' Position.—You will recall that during the course of my testimony before your subcommittee on January 22, 1964, Congressman Harris inquired in respect of whether the commissioners of all 50 States and the District of Columbia, subscribed to the position of the NAIC then being expressed. I advised Congressman Harris that we would undertake to obtain the written commitment of all of the commissioners. These written commitments have now been submitted to your committee by Commissioner Charles Howell of New Jersey.

In view of the foregoing, I would like to conclude by stating that the NAIC and the entire insurance industry is opposed to the inclusion of insurers within the scope of the subject legislation. The NAIC has indicated a willingness and an ability to require adequate disclosure of financial, proxy and insider transaction information to stockholders. We earnestly urge that you consider excluding insurers completely, at least for a period of a year or two in order to see whether the steps already taken and planned to be taken by the NAIC prove to be adequate.

I respectfully request that this letter be made a part of the record in this matter. I am sending a copy of this letter to each of the members of your committee so that they will be fully advised. If we can be of any further assistance to you, please advise.

Sincerely,

STAFFORD R. GRADY,
Insurance Commissioner, State of California.

CALIFORNIA LEGISLATURE, 1964 FIRST EXTRAORDINARY SESSION

Assembly Concurrent Resolution No. 12 introduced by Assemblyman Mills, March 12, 1964. Referred to Committee on Rules

ASSEMBLY CONCURRENT RESOLUTION NO. 12—Relative to a study of the investments of officers, directors, and principal stockholders of insurance companies, and creating the Joint Interim Committee on Insurance Company Management.

WHEREAS, It is incumbent upon the Legislature of the State of California to protect the interest of the insurance buying public by taking steps to assure soundness in the financial structure and management of insurers admitted to do business in this State; and

WHEREAS, The stability of an insurer would be adversely affected if certain officers, directors and principal shareholders should be permitted to unfairly derive profit from the trading of company shares and securities; and

WHEREAS, Legislation to curb such activities by officers, directors and principal shareholders should be considered by the Legislature and could take substantially the following form:

An act to add Sections 1104.3, 1104.5 and 1104.7 to the Insurance Code relating to investments of officers, directors and principal stockholders.

The people of the State of California do enact as follows:

SECTION 1. Section 1104.3 is added to the Insurance Code, to read:

1104.3. Every person who is directly or indirectly the beneficial owner of more than 10 percent of any class of stock of a domestic insurer or who is a director or officer of such insurer shall file in the office of the Insurance Commissioner on or before the 31st day of January, 1965 or within 10 days after he becomes such beneficial owner, director or officer a statement, in such form as the Insurance Commissioner may prescribe, of the amount of all stock of such insurer of which he is the beneficial owner, and within 10 days after the close of each calendar months thereafter, if there has been a change in such ownership during such month, shall file in the office of the

Insurance Commissioner a statement, in such form as the Insurance Commissioner may prescribe, indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

SEC. 2. Section 1104.5 is added to said code, to read:

1104.5. For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director or officer by reason of his relationship to such insurer, any profit realized by him from any purchase and sale, or any sale and purchase, of any stock of such insurer within any period of less than six months, unless such stock was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the insurer, irrespective of any intention on the part of such beneficial owner, director or officer in entering into such transaction of holding the stock purchased or not repurchasing the stock sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the insurer or by the owner of any stock of the insurer in the name and in behalf of the insurer if the insurer shall fail or refuse to bring such suit within 60 days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This paragraph shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the stock involved, or any transaction or transactions which the Insurance Commissioner may by rules and regulations exempt as not comprehended within the purpose of this paragraph.

SEC. 3. Section 1104.7 is added to said code, to read:

1104.7. It shall be unlawful for any such beneficial owner, director or officer, directly or indirectly, to sell any stock of such insurer if the person selling the stock or his principal (i) does not own the stock sold, or (ii) if owning the stock, does not deliver it against such sale within 20 days thereafter, or does not within 5 days after such sale deposit it in the mails or other usual channels of transportation; but no person shall be deemed to have violated this paragraph if he proves that notwithstanding the exercise of good faith he was unable to make such delivery or deposit within such time, or that to do so would cause undue inconvenience or expense;

now, therefore, be it

Resolved by the Assembly of the State of California, the Senate thereof concurring, As follows:

1. The Joint Interim Committee on Insurance Company Management is hereby created and authorized and directed to ascertain, study and analyze all facts relating to legislation which would prevent the management and principal shareholders of insurers from deriving unfair profit from their connections with an insurer, giving particular attention to legislation in the form suggested by this resolution and including but not limited to the operation, effect, administration, enforcement and needed revision of any and all laws in any way bearing upon or relating to the subject of this resolution, and to report thereon to the Legislature, including in the reports its recommendations for appropriate legislation not later than the 30th calendar day of the 1965 Regular Session.

2. The committee shall consist of three members of the Senate appointed by the Committee on Rules thereof, and three members of the Assembly appointed by the Speaker thereof. Vacancies occurring in the membership of the committee shall be filled by the appointing power.

3. The committee is authorized to act during and after this session of the Legislature and until the filing of its report at the 1965 Regular Session.

4. The committee and its members shall have and exercise all of the rights, duties and powers conferred upon investigating committees and their members by the provisions of the Joint Rules of the Senate and Assembly as they are adopted and amended from time to time at this session, which provisions are incorporated herein and made applicable to this committee and its members.

5. The committee has the following additional powers and duties:

(a) To select a chairman and a vice chairman from its membership.

(b) To contract with such other agencies, public or private, as it deems necessary for the rendition and affording of such services, facilities, studies and reports to the committee as will best assist it to carry out the purposes for which it is created.

(c) To cooperate with and secure the cooperation of county, city, city and county, and other local law enforcement agencies in investigating any matter within the scope of this resolution and to direct the sheriff of any county to serve subpoenas, orders and other process issued by the committee.

(d) To report its findings and recommendations to the Legislature and to the people from time to time and at any time, not later than herein provided.

(e) To do any and all other things necessary or convenient to enable it fully and adequately to exercise its powers, perform its duties, and accomplish the objects and purposes of this resolution.

6. The sum of _____ dollars ($_____) or so much thereof as may be necessary is hereby made available from the Contingent Funds of the Senate and Assembly for the expenses of the committee and its members and for any charges, expenses or claims it may incur under this resolution, to be paid from the said contingent funds equally and disbursed, after certification by the chairman of the committee, upon warrants drawn by the State Controller upon the State Treasurer.

LEGISLATIVE COUNSEL'S DIGEST

A.C.R. 12, as introduced, Mills (Rls.). Investments in insurance companies.

Creates Joint Interim Committee on Insurance Company Management to study investments in insurers by officers, directors and principal shareholders thereof and to study suggested legislation controlling investments of such persons.

Allocates unspecified amount for expenses of committee from contingent funds of Senate and Assembly.

Mr. HARRIS. Thank you very much and thank you Mr. Chairman.

Mr. STAGGERS. Thank you, Mr. Chairman. At this time we will call on one of our colleagues from the State of Indiana, Congressman Ross Adair. Would he come forward and bring his constituents with him and introduce them to this committee, please?

Mr. HARRIS. Mr. Chairman, before we do that, I am not sure that permission has been given that all of the enclosures to be included with the statement of Mr. Grady have been included in the record, and I would ask that all of this information included in his statement be included in the record at the appropriate place following his presentation.

Mr. STAGGERS. It shall be done and included in the record. I think it has probably been done before, but if not it shall be included in the record at the proper place.

Mr. GRADY. Thankyou very much.

Mr. STAGGERS. Ross Adair, would you introduce your constituents? Ross Adair, one of our colleagues. He has a long and distinguished record here in the Congress. Back in 1950 or 1951 I served with him on Veterans' Affairs. He has been here a long time. Would you proceed.

STATEMENT OF HON. E. ROSS ADAIR, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF INDIANA

Mr. ADAIR. Thank you, Mr. Chairman, and members of the committee. I am here and pleased to present Mr. Walter Menge, of Fort Wayne, Ind., a fellow townsman of mine. Mr. Menge has with him other gentlemen who will be identified and introduced by him. He is the president of the Lincoln National Life Insurance Co., but is speaking here today in a broader capacity than that. He is representing all of the life insurance companies.

Mr. Menge is a former president of the Life Insurance Association of America. He is a former director and executive committee member of the American Life Convention, and a member of the Life Insurers

Conference. It is my understanding that these groups among them represent some 99 percent of the life insurance companies of this country, so Mr. Menge and his associates are speaking for the industry. I am sure the committee will find him to be a knowledgeable and articulate witness.

Thank you, Mr. Chairman.

Mr. STAGGERS. Thank you, Ross. You may proceed, Mr. Menge. Would you first introduce the gentlemen who are with you?

STATEMENT OF WALTER O. MENGE, PRESIDENT OF THE LINCOLN NATIONAL LIFE INSURANCE CO.; ACCOMPANIED BY MILLARD BARTELS AND JAMES P. SWIFT

Mr. MENGE. Yes. With me I have Mr. Millard Bartels, chairman of the Insurance Executive Committee and general counsel of the Travelers Insurance Co. Mr. Bartels is on my left. And also Mr. James P. Swift, senior vice president and general counsel of the Southwestern Life Insurance Co., of Dallas and this is Mr. Swift on my right.

Mr. STAGGERS. You may proceed.

Mr. MENGE. I am in very poor voice this morning.

Mr. STAGGERS. Would you wait a moment? Before he begins, I am sure we are going to have quorum soon, Mr. Chairman, and I would suggest that we adjourn now and come back at 2 o'clock. I assume we will have a quorum call. We might proceed. What is the desire of the committee?

Mr. KEITH. Wait for the quorum call.

Mr. STAGGERS. All right. Suppose you proceed.

Mr. MENGE. I am in very poor voice this morning, Mr. Chairman, and I hope you will bear with me.

Mr. STAGGERS. All right.

Mr. MENGE. We are testifying today in behalf of the combined membership of the American Life Convention, the Life Insurance Association of America, and the Life Insurers Conference comprising 362 United States and Canadian legal reserve life insurance companies. Of these companies, 261 are stock companies, and the remaining 101 are mutual companies. Collectively they hold approximately 99 percent of the total assets of all legal reserve life insurance companies doing business in the United States.

Primarily we are concerned with those parts of H.R. 6789, H.R. 6793, and S. 1642 which would extend the reporting requirements, proxy rules, and "insider trading" provisions of the Securities Exchange Act of 1934 to certain companies, including stock life insurance companies, whose securities are traded in the over-the-counter market.

We oppose the extension of SEC jurisdiction to life insurance companies for the reason that it would result in Federal intervention in a business which for many years has been successfully regulated by the several States, and for the reason that we do not believe that the companies or the taxpayers should be put to the added expense which duplicate regulation would necessarily entail.

Congress has consistently rejected similar proposals by the SEC.

The bills presently before the subcommittee are similar to a number of previous proposals of the SEC. These earlier proposals have

consistently failed, and their legislative history beginning with the year 1949 is outlined in the supplemental exhibit attached. In 1955, and again in 1957, the Senate Committee, after full consideration of the matter, expressly exempted insurance companies from similar proposals, and we urge that the current bills be similarly amended.

State regulation has been unqualifiedly endorsed by Congress.

For more than 75 years prior to 1944, the U.S. Supreme Court consistently held that insurance was not commerce and therefore was subject to State rather than Federal regulation. When the Supreme Court reversed that longstanding doctrine, Congress quickly enacted the McCarran Act restoring the States to the position they had previously occupied.

The fundamental purpose of the act (Public Law 15, 79th Cong.) was simply and clearly stated as follows:

> Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest. * * *
>
> The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.

As a result of this long history, the several States over a period of many years have built up a comprehensive regulatory and supervisory system. No other business operates under so great or so detailed a volume of regulatory law, and in no other area of business activity have the States performed a more impressive record of service in the public interest.

Except for a very few instances, there is great uniformity not only in the legislation which has been adopted by the 50 States, but in departmental rulings. Principal credit for this belongs to the National Association of Insurance Commissioners (NAIC) consisting of all of the officials of the various States charged with supervision of insurance affairs. It is a purely voluntary association, but it functions in a way which merits the admiration of anyone at all familiar with it. Practically every regulatory official has recognized the value of the NAIC and has given it his unstinted cooperation.

Out of the opportunity for cooperation which the NAIC has afforded, there has evolved a uniform annual statement form which is known as the convention blank. It has been adopted by every State in the Union and the adequacy and completeness of these reports is well recognized. They conform to the highest standards of life insurance accounting, and are under constant review by the NAIC Committee on Blanks which recommends changes, additions, and improvements to the statement form each year.

The form of the financial report of life insurance companies is one which has been adopted by the National Association of Insurance Commissioners for the purpose of providing the State insurance departments the complete and detailed information which they need for supervision.

As a result, the report is lengthy, technical with respect to such data as policy reserves, and detailed with respect to assets, liabilities, income, and disbursements. It includes a balance sheet of assets, liabilities, and surplus; a summary of operations (income and disbursements), arranged to show their effect on surplus; a number of exhibits giving further details of income; expenses; taxes; policy reserves;

policy claims; life insurance policies and annuities issued, terminated, and outstanding; and finally, a number of supporting schedules. Several of these schedules pertain to assets, providing considerable detail and classification of real estate, mortgage loans, and securities.

Other schedules deal with bank balances; resisted claims; legal and legislative expenses; amounts (individually listed) paid to trade, service, or similar organizations when in excess of $1,000, salaries of directors and top officers, and, when in excess of $20,000, amounts paid to any person, firm, or corporation.

Life insurance accounting requirements are unique. A life insurance company generally has large assets because it has obligations to so many people. In the average life insurance company, approximately 90 percent of assets are required to provide for policy liabilities, both accrued and to accrue in the near and in the long-term future.

To evaluate these liabilities properly, highly complicated calculations involving many assumptions and contingencies are involved. It is well recognized that the mortality, interest, and expense factors which underlie this actuarial process are subject to change over the years.

What the States have attempted to do is establish safe and conservative methods for the evaluation of these liabilities, and also set up investment standards for the protection of assets so that the companies will be able to discharge their contractual obligations notwithstanding the changing conditions of future years. That a proper relationship must exist between the method used for the evaluation of the asset side of the balance sheet and the method for the liability side is obvious.

We disagree with those who assert that State regulation gives no protection to stockholders, and that SEC regulation is required in order to protect the investor in life insurance stocks. The States have long understood that the stockholder equity represented by the company surplus must necessarily be the residue which remains after all of the liabilities of the company, past, present, and future, have been accounted for.

Although it is true that the State supervisory authorities have placed the emphasis of our accounting on policyholder interests, stockholder interests have not been overlooked. It is well recognized that the convention blank contains detailed information which is of interest to stockholders.

In a long-term business such as life insurance where policy contracts being issued today will often continue in force for periods of the next 25 to 50 years or more, there is the inevitable risk that actual results may not conform and, in fact, they seldom do conform, with the assumptions which have been made involving the contingencies of mortality, changing expense patterns and the ups and downs of investment return.

Necessarily, the methods of accounting used in the life insurance business differ in important respects from those recognized in other types of business. Perhaps a few examples will serve to better illustrate the unique accounting required of the life insurance business by the NAIC.

Example 1. Under NAIC regulation, it is customary for life insurance companies to use a 5-year averaging rule to determine carrying

values for preferred stocks. This differs from the usual method in general use for commercial and industrial companies. Life insurance companies buy preferred stocks for income and actually hold them for long periods of time. Very seldom is there a need to liquidate company holdings. The 5-year averaging rule produces stability in the valuation of preferred stocks. This is basically consistent with general practice in life insurance accounting to amortize bond premiums and to accumulate bond discounts.

Example 2. A large part of the expense of selling and maintaining a life insurance policy in force must be paid by the company during the first policy year and expensed immediately. Some accountants contend that a substantial part of this initial expense should be capitalized in the first year and expensed gradually over a period of years.

In life insurance accounting, however, a similar effect may be obtained by the use of a preliminary term system of valuation. Under such a system, a part of the expense is in effect deducted from the policy reserve, thereby accomplishing the same adjustment of earnings as the expense capitalization procedure.

Example 3. Common stocks owned by life insurance companies are required by the NAIC to be carried at current market values. Increases in these values generally have to be balanced off by additions to the mandatory securities valuation reserve (a required liability item for life insurance companies) and as such are not included in the company's surplus.

The method of accounting normally used by commercial and industrial companies would require that these paper profits, if recognized in the assets, be included in surplus under a caption entitled "surplus arising from revaluation of assets." This points up a uniqueness in the treatment of this situation in life insurance accounting.

Uniqueness of life insurance accounting is recognized. It is not necessary to look beyond the Internal Revenue Code to see that the unique problems of the life insurance business prompted Congress to adopt separate provisions which apply only to life insurance companies.

The income taxation of life insurance companies specifically recognizes the regulations and accounting procedures prescribed by State law. This was made clear by the floor debate in the House of Representatives on the Life Insurance Company Income Tax Act of 1959 (Public Law 86–89), an excerpt of which follows:

Mr. SIMPSON of Pennsylvania * * *

There is a matter of great importance on which I am sure the gentleman from Arkansas [Mr. Mills], the chairman, holds an opinion which coincides with mine, namely: that the committee has no intention of placing jurisdiction of the management of insurance company reserves within the hands or powers of the Commissioner of Internal Revenue. Specifically, I refer to section 806 of the bill before us. This section of the bill relates to a change of basis in computing reserves. I ask whether it is intended that permission to change the basis requires approval of the Secretary of the Treasury or his delegate as provided by section 446(e) of the code?

Mr. MILLS. Certainly, it is not the intention of the chairman that that be required. I think I can speak without fear of contradiction and say it is not the intention of the committee. We are trying to preserve as best we can in this bill the management of this industry in the hands of the State regulatory agencies and not to change in any way that situation so as to turn over to the Commissioner of Internal Revenue, the Secretary of the Treasury, or any one else in Washington the regulatory authority.

Last year when it passed S. 1642, the Senate also recognized that life insurance companies have unique accounting requirements. Moreover, the Securities and Exchange Commission in a letter to Senator Robertson, chairman of the Senate Banking and Currency Committee, dated July 15, 1963, has expressly stated its recognition of this fact (see letter at pp. 48–49 of S. Rept. 379, 88th Cong., 1st sess., to accompany S. 1642).

At pages 37–38 of its report on the bill, the Senate Banking and Currency Committee said:

> Your committee has taken cognizance of the fact, however, that life insurance companies have unique accounting problems due to the long-term nature of the life insurance contract and due to the assumptions which must be made with respect to mortality, expenses, and investment return. The problems connected therewith have, for the most part, been resolved by the States in the reports submitted to the State insurance commissioners.
>
> There are about 150 stock insurance companies, including 96 life insurance companies, which, having made public offerings since 1936, must now meet the reporting requirements of sections 13 and 15(d) of the exchange act. Your committee has taken cognizance of the fact that with regard to these life insurance companies the Commission has accepted duplicate copies of the annual statement approved by the National Association of Insurance Commissioners, or parts thereof, with explanatory notes as required by the Commission, in lieu of the financial reports required under sections 12 and 13 of the Securities Exchange Act in respect to the same matter.
>
> Your committee recognized that insurance companies operate under special accounting procedures and, further, that for those life insurance companies filing under section 15(d) the Commission has not required that these companies alter their accounting procedures in order to comply with the reporting requirements of sections 12 and 13.
>
> Your committee has, therefore, requested and received from the Commission a letter describing its procedure and requirements with respect to financial reporting by life insurance companies (see p. 48). It is the understanding of your committee that, with regard to life insurance companies, the Commission has not in the past prescribed "any method of accounting which is inconsistent with the methods of accounting required by the annual statement blank adopted by the National Association of Insurance Commissioners," and further, that "it would be the intention of the Commission to continue to follow these general principles in the future."
>
> Insofar as the life insurance companies are now meeting the SEC reporting requirements without any basic modification of their general accounting procedures, the committee takes notice of the fact that the Commission has expressed an intention to continue this practice in the future, and it expects the Commission to do so.

We commend the SEC for its forthrightness in making these statements for the record. We differ with the Commission, however, with respect to the relief for life insurance companies which should be granted as a result of these statements. The Commission feels it is enough that the statements be made. We feel that the mere making of the statements is not enough, however, and that they, that is, the statements, support our view that life insurance companies should be exempted from this proposal with regulation remaining in the hands of the States.

Additional regulation of proxies and insider trading is not necessary.

The insurance business is so completely regulated by the States that we feel there is no need for SEC regulation with respect to proxies and insider trading. State statutory provisions governing the operations of life insurance companies are quite extensive and, are in fact, more numerous and detailed than provisions relating to any other type of financial institution. The State insurance statutes cover, among other

things, provisions relating to organization procedures, minimum capital requirements, deposit requirements, filing and auditing of annual financial reports, periodic examinations by the supervisory officials, investment of assets, valuation of assets and policy reserve liabilities, annual licensing of companies and their agents, unfair trade practices, standard policy provisions for various types of contracts, prohibited policy provisions, approval by the supervisory officials of policy forms prior to issuance, and rehabilitation and liquidation in event of insolvency. Manifestly, statutory provisions of this kind protect stockholders as well as policyholders.

It should be understood that the triennial examinations conducted by the State insurance departments are not confined to financial affairs, but deal with every type of corporate activity. All information concerning proxy practices is available to the examiners and any irregularities can be easily and quickly corrected.

Moreover, every company seeks to avoid conduct which might be made the subject of an adverse comment in the examination report. We have brought with us today copies of the last examination reports of our three companies.

I might say, Mr. Chairman, that I have here our own report and the other gentlemen with me have brought theirs, and, while I don't think you want to put a volume that voluminous into the record, I would be delighted to pass it around and let you see the table of contents and leave it with the committee if it cares to examine it further.

Mr. STAGGERS. Mr. Menge, thank you very kindly.

Mr. MENGE. We invite the committee to take note of the table of contents which includes not only detailed comments on many asset items, on liabilities, surplus and other funds, but includes review of the articles of incorporation, bylaws, and the organizational provisions which deal with management and control.

With respect to insider trading, the periodic examinations conducted by the State insurance departments are broad enough to uncover any such practices and bring about corrective action.

In addition, the National Association of Insurance Commissioners in recent years has included on the annual statement form a question as to whether the company has a program for disclosing conflicts of interest on the part of its directors, officers and key personnel. Thus it would seem clear that there is no need for superimposing Federal regulation in this area.

The report of the Securities and Exchange Commission is not persuasive.

The Commission's conclusion in its report that the insurance companies studied do not currently follow SEC regulations by no means suggests that they are not adequately regulated or that their reporting and proxy procedures are insufficient.

There are always more ways than one to accomplish a desired result. The fact that two approaches may differ does not indicate that one is better than the other. While the States do not presently require some of the details deemed desirable by the SEC, the States in many other respects require much greater detail and more thorough examination of the practices of the companies.

It may well be argued that thorough study and examination by State officials who are expert in the insurance business provides greater

protection to the public than the dissemination of details to stockholders not as well equipped to understand the information.

We respectfully submit, therefore, that the Commission's study provides no justification for duplicative regulation of the insurance companies, with all of its attendant burdens and expenses, as well as possible conflicts between State and Federal authorities.

Moreover, it should be pointed out that the State insurance departments are continually reexamining their procedures in an effort to determine whether any changes are necessary.

In line with this policy, the National Association of Insurance Commissioners, at its meeting during the week of December 2, 1963, approved a program calling for the required use of a stockholders' information supplement as a part of an insurance company's annual statement.

The "Stockholders' Information Supplement" would inquire as to whether companies have distributed copies of an annual report to stockholders, and whether such report contains certain financial information with respect to the companies.

It would include a schedule which would require all directors and the three highest compensated officers whose remuneration exceeded $30,000 to show salaries and retirement benefits as well as estimated benefits on retirement. It would also require the reporting of information as to insider trading on the part of directors, officers, and owners of more than 10 percent of the outstanding securities of the company.

For the above reasons, it is respectfully recommended that this bill be amended, as in the past, to exclude all insurance companies which are subject to State supervision. To accomplish that purpose, we propose the following language to be inserted following line 8 on page 9 of the bill:

(F) any security issued by an insurance corporation subject to the supervision of the insurance commisisoner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia.

We understand that the other branches of the insurance business take the same position with respect to this bill.

Supplemental exhibit listing the legislative history of previous SEC proposals:

As far back as 1946, the Securities and Exchange Commission urged the Congress to extend the Securities Exchange Act of 1934 to over-the-counter securities, including life insurance company stocks.

In 1949, Senator Frear introduced a bill (S. 2408) designed to carry out the SEC's recommendations. After a public hearing on the bill, the Senate Banking and Currency Committee took no further action with respect to the SEC's recommendations.

In 1951, Senator Frear introduced a similar bill (S. 1860). Again the Senate Banking and Currency Committee took no action.

In 1955, Senator Fulbright introduced a bill (S. 2054) which was similar to the two Frear bills. The life insurance business requested a Subcommittee of the Senate Banking and Currency Committee to exempt insurance companies. The subcommittee approved S. 2054 with an amendment exempting insurance companies.

In 1957, Senator Fulbright introduced S. 1168. As introduced, the bill would have included insurance companies. Again, however, the Senate Banking and Currency Committee restored the exemption for insurance companies.

If I may add a supplemental statement, Mr. Chairman, to summarize our argument we have two important points regarding which we are concerned.

The first of these has to do with the gradual extension of jurisdiction by the SEC over the life insurance business. It has been pointed out in my testimony here that we are now subject to regulation by all States in which we operate and we do not need another superimposed regulatory body.

We are afraid that gradually the jurisdiction of the SEC will be extended further and further and that ultimately there will be a conflict between SEC regulations and NAIC regulations. This would put us in a serious predicament as to which of these contradictory regulations to follow.

The other concern that we have is the difficulty of reconciling the usual life insurance accounting methods with those usually used by accountants in other fields. This implies that we will need a series of footnotes to explain the differences and these footnotes would be extremely complicated and hard to understand. We think that this would create confusion among policyholders and stockholders.

Mr. STAGGERS. Is that the end of your statement?

Mr. MENGE. That is the end of my statement.

Mr. STAGGERS. Thank you, Mr. Menge. I think you have given a very comprehensive and understandable statement on the position of the insurance companies.

Mr. MENGE. Yes, I am speaking for three insurance organizations.

Mr. STAGGERS. I am sure you are and for their side, and I think it will be recognized as a compliment to you and your position.

Mr. Van Deerlin?

Mr. VAN DEERLIN. No, thank, you, Mr. Chairman.

Mr. STAGGERS. Mr. Glenn?

Mr. GLENN. I have no questions, Mr. Chairman, but I would like to compliment Mr. Menge on his statement and suggest that perhaps your statement backs up the statement and the discussion which we had with the officials of the National Association of Insurance Commissioners, and I think we made a very good record during that discussion so that the record will indicate your insurance companies themselves take the same position as the commissioners did.

Mr. MENGE. Thank you, sir.

Mr. STAGGERS. Mr. Keith?

Mr. KEITH. Thank you, Mr. Chairman. In the earlier testimony it was pointed out that some insurance companies already are forced to comply with SEC requirements. Do you know whether there has been any conflict of form with reference to the furnishing of that information?

Mr. MENGE. I am under the impression, at least with respect to the life insurance companies who have filed under SEC, and that has been usually because they were going into the public market for additional funds, that in those instances they are generally small and newly formed life insurance companies and as such would not have

the backlog of accounting procedure, the reconciliation of surplus problems, that an established and long-term life insurance company would have.

For example, our company was organized in 1905 and, as I understand, the proposed bill would require that we give a reconciliation of surplus from the year one, which covers a period of 58 years, I believe. That would be a very extremely difficult task for us to reconstruct at this very late date.

Mr. KEITH. In other words, those companies which come under the SEC under the provisions of the 1933 or 1934 acts would not be those like the old line mutuals. They would just be new companies and they don't have to file current statements?

Mr. MENGE. They would be companies which are issuing new issues of stock and they would be by and large the newly formed life insurance companies. Our own company—I think this applies generally to most of the well established companies—has not been in the market for public funds since way back in the 1920's, a period of some 40 years, so I would suspect that, of the 110 insurance companies which are already under SEC, 95 percent of them probably are companies which are just beginning their organization, and as such compliance with the SEC requirements would be much less onerous in their case than they would be in ours.

Mr. KEITH. I am trying to develop a point here as to whether or not these companies report annually, or just at the time they go to the public for the money.

Mr. MENGE. As I undertand it, they have to file a prospectus at the time that they go to the public for funds and that thereafter they have to report annually as well.

Mr. BARTELS. Might I add something to this?

Mr. KEITH. Yes, sir.

Mr. BARTELS. I think Mr. Menge made the point that our major concern is this almost unlimited rulemaking power which SEC would get as a result of this legislation, so I suspect that what has happened to date is not reflective of what will happen in the future.

Actually the ground rules are not well laid so far as the life insurance business is concerned. These have been sort of handled on an ad hoc basis, according to my understanding, and the process of working out this idea of modern accounting principles in comparison with the rather stabilized accounting methods that NAIC has yet to be worked out; that is, for the business as a whole, so these cases are very minor in number as compared to the 1,500-odd life insurance companies there are in this country.

Mr. KEITH. Thank you. Are premiums that are paid in advance—I mean those discounted over many years' time or on a current basis—listed as assets to the corporation?

Mr. MENGE. In life insurance accounting if a policyholder pays premiums in advance; that is, beyond those due and payable currently, we set them up as a liability.

Mr. KEITH. Do you use these premiums in your corporate ventures?

Mr. MENGE. We do not segregate them in a special asset account. We consider them as a liability of the company generally and we would make use of them; yes. As a matter of fact, we allow discount on them so we have to invest them in order to earn the discount which we allowed policyholders.

Mr. KEITH. What I have in mind is what took place in the Ira Haupt Co., when they used customer funds as assets of the corporation and these funds were not available to the customers when they actually were having difficulties. I don't know of any insurance company parallel. It may be more appropriate to ask casualty companies than life companies, because I don't think there has been a failure of a life insurance company in years, has there? Can you speak to that?

Mr. MENGE. In the first place, with respect to the discount of premiums due in the future, that is a routine operation in our company. We have thousands of policyholders who prefer to pay their premiums in advance; on these premiums we allow a discount so that it doesn't cost them as much as if they had waited to pay the premiums.

We in turn invest these funds. We set them up as a liability in our liability account and since these liabilities are covered by the assets side they are certainly as secure as they could be in a bank or in any other depository.

The other question that you had was?

Mr. KEITH. With reference to the general stability of the life insurance industry.

Mr. MENGE. There have been some failures of life insurance companies over the years. I can recall in the thirties there were several companies. As a matter of fact, my own company assisted two of the insurance departments by administering two insolvent companies at that time, and there have been other instances of the same thing, but as far as I am aware I can't recall the insolvency of any major life insurance company, at least in the last 20, 25 years.

Mr. KEITH. Thank you. Thank you, Mr. Chairman.

Mr. STAGGERS. Thank you very kindly Mr. Menge. We appreciate your coming and giving us the benefit of your views and those of the insurance companies. Also I want to thank Mr. Bartels and Mr. Swift for coming and being with you.

At this time, too, I want to thank Mr. Grady and all of those who appeared with him here this morning; Mr. Howell, Mr. Price, Mr. Farnum, and Mr. Biddle.

I would like to ask permission to put in the record a clarification of a statement yesterday by Mr. Toupin, general counsel for the Insurance Securities Inc., and have it put in the record at the appropriate place to clarify an answer which he made to Mr. Keith.

The committee will adjourn until 2 o'clock this afternoon. We will try to secure permission of the House to sit at 2 o'clock and, if possible, we will be here at two or as soon after as possible. If we cannot secure permission we will meet in the morning at 10 o'clock. We will try to come back. If Mr. Ridgway is present tell him that we are going to try to accommodate him while he is here and get his testimony this afternoon.

Mr. RIDGWAY. Thank you, Mr. Chairman.

Mr. SWIFT. Mr. Chairman, are these witnesses here excused?

Mr. STAGGERS. Yes. Thank you so much for coming. The committee is adjourned.

(Whereupon, at 12:36 p.m., the committee adjourned to reconvene at 2 p.m. the same day.)

AFTERNOON SESSION

Mr. VAN DEERLIN (presiding). The hearing will come to order, renewing the subcommittee session on S. 1642 and H.R. 6789, Securities and Exchange Commission omnibus bills.

The witness this afternoon is Mr. William Ridgway, Jr., chairman of the board of Crum & Forster Insurance Co., of New York City.

Mr. GRADY. Mr. Chairman, my name is Stafford Grady, and may I correct something or straighten it out, something that was in the record earlier today, concerning the March meeting of the NAIC? I testified that that meeting was going to be in March, and I understood it was going to be in March. Normally it is the last week of March, but this year, because of the intervention of the Easter holiday, I understand it is going to be the first week in April, and I just wanted the record to be clear on that.

Mr. VAN DEERLIN. Your testimony will be so purged.

Mr. GRADY. Thank you.

Mr. STAGGERS (presiding). Mr. Ridgway, we are glad to have you. You may give your name and position and go right ahead.

STATEMENT OF WILLIAM C. RIDGWAY, JR., CHAIRMAN OF THE BOARD, CRUM & FORSTER GROUP OF INSURANCE COS., NEW YORK CITY; ON BEHALF OF THE ASSOCIATION OF CASUALTY & SURETY COS. AND THE NATIONAL BOARD OF FIRE UNDERWRITERS

Mr. RIDGWAY. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, my name is William C. Ridgway, Jr., and I live in Short Hills, N.J. I am chairman of the board and chief executive officer of the Crum & Forster Group of Insurance Cos., whose home office is 110 William Street, New York City.

I appear before you today, however, as president of the Association of Casualty & Surety Cos. This statement is also made on behalf of the National Board of Fire Underwriters. Both organizations are located in New York City.

The Association of Casualty & Surety Cos. is an organization of 125 capital stock insurance companies, engaged in writing casualty insurance and fidelity and surety bonds throughout the United States. The National Board of Fire Underwriters is an organization of 191 capital stock companies writing fire insurance and allied lines in all States.

There is substantial duplication of membership in these two organizations. The distinguishing characteristic of the two organizations, on whose behalf I am presenting this statement, is that they are composed of stock companies which sell insurance through independent agents and brokers. I mention this because there are a number of fire and casualty insurers which are known as direct writers.

My remarks will be confined to those parts of these bills which would newly impose on corporations, whose shares are traded over the counter, the same financial reporting, proxy solicitation and insider trading requirements now applicable to corporations whose shares are traded on a fully listed basis on a national exchange.

Our organizations have consistently opposed the application of these provisions to insurance companies. Our position has been stated to the Congress whenever this proposal has been aired at public hear-

ings, going back to 1950. (See transcript of hearings before subcommittee of Senate Committee on Banking and Currency on S. 2408, 81st Cong., 2d sess., Feb. 7–10, 1950, on S. 2054, 84th Cong., 1st sess., June 27–30, and July 1, 1955, and on S. 1168, 85th Cong., 1st sess., May 20–24, 27, and 29, 1957.)

Our opposition to this legislation was recently expressed at hearings before the Senate Subcommittee on Securities on S. 1642. (See transcript of hearings before subcommittee of Senate Committee on Banking and Currency on S. 1642, June 24, 1963.)

We have previously urged a provision which would exempt "any issuer which is an insurance corporation subject to the supervision of the insurance commissioner, banking commissioner, or any agency or officer performing like functions, of any State or territory of the United States or the District of Columbia." We urge a similar amendment today.

Insurance companies in a very real sense live in a goldfish bowl. We must file with State supervisory authorities a detailed financial report on a form, called an annual statement blank, carefully developed over many years by the National Association of Insurance Commissioners. A copy is furnished herewith to the committee, not for the record, but for your information, together with other exhibits I will refer to, Mr. Chairman.

Mr. STAGGERS. Thank you.

Mr. RIDGWAY. All States require fire and casualty insurance companies to file insurance loss and expense exhibits at the end of each year giving a detailed report of underwriting results by line of business. A copy of that report has been furnished the committee.

From these exhibits, the New York Insurance Department annually compiles and publishes underwriting results for each company and for entire classes of similar type companies. (A copy of the 1962 loss and expense ratios will be furnished the committee.)

Some States, including New York and California, require all fire and casualty insurance companies to file quarterly statements in addition to the annual statement which is due on March 1.

Insurance companies are examined triennially and can be examined more often if that is deemed necessary by supervisory authorities. It is sometimes difficult for those not a part of our business to visualize the comprehensiveness and minute detail of these examinations which are conducted under the auspices of the National Association of Insurance Commissioners with representatives of all States participating. The reports of these examinations, when filed, are public records, the same as are the annual statements which are filed with the insurance departments of every State where a company is licensed to do business.

Please bear in mind that there is no limitation at all on the extent to which an insurance department can examine the operations of a company; there is no limitation on the number of times a company can be examined; there is no limitation on the power of an insurance commissioner to require the furnishing of any document or material which he desires to review.

Thus, there is no paucity of public information concerning insurance companies. All of the material I have mentioned, which is filed and becomes a public record, is reviewed and studied by financial houses, security analysts, as well as by the numerous trade publica-

tions, some of which over the years have developed outstanding reputations for their capacity to analyze and rate the financial integrity of insurance companies and the ability of their management.

It is asserted that insurance regulation is designed to assure solvency. I agree that this is, and should be, the primary purpose of insurance regulation. Insurance accounting is geared to the requirements of our annual statement blank, which is, and necessarily should be, conservative.

In fact, insurance accounting procedures are more conservative than the accounting procedures recognized by the Securities and Exchange Commission. If they were less conservative, then we could readily understand the desire of SEC to protect the investing public. Since just the opposite is so, it escapes us just how SEC accounting procedures can better protect the investing public.

In an appearance before the Subcommittee on Securities of the Senate Banking and Currency Committee on June 18, 1963, Mr. William L. Cary, Chairman of the the Securities and Exchange Commission, in referring to insurance companies made the statement: "Accounting methods do not in all instances follow generally accepted accounting principles and practices." This is in reference to insurance companies.

This is a valid statement but only because such practices are not properly applicable to the insurance industry. I can assure you that the insurance industry's accounting methods do definitely follow generally accepted accounting principles and practices in the insurance industry.

The fact that insurance regulation is primarily designed to protect the policyholder, and the fact that insurance accounting practices are necessarily conservative, does not mean that they are ineffective and inappropriate insofar as the investing public is concerned. In fact, we submit that conservative accounting practices geared to the protection of policyholders afford a maximum degree of protection to stockholders.

Certainly, we are not suggesting that other businesses be subjected to a regulation even remotely similar to that of insurance companies, but we strongly believe that our kind of regulation protects the investing public better than the disclosure method of the Securities Exchange Act of 1934, yet still provides full disclosure of financial information for the benefit of the investing public as well as the security analyst.

It will, I think, interest this committee to know that accounting technicians in the insurance industry are working now with members of the American Institute of Certified Public Accountants in an attempt to resolve the differences in accounting figures that develop between our present form of insurance accounting and what are apparently the accounting procedures required by the SEC.

Frankly the suggested SEC accounting procedures, we in the insurance industry feel, would develop financial results that would be misleading to the investor as well as the policyholder. They would be different than those accounting figures required by insurance regulation and therefore could not help but be confusing to the public. These are the differences the insurance industry is trying to resolve with the accounting industry.

In 1955, the SEC completed a limited study confined to insurance companies. In general, the SEC found "material deficiencies" in a large number of stockholder reports, and "a general failure to furnish important information which would be required by the Commissioner's proxy rules."

The recent study contained in chapter IX of the Report of Special Study of Securities Markets, dated April 3, 1963, is an even more limited study of insurance companies. It covers only 44 insurance companies which responded to the questionnaire.

Again, for the most part, the deficiencies consist of failure to meet SEC standards. Certain practices may be adequate on the basis of other standards, even though they do not conform to criteria established by the SEC. Understandably, we find the conclusions of the SEC study as rather frustrating since we have not had an opportunity to review any of the questionnaires which they received from insurance companies, nor do we know what insurance companies received this questionnaire.

It should be noted that the 1955 supplemental study, covering insurance companies, specifically stated that it did not cover the subject of insider trading. The recent study makes no such statement but we find no reference to insider training as it may relate to the insurance business. I would seriously doubt that insurance management has engaged in short-swing trading.

Insurance companies are naturally desirous of cultivating good investor stockholder relations. Based on my own personal observations, I do not think insurance companies have experienced serious criticisms from their stockholders that their reports and other information sent to such stockholders are inadequate or unsatisfactory. If an interested investor is in any way puzzled by insurance accounting methods, he can readily receive an analysis from one of the investment houses specializing in insurance stocks, and these analyses furnish such information in terms of SEC accounting procedures.

Moreover, some companies voluntarily furnish such analyses as supplemental information to their stockholders. Other companies are reluctant to do this because they have reservations about any departure from recognized insurance accounting procedures and believe that departures could lead to unsound and misleading assumptions and conjectures, thereby creating confusion in the minds of investors as well as policyholders.

I would like to mention recent developments in the regulatory pattern at the State level which I believe bear on the matter before us. Two years ago, the National Association of Insurance Commissioners included on the annual statement blank a question on whether or not a company had a program for disclosing potential conflicts of interest on the part of directors, officers, and key personnel.

Many companies have long had such programs, but the inclusion of this question on the annual statement blank had the effect of bringing this subject to the forefront and companies which did not have such formalized programs naturally instituted such programs.

When it was my privilege to testify on this legislation before a subcommittee of the Senate Banking and Currency Committee, I mentioned that the National Association of Insurance Commissioners was reviewing the SEC recommendations. It can now be reported—as

it has been this morning—that the NAIC has adopted a program at its recent regular meeting, and this program will require disclosure to the same extent as, and very likely to a greater extent than, the SEC requirements.

Specifically, the NAIC has adopted a stockholder information supplement to its annual statement. This will cover (*a*) financial reports submitted to stockholders, (*b*) statement of beneficial ownership of securities (designed to disclose insider trading) and (*c*) information regarding compensation and stock holdings of management and directors. A copy of this Stockholder Information Supplement has been furnished to the subcommittee for their information.

There is a possibility that the details of this Stockholder Information Supplement will be changed prior to its official promulgation by the NAIC. Conceivably, in its final form it will require the disclosure of the compensation of the three highest paid officers, using a salary criterion less than the $30,000 SEC level.

Presently, the NAIC disclosure requirements apply to all stock companies and not just those with 750 stockholders and $1 million in assets. If some revision is made in this area for the purpose of practicability, I am certain that the NAIC requirements will cover many more companies than the SEC recommendations. I mention the possibility of these changes because, in adopting this program, the NAIC authorized its blanks committee to make such minor modifications as seem desirable.

This disclosure program will form part of the annual statement for the year 1964. Companies will immediately commence reviewing their procedures in order to comply with these requirements. Admittedly, this is not a mandatory requirement on its face. That is to say, if a company is not making appropriate disclosures in line with this program, such a company could theoretically answer in the negative the pertinent questions in the 1964 annual statement.

While noncompliance is a theoretical possibility, it would be most unrealistic to anticipate such a development. Those who live with the processes of State regulation of the insurance business know only too well that in practical effect this interrogatory becomes a mandate. In short, companies will realize that they will have to measure up to the requirements set forth in the stockholder information supplement.

Insurance companies are often asked why they object to this further regulation on the part of SEC when they have been living with a much more rigid form of regulation for many years, and particularly now when they will be subjected to the same kind of disclosure requirements at the State level. There are a number of solid answers to that question.

First, there is good cause to believe that we already have too much regulation and that this regulation is making it difficult for insurance companies to operate efficiently and economically. We have seen what has happened to other businesses through overregulation. Chairman Cary at the Senate hearings said: "The insurance industry has a certain traditional sensitivity against Federal regulation." Our fears go much beyond such sensitivities. We are deeply concerned that we will be stifled by an excess of regulation. We do not welcome any further layer of regulation from another regulatory body, especially when we are not convinced that it will serve a useful purpose.

Second, our business has become tremendously competitive, and we are all under heavy pressure to keep our operating costs at the lowest possible level. Indeed, this is an absolute necessity if a fire and casualty company is to survive today. How much compliance with all SEC requirements will cost our business is anybody's guess, but rest assured it will be a further cost burden on a business already saddled with substantial supervisory expenses.

Third, fire and casualty stock insurers compete with other kinds of insurers, such as mutual companies and reciprocal exchanges. Such carriers are subject to the same State regulation as stock companies, but, since they have no stockholders, the added burden of this proposed legislation will be borne by our companies and not by some of our principal competitors. A perusal of the fire and casualty companies whose stock is traded in the over-the-counter market will show that the onus of the proposed requirements will fall almost solely on the stock companies operating through independent agents and brokers.

Fourth, our business has been regulated at the State level for many, many years. The effectiveness of State regulation has been recognized by the Congress in the enactment of the McCarran Act in 1945 (Public Law 15, 59th Congress, 15 U.S.C. 1011–1015). As above shown, the investor, as well as the policyholder, is amply protected by the stringent criteria for financial stability imposed by the States.

Fifth, because of the cost of complying with State regulation, U.S. companies are already at a distinct disadvantage in competing with alien unauthorized insurers—that is, non-U.S. companies operating on a nonlicensed basis. The added cost of SEC regulation can only increase that disadvantage.

Sixth, we believe that information reported periodically to the various State insurance departments is more searching, comprehensive and reliable than that called for by SEC standards of reporting as respects both investor and policyholder. We are apprehensive that accounting procedures applicable to noninsurance businesses applied on a Federal level would have the effect of undermining the necessarily conservative accounting to which insurance companies are subject on a State level, thereby operating to the ultimate detriment of both policyholders and investors.

Seventh, we are concerned by the problems involved in reporting to two regulatory authorities, the SEC and the insurance commissioner, one a Federal authority and the other a State authority. In 1945 by the passing of the McCarran Act, Congress delegated supervision of the insurance industry to the insurance departments of the various States. We feel that attempting to serve two masters can only cause confusion.

Eighth, it is clear that disclosures for the benefit of stockholders and investors similar to, or even beyond, SEC standards will be required at the State level. Thus, the case for the SEC bills as they relate to insurance companies rests solely on a technical solicitude for SEC accounting procedures as opposed to insurance accounting procedures. This rationale cannot be justified on any ground and strangely enough least of all from the standpoint of investor protection.

Accordingly, we respectfully submit that the proposed extension of SEC requirements to insurance companies is not in the interest of

stockholders, investors, policyholders, nor of the general public, and we urge that insurance companies be exempted from the provisions of this legislation.

Thank you, Mr. Chairman.

Mr. STAGGERS. Thank you, Mr. Ridgway. I think you have presented a very comprehensive statement.

Is there a service that investors can turn to with service covered property as to the stock insurance companies, something like the stock insurance service?

Mr. RIDGWAY. Yes, Mr. Chairman, there are a number of such services. I would say that the most outstanding one in this particular field of fire and casualty companies, is the Alfred M. Best report that they put out, in which they include financial statistics on all insurance companies, stock insurance companies, and mutual companies, throughout the country.

Mr. STAGGERS. Does this include all?

Mr. RIDGWAY. It is my understanding that it includes all. There may be some of the very minute ones that are not included in it, but it goes down to a very small, low level as far as financial strength is concerned.

Mr. STAGGERS. What is the name of that?

Mr. RIDGWAY. Alfred M. Best & Co. is the concern. It is called Best Annual Statements, I think, or Annual Report. It is a rather sizable volume.

Do we have it? I show you the extent of it, Mr. Chairman. It is very sizable, running to—it is in two different sections, but here it runs up to some——

Mr. STAGGERS. How many insurance companies are there in the United States?

Mr. RIDGWAY. I think, if I recall correctly, Commissioner Grady made the statement around 2,800. I am frank to say I can't answer that question myself. I do not know how many there are, but I would estimate 2,800 to 3,000.

I might, if I may, Mr. Chairman—this particular volume is quite comprehensive. It includes not only the property and casualty insurance companies, the stock companies, the mutual companies, the lawyers' organizations, reciprocals or interinsurance exchanges, State funds, Canadian companies, Blue Shield, and so forth, and so on. It rates every one of these companies on a financial basis, and if I am not mistaken, the lowest rating, lowest financial rating, is policyholders' surplus of $250,000 and less. So it goes down the line quite a ways.

Mr. STAGGERS. You don't know how many companies are included in that?

Mr. RIDGWAY. No, I don't, sir, at the moment. The index runs, I would roughly say, 20 pages or so, fine print.

If I may add, Mr. Chairman, if I were an investor, I don't think I would be interested in any company that is not listed in this book, it would be so small.

Mr. STAGGERS. Where are you going to find that book?

Mr. RIDGWAY. Find it? For any other company?

Mr. STAGGERS. Yes.

Mr. RIDGWAY. Well, my statement was that if I were an investor——

Mr. STAGGERS. I understood that. I just say where would a person go to find that book, if he wanted to find one?

Mr. RIDGWAY. Oh, it is available in a great many libraries throughout the country. It is available in the insurance department in Best's office in New York City, and it is on file probably, available to anybody, in all of the larger specialty brokerage houses throughout the country.

I might add, in addition to Best's Insurance Reports, there are a number of well-qualified professional insurance experts in the brokerage field, stock brokerage field, who also render reports that are distributed to public and interested parties that summarize the financial results of some major insurance companies, and for such major insurance companies, I refer you to First Boston Corp., Conning & Co. in Hartford, John C. Legg & Co. in Baltimore, and many others throughout the country.

Mr. STAGGERS. Reading this, it was stated that insurance companies, when these blanks are sent out to them they are required to answer yes or no as to stockholders, make disclosures on their stockholders' information. I believe that is right, isn't it, that on these blanks that are sent out to each company, that they have to make disclosure stockholders' information which is comparable to that required by the SEC, or not?

Mr. RIDGWAY. Well, I understand that that will be a part of the 1964 blank, covering this year.

Mr. STAGGERS. If they say no, what can they do about enforcing it?

Mr. RIDGWAY. Mr. Chairman, I am very pleased that you asked me that, because I can assure you, sitting on this side of the fence, that I doubt if there is a single insurance executive in the country that would not give tremendous consideration to taking a stand refusing to provide such information to his insurance commissioner.

You asked how the insurance commissioner could impose or require such information to be furnished. I can assure you that the insurance commissioner of every State has the right to take any action necessary, in his estimation, as a result of actions taken by an insurance official, of a punitive nature. I am referring to the fact that every insurance company is licensed in one or more States, and it is within the power of every insurance commissioner of every State to revoke their license, if he feels that the actions being taken by the insurance company officials are not in the public interest. In other words, he could put us out of business.

Mr. STAGGERS. Do all of the 200 stock life insurance companies which you represent here today solicit proxies?

Mr. RIDGWAY. Mr. Chairman, I am sorry I can't answer that. I can't answer it by study—let's put it that way. The companies that I am representing through the association and the national board are of sufficient size that, in my best judgment, every one of them is soliciting proxies in some form.

Now whether the form of proxy solicitation is in 100 per cent agreement with the present SEC requirements, I would doubt very much, but there is no reason why it can't be brought into conformity, if the insurance departments require.

Mr. STAGGERS. I believe in their study they claim that this is one of the things that was deficient. Now do the State commissioners require this solicitation?

Mr. RIDGWAY. Of proxy information, you mean, sir?

Mr. STAGGERS. Yes.

Mr. RIDGWAY. No, at the moment they do not.

Mr. STAGGERS. You just do it voluntarily?

Mr. RIDGWAY. Voluntarily. That is correct, sir.

Mr. STAGGERS. When you solicit proxies, do you not furnish the information that you have heard testified, that the Commission would require in the future? Do you furnish this information now?

Mr. RIDGWAY. The information as respects insider trading, and proxy solicitation of material, and so forth?

Mr. STAGGERS. Well, I believe the NAIC would have a whole list there.

Mr. RIDGWAY. That is right, which are being proposed in this new supplemental information, the questionnaire.

Mr. STAGGERS. That is right.

Mr. RIDGWAY. We do not furnish it today because we are not required to. It is available, however, on the examinations triennial or otherwise of the insurance department. It is available to every insurance department throughout the country, and I can assure you that it is looked at also.

Mr. STAGGERS. Do you think that the several States, the 50 States, have given adequate authority for the commissioners to require that you solicit proxies?

Mr. RIDGWAY. Yes, Mr. Chairman, I do. I think indirectly by the very fact that the insurance commissioners of every one of the States are charged by law with the supervision and regulation of the insurance industry, they can require and ask for anything that they deem is necessary.

Mr. STAGGERS. And that you supply them any information that they require.

Mr. RIDGWAY. That is correct, sir.

Mr. STAGGERS. You have heard testimony this morning concerning the disclosure of profits made on insider information. I take it that you have no objection to this type of disclosure?

Mr. RIDGWAY. None whatsoever, sir. I might add in that respect, if I may, Mr. Chairman, that although there is no specific requirement on our part at the moment for the reporting of short-swing insider trading, I would consider such short-swing trading as being a violation of the conflict of interest and code of ethics that the insurance departments of the various States, all States, have required the insurance industry to comply with, and therefore would be contrary to the completion of the questionnaire as respects conflict of interest and the examination thereunder.

Mr. STAGGERS. I don't quite understand. You mean that to require this insider information would not be right?

Mr. RIDGWAY. I personally, and every other key executive in my organization, and in every insurance organization, is required to file with me or with the organization company that they belong to, a statement to the effect that they are not in violation of the conflict of interest code of ethics as proposed, and I am reasonably certain

in my own mind that on the short-swing trading, such would have to be reported to the company, and therefore in their files would be available to the insurance commissioner.

Mr. STAGGERS. Well, I am just wondering if you are doing this at the present time, on this conflict of interest or insider information. Are you doing this either voluntarily or by State requirement now, or not?

Mr. RIDGWAY. On the conflict of interest, we have been asked to do so by the insurance departments of each of the 50 States, through the NAIC, and although that is also the type of interrogatory that can be answered no, it is my understanding that every insurance company has set up some form of controlling conflict of interest, and established a code of ethics and a procedure for the enforcement of it.

Mr. LONG. Mr. Chairman, would you yield for a moment?

Mr. STAGGERS. Surely.

Mr. LONG. How long has that been in effect?

Mr. RIDGWAY. Approximately 2 years, Mr. Long.

Mr. LONG. What gave rise to it? Was it a result of insider trading? Could you give the committee the benefit of the history? I am familiar in general with it, but not specifically.

Mr. RIDGWAY. I think I can only answer it as respects my own opinion as to why it developed. I think it developed through a series of circumstances that arose in the industry, without naming names, one of them in a major life insurance company in the metropolitan area, another major company in Newark, where a conflict of interest came into the picture, and as the result of it, the insurance department of the State of New York in one case and the State of New Jersey in the other case—and I am referring to the Equitable Life and the Prudential—took the necessary action to see that the situation was resolved, and the conflict of interest that had arisen did not materially affect in any form, shape, or manner either the policyholder, or in both cases, I guess, their mutual companies.

At that same time, or very shortly around that same time, there was in other industry throughout the country areas that apparently involved conflict of interest. I refer to the Chrysler Corp. problem as respects this particular area, and as the result of it, the insurance departments, I feel, of the various States felt that this was an area that should be better defined than had been before, and took the necessary steps to do so.

Mr. STAGGERS. Would the gentleman yield?

Mr. LONG. Yes, sir.

Mr. STAGGERS. In one of these cases, was the president of the organization asked to resign?

Mr. RIDGWAY. It is my understanding that he was. If I am not mistaken, in both cases of the life companies.

Mr. LONG. Well, you feel that this is adequate protection against short-swing trading? Or adequate protection to be sure that it is disclosed? Let's put it that way.

Mr. RIDGWAY. Let's put it another way around, if I may, Mr. Long. I feel that it certainly will disclose or make available to any insurance department that feels that there might be a situation that needs investigating, he has it right at his fingertips as respects short-swing trading, and it would be available to him.

Mr. LONG. Could you give me the time sequence that would be followed in the reporting of such instances with respect to the filing of the annual report under the proposal of the conference in Phoenix?

Mr. RIDGWAY. I am sorry, Mr. Long. I lost the intent of your question.

Mr. LONG. When would this information, under the contemplated course of action, become available to the people who need to know?

Mr. RIDGWAY. You are again referring to short-swing trading. Is that correct?

Mr. LONG. Yes.

Mr. RIDGWAY. As I understand it, this particular subject of short-swing trading was not resolved at the Phoenix meeting of the NAIC. It is my understanding from what Commissioner Grady said this morning that this particular subject of short-swing trading will be given further consideration as respects the supplemental questionnaire, and will be resolved in one form or another at their meeting, as he said, now, in April.

I can't predict what the answer to it is going to be, but I would assume that some consideration would be given in this area, and some safeguards set up for reporting such.

Mr. LONG. But it would appear that unless some substantial departure is made from the course of action now contemplated, that such information would not be available for periods of upward of at least 15, 16 months after the acts took place. Is that not correct?

Mr. RIDGWAY. No. I would say it would be no later than 12 months.

Mr. LONG. Well, let's assume——

Mr. RIDGWAY. You are right, correct, 15 months.

Mr. LONG. I don't know what the different States' laws are, requiring the filing of the annual report, but if one took place right now, then it would not be disclosed until the annual report for 1964, and let's assume they have 90 days to file that report after the end of the year, that would be 15 months from now.

Mr. RIDGWAY. That is right. Under the present procedures, that is correct, Mr. Long, it would not be. However, I don't think that there is anything that would prevent the insurance departments of the various States shortening that period on short-swing trading, if they felt it advisable to do so.

Mr. LONG. I do feel that this is a major point: that if you allow up to 15 months to transpire before the information was available to the interested persons, it is really too long to be of much importance in many instances.

Mr. RIDGWAY. Mr. Long, the only element of importance really lies in the fact that it is a procedure that is not morally acceptable to industry and commerce today, nor to the aggressively well-managed corporation, either insurance company or otherwise.

Mr. LONG. Well, other than that, of course it creates a legal right in persons that might be greedy.

Mr. RIDGWAY. Well, it is not my understanding that as we sit here this moment that short-swing trading, by a director or officer of a company that is not reporting to the SEC, is a violation of any law.

Mr. LONG. No, I was speaking of that if it were reported, that it constitutes a legal right.

Mr. RIDGWAY. That is right.

Mr. LONG. Creates a legal right.

Mr. RIDGWAY. That is right.

Mr. LONG. Thank you, Mr. Chairman.

Mr. STAGGERS. Mr. Glenn.

Mr. GLENN. Mr. Chairman.

Mr. Ridgway, I have only one question, but I would like to have a better explanation of what you mean on page 11 of non-U.S. companies operating on a nonlicensed basis.

Mr. RIDGWAY. Thank you, Mr. Glenn. I will attempt to answer that, if I may.

In many areas of our business, in many States, there are foreign companies, there are companies licensed in one State but not in another State, that actually do business in the States in which they are not licensed. Such insurance is probably perfectly sound, but it does not have the protection of the company being licensed, nor does it give to the insured the protection of appeal to the insurance department of that particular State in which he lives, and in which his property is located.

When they do that, in many cases they are not required to report to that State. In other cases of foreign insurance companies, they are not subject to the premium taxes in that State, and there is quite an advantage to them expensewise on it. This is an area, if I may add, that I am sure you are aware of, is being studied at quite some length by Senator Dodd of Connecticut.

Mr. GLENN. Thank you.

Mr. STAGGERS. I would like to pursue further a question which Mr. Long asked.

Mr. RIDGWAY. Yes, Mr. Chairman.

Mr. STAGGERS. You said that short-swing profits were not in violation of the law?

Mr. RIDGWAY. That is my understanding.

Mr. STAGGERS. Well, I would like to know if you are opposed to the principle of recapture of these benefits for the benefit of the stockholders?

Mr. RIDGWAY. Mr. Chairman, I am not personally, nor do I think our industry is opposed to it, the recapture of any profits under short-swing trading. There may be individuals in our industry that are opposed to it, but I am sure the industry as such is not. I believe wholeheartedly, as a matter of fact, in the basic principles, moral principles involved in the elimination of short-swing trading or the recapture of any profits.

Mr. STAGGERS. Well, I am glad you say that. Even though that is not the basic violation of the law, that there is a moral basis here.

Mr. RIDGWAY. Very definitely, sir.

Mr. STAGGERS. I am glad you clarified that.

Mr. Harris, do you have any questions?

Mr. HARRIS. No thank you, Mr. Chairman.

Mr. STAGGERS. Well, I would say, Mr. Ridgway, we thank you very kindly for coming and appearing here before the committee,

and for giving us the benefit of your views and your organization's.

Mr. RIDGWAY. Thank you, Mr. Chairman. I appreciate the opportunity.

Mr. STAGGERS. The committee is adjourned until 10 o'clock tomorrow morning.

(The following correspondence was submitted for the record:)

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., January 21, 1964.

HON. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, Washington, D.C.

DEAR MR. STAGGERS: I am transmitting with this letter the results of a study made by the Commission's Division of Trading and Markets of specialist and floor trader activity on the New York Stock Exchange on November 22 and 26, 1963. The study includes a memorandum and individual profiles of specialist and floor trader activity in 25 selected stocks.

The Division's memorandum answers the specific questions raised in your letter of December 2, 1963.

One point should be emphasized about the reconstruction of the market for individual stocks contained in the attached study. It was based entirely on reports filed by individual specialists and floor traders with the New York Stock Exchange and the Commission. Thus, the accuracy of the present study is necessarily limited by the reliability of the underlying documents. As the report of the special study noted, under present procedures and techniques this type of market reconstruction is a difficult and complex task involving the use of disparate and sometimes conflicting records.

In this connection, it might be noted that our staff has been consulting with the major exchanges for some time with a view to implementing the study's recommendations concerning automation. If put into effect, these recommendations could obviate many of the present difficulties involved in market reconstruction by capturing and preserving more accurate market data. Creative use of modern computer technology would enable the exchanges and the Commission to more effectively discharge their important responsibilities of market surveillance.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

Enclosures.

MEMORANDUM PREPARED BY THE DIVISION OF TRADING AND MARKETS IN REPLY TO CHAIRMAN STAGGERS' LETTER DATED DECEMBER 2, 1963

In his letter of December 2, 1963, Chairman Staggers noted the sharp price swings of many New York Stock Exchange (NYSE) securities on November 22 and 26, 1963, and the corresponding movements in the stock averages. Chairman Staggers also noted that the exchange had opposed some of the special study recommendations in the specialist area. He also mentioned that one of the findings of the special study with respect to the May 1962 market break was that specialist performance varied considerably among various firms. He asked that the Commission conduct a study of the performance of the specialist registered in the stock of American Telephone and Telegraph to determine the nature and extent of his market activities on November 26 and the profitability thereof.

In Chairman Cary's reply of December 6, 1963, the Commission stated that the staff of the Division of Trading and Markets had commenced a study of specialist and floor trading activity in a group of selected stocks and that the stock of American Telephone & Telegraph would be included in the sample. The study made by the Division focused on 25 stocks selected because of their unusual price movements during the period studied. In addition, the price action of some of these stocks had been the subject of inquiries by investors. A profile of specialist and floor trading activity in each of the 25 stocks studied is contained in appendix A.

Data for the study of specialist activities was provided by the New York Stock Exchange which collected transactional data from each specialist and for the analysis of floor trading from reports filed by floor traders with the Commission and the exchange.

This study must be viewed in the context of the unusual market situation which existed on the afternoon of November 22, 1963.

The first information regarding the assassination of the President seems to have become generally known about 1:40 p.m., e.s.t. Within 6 minutes prices on the New York Stock Exchange started to decline. At 1:30 p.m., e.s.t., the Dow Jones industrial average was 735.96, up 3.31 points for the day on heavy volume. From the opening until about 1:40 p.m., e.s.t., reported volume on the exchange was about 4,230,000 shares. From about 1:40 p.m., e.s.t., until the close at 2:07 p.m., e.s.t., volume was extraordinary with about 2,400,000 shares traded. If the volume for this short period were projected for the normal length of a trading day, there would have been a volume of 27 million shares as against a 1962 daily average volume of 3,800,000 shares. The ticker tape fell behind in reporting transactions. By the close, the Dow Jones industrial average had fallen 21.16 points from the previous day.

Tuesday, November 26, the next trading day, was also one of extraordinary volume and price changes on the New York Stock Exchange. Some 9,320,000 shares were traded. The influx of orders delayed openings in many stocks for an hour or more. Important stocks such as United States Steel and American Telephon & Telegraph did not open until 11:07 and 12:59, respectively. Many other stocks did not open until the close. In many cases the losses of November 22 were wiped out at the opening, and by the close the Dow-Jones industrial average stood at 743.52, a gain of 32.03 points from Friday's close. In 10 of the 25 stocks selected for study the price increases at the opening on Tuesday at least equalled or exceeded the declines on Friday. Another 10 stocks regained at least 75 percent of their losses at the opening, while the remaining 5 regained at least half of Friday's declines.

The stock markets historically respond to major unsettling events even if such news is not of a business or economic nature. For example, a major selloff occurred following President Eisenhower's heart attack in September 1955. The tragic, wholly unexpected news of President Kennedy's assassination caused a similar reaction. Aside from reactions to the news of the assassination, other factors tend to have a snowballing effect in such situations. The volume of orders which came into the market was such that almost immediately the ticker tape began to run late. By 2 p.m., e.s.t, the tape was 10 minutes late; by 2:02 the lag was 11 minutes and at the close at 2:07 the delay was almost 20 minutes. The clogging of communications media made it difficult for investors to receive reports of transactions, current quotations or other market data. Such an inhibition upon the flow of information may have multiple effects. For example, it may tend to cause additional selling and, further, it may cause those who might be interested in purchasing "bargains" to delay their orders until the situation is clarified. Thus, the imbalance between supply and demand may be amplified.

In times of crisis, as an increased number of market orders to sell reach the floor, they are met by an abnormally small number of market orders to buy. The excess of sell orders can then be absorbed only by two major sources of buying power. The first is the stored-up demand represented by limit orders on the specialist's "book." These are orders previously left with the specialist to purchase at specific prices below the market. Previous studies have shown that these limit orders tend to be clustered close to the existing market. Even in active stocks, with "thick" books, once heavy selling forces prices down about 10 percent, limit orders on the specialist's book tend to thin out and no longer serve to provide any floor on further declines. The second major source of potential buying is the specialist.

As was pointed out in the special study report, the activities of specialists have an important impact on the market. In 1963, specialists participated as buyers or sellers in about 25 percent of all transactions. How and when the specialist does his buying and selling may have a discernible—and sometimes marked—effect upon the market. Thus, it is appropriate to study the activities of particular specialists within the picture of general market decline.

Specialists in their capacity as dealers bear the responsibility of maintaining a fair and orderly market. The term "fair and orderly" market is contained in section 11 of the Securities Exchange Act of 1934 which deals with the conduct of specialists. This concept has generally been construed as referring to transaction which enhance price continuity and minimize the effects of temporary imbalances between supply and demand. The rules and practices of the exchanges are directed toward restricting specialist dealer transactions to those reasonably necessary to maintain a fair and orderly market.

In its report, the special study found that the NYSE specialist system contained no widespread abuses or patterns of illegality. However, it was noted that there were "serious problems * * * concerning the system itself and its surveillance and regulation by the exchange." The study also found that "the regulatory framework (governing specialists) permits too wide a tolerance from acceptable norms." Some of these findings were based on the fact that there were wide variations among the various NYSE specialist units in financial and other capacities, as well as in performance. This resulted, in the study's words, "in considerable divergence in the nature and quality of markets" on the NYSE. In a market under stress the wide tolerance of the regulatory structure becomes apparent.

Among the proposals stemming from the study's analysis of the May 1962 market break and other data were the following:

(*a*) clarification of the regulatory structure with emphasis upon pinpointing the affirmative obligation of specialists to maintain a fair and orderly market;

(*b*) a substantial increase in specialist capital requirements;

(*c*) improvement in surveillance and enforcement to bring deficient specialists up to acceptable levels of performance; and

(*d*) greater controls over the liquidation of inventories by specialists.

These recommendations are relevant to the events of November 22.

There were wide variations in performance among the specialist units studied.

Some specialist units studied absorbed large quantities of stock, on a scale-down, at reasonable price intervals. Limited liquidations of inventory by these specialists generally had a minimal impact on the market. Thus, the study shows that in a number of stocks e.g., Radio Corp. of America, General Motors, Polaroid, and Sperry Rand, the specialists were willing to and did make substantial capital commitments. The specialist in RCA made especially large purchases all during the decline. During the period between 1:41 and 2:07 this specialist made total purchases of 11,700 shares and sold 100 shares. Activity of this kind provides markets with reasonable depth, even in abnormal situations.

At the other extreme were the specialists registered in Korvette, International Telephone, American Motors, and American Photocopy. In the first three of these securities the specialists sold substantial qualities of stock almost immediately after the news of the assassination. Thereafter, these specialists returned to the market and bought stock on balance only after prices had declined. Not only did their selling contribute to the disorderliness of the market, but the specialists were able to use their central market position to liquidate their positions ahead of the public.

American Photocopy is unique. The specialists registered in this stock not only liquidated large positions in the minutes after the news and assumed short positions but they did not subsequently reenter the market as purchasers at all on November 22.

Specialists registered in certain of the most important stocks studied (from the standpoint of market leadership) appeared to meet their obligations. Thus, the specialist registered in the stock of American Telephone & Telegraph purchased, on balance, 11,200 shares of stock as the price declined from 138⅜ to 130. He caused the suspension of trading in that stock at 2 p.m., e.s.t., before the official close of the exchange. In answer to the specific question as to the profitability of this specialist's trading it would seem that on the liquidation of his position on November 26, there was a profit of approximately $80,000. This was on a capital committment of $1,600,000 as of the close on November 22. It should be pointed out that this profit figure has no bearing on the performance of the specialist in American Telephone & Telegraph stock.

One important point should receive special emphasis. As the special study concluded with respect to the 1962 market break: "No system of dealer trading can be expected to stabilize—in the sense of preventing price changes—in a market subjected to heavy public buying or selling." All that can be expected is that the specialist in his central market position cushion the public's selling by giving reasonable depth at each price level to the markets for which he is responsible.

The results of the study of floor trader activity shed little new light on this subject. Floor traders are members of exchanges who trade for their own account and initiate their transactions while personally present on the floor of the exchanges. Unlike specialists, floor traders have no affirmative market responsibilities, although there are certain restrictions under exchange rules upon their trading.

Based upon the reports filed by floor traders with the Commission and the exchange, there was floor trader activity in only nine of the stocks studied and some of this was not in great volume. However, many of the floor traders' sales came immediately after the news of the assassination but before the public reacted. Although this trading may have been in negligible quantities it illustrates the floor traders' ability to react more swiftly to news than the public. Other floor trading activity seems to have been of the "bargain hunting" variety with the trader making purchases after substantial declines. In one case, Sperry Rand, one well-capitalized trader who has been active in this security, seems to have provided almost as much support to the market as the specialist registered in the stock.

In the unprecedented and unusual situation which they faced on November 22 the exchanges acted with reasonable promptness. Within little more than one-half hour after the news was publicly disseminated, the principal securities exchanges had closed their doors. The exchanges acted on their own, before the Commission was able to establish telephone communications with them. Even before the official close some floor officials on the New York and American Exchanges had halted trading in many individual stocks. Under the circumstances, this was clearly a proper method of handling the situation. For example, in one notable case—Xerox—where trading was halted about 5 minutes after the news, there was only a negligible price decline and a corresponding small increase on Tuesday morning at the opening. The selective suspension of trading during periods of unsual market stress is one that the special study recommended for possible greater use.

We have made some inquiry in connection with the procedures used for halting trading and closing the exchanges on November 22, as well as steps taken between November 22 and 26 to review the financial condition of specialists. A copy of our letter and the replies of the NYSE and Amex are set forth in appendix B. A few points covered in this correspondence might be noted.

The special study was critical of procedures employed to determine the financial condition of specialists during the May 1962 market break. It appears that both exchanges, especially the Amex, have substantially changed their procedures in this area. The special study's recommendation that procedures be developed to keep the Commission informed of specialist financial difficulties and the adoption of certain other rules in this area have not yet been implemented. We are still awaiting the conclusion of the study by the exchanges of this and other specialist recommendations.

With respect to the procedures employed in closing the exchanges, we understand that both exchanges are working on improvements in these procedures in the event of future market crises. We intend to follow closely developments in this area.

PROFILES OF SPECIALIST AND FLOOR TRADER ACTIVITY IN 25 SELECTED STOCKS ON NOVEMBER 22 AND NOVEMBER 26, 1963

Studies of specialist activity in the following securities on November 22 and 26, 1963, are included herein:

1. American Motors Corp.
2. American Photocopy Equipment Co.[1]
3. American Telephone & Telegraph Co.[1]
4. Collins & Aikman Corp.[1]
5. Crown Cork & Seal Co., Inc.
6. Delta Air Lines, Inc.
7. General Motors Corp.
8. General Refractories Co.
9. Great Northern Paper Co.
10. High Voltage Engineering Corp.[1]
11. International Telephone & Telegraph Corp.[1]
12. Korvette, (E. J.) Inc.
13. Mueller Brass Co.
14. National Airlines Co.
15. Perkin-Elmer Corp.
16. Polaroid Corp.
17. Radio Corp. of America[1]
18. Rockwell-Standard Corp.
19. Smith-Douglas Co., Inc.
20. Sperry Rand Corp.[1]
21. Technical Materiel Corp.
22. Twentieth Century-Fox Film Corp.
23. United Air Lines, Inc.
24. United States Steel Corp.[1]
25. Wilcox Oil Co.

[1] Indicates stocks studied that had floor trading activity on Nov. 22. Floor trading on Nov. 26 was not studied.

American Motors Corp.

Nov. 22:

Reported volume	78,900
Open	19½
High	19⅞
Low	16
Close	16
Change (17.9 percent)	−3½

At the opening the specialist in American Motors was long 5,600 shares. From the opening until 1:41, 18,700 shares traded at prices ranging from 19½ to 19⅞. The last sale before 1:41 was at 19¾. During this time the specialist purchased 600 and sold 2,900 shares reducing his position to 3,300 shares long.

During the first few minutes following 1:41 the specialist liquidated his entire position and sold short an additional 900 shares at prices down to 18¾. The specialist's first purchase after 1:41 consisted of 800 shares following trading of 20,500 shares. The specialist acquired an additional 4,200 shares before the close. All price changes were one-fourth of 1 point or less except the last change which was one-half of 1 point.

Nov. 26:

Reported volume	255,000
Open	20½
High	20½
Low	20½
Close	20½
Change (28.1 percent)	+4½

American Motors opened at 3.30 p.m. as 255,000 shares were traded at 20½, up 4½ from Friday's close. The specialist sold 30,700 of these shares.

American Photocopy Equipment Co.

Nov. 22:	
Reported volume	85,400
Open	14
High	14⅜
Low	11⅞
Close	11⅞
Change (13.6 percent)	−1⅞

There are two specialist units in American Photocopy. At the opening, specialist A was long 1,400 shares and specialist B was long 800 shares.

From the opening until 1:41, specialist A purchased 3,600 and sold 2,100 shares. Specialist B purchased 3,000 and sold 2,500 shares, resulting in positions of 2,900 and 1,300 shares long, respectively.

From 1:41 until the close the stock declined from 14¼ to the low at the close of 11⅞. During this interval, 55 sales were reported consisting of a total of approximately 49,500 shares; 75 percent of this volume was accounted for by 19 sales of 1,000 shares, and over. During this period, specialist A sold 5,400 shares, of which 2,500 shares were sold short; specialist B sold 3,500 shares, of which 2,300 were sold short. Combined sales of the 2 specialists totaled 8,900 shares; neither specialist made any purchases during this period. The predominant source of buying appears to have been from limited orders on the specialists' book.

At the close, specialist A was short 2,500 shares and specialist B was short 2,300 shares.

Nov. 26:	
Reported volume	101,500
Open	14½
High	14½
Low	13¾
Close	13¾
Change (15.8 percent)	+1⅞

American Photocopy opened at 1:30 p.m. at 14½ (up 2⅝) on 70,000 shares. The specialists supplied 15,000 shares through short sales of 7,500 shares each. During the remainder of the day the stock declined to a low of 13¾ at the close. The specialists covered part of their short positions during this interval by purchases of 3,700 and 4,100 shares respectively.

Floor trading, November 22.—Between the opening and 1:41 floor traders purchased 1,100 and sold 1,800 shares of American Photocopy. After 1:41 floor traders purchased a total of 400 shares at prices of 13⅝, 13½, 13, and 12⅛. They sold a total of 500 shares at 13½ and 13⅜.

American Telephone & Telegraph Co.

Nov. 22:	
Reported volume	189,200
Open	137⅛
High	138½
Low	130
Close	130
Change (5.1 percent)	−7

The specialist in American Telephone & Telegraph was long 1,800 shares at the opening. From the opening until 1:41 he purchased 3,800 and sold 4,800 shares, resulting in a position of 800 shares long. During this period the stock traded approximately 72,000 shares at prices ranging from 136¾ to 138½.

At 1:41 American Telephone & Telegraph was at 138⅜; from then until trading was suspended at 2 o'clock the price declined to the low and close of 130 on approximately 117,000 shares. During this interval the specialist purchased 13,700 and sold 2,500.

As American Telephone & Telegraph declined from 138¼ to 135 on approximately 54,500 shares, the specialist purchased 1,000 and sold 1,300 shares. The bulk of this buying appears to have come from orders on the specialist's book. During the remainder of trading the stock declined to 130 on approximately 62,500 shares of which the specialist purchased 12,700 and sold 1,200 shares; 2,800 shares were purchased at a price of 133½ and 1,800 shares were purchased at 132½. Most price changes were of eighths and quarters; only one change exceeded one-half point.

Nov. 26:	
Reported volume	245,000
Open	[1] 140
High	140
Low	138⅛
Close	138¾
Change (7.5 percent)	+9¾

[1] The stock was exdividend $1.

American Telephone & Telegraph opened at 12:59 p.m. at a price of 140 on 150,000 shares, of which the specialist supplied 11,000 shares. The stock traded for the remainder of the day at prices ranging from 138⅛ to 140, and closed at 138¾. Of 95,400 shares traded after the opening the specialist purchased 3,500 and sold 4,800 shares.

Floor trading, November 22.—From the opening until 1:41 floor traders purchased 5,100 and sold 4,500 shares. From 1:41 until the close floor traders sold 1,000 shares (100 short) near the beginning of the decline at prices ranging from 137⅝ to 137⅛. During that period they purchased 800 shares at 135 and 134½ and 400 shares at prices from 131½ to 130⅛. The stock closed at 130.

NOTE.—Reference was made, in the attached memorandum, to the specialist's profit in American Telephone & Telegraph Co. This computation was made on a FIFO basis and only included the specialist's transactions between 1:41 p.m. on November 22 and the opening transaction on November 26.

Collins & Aikman Corp.

Nov. 22:	
Reported volume	10,200
Open	26
High	26
Low	22⅜
Close	22⅜
Change (15.6 percent)	−4⅛

The specialist in Collins & Aikman was long 200 shares at the opening. Between the opening and 1:41 he purchased 1,300 shares and sold 500 increasing his long position to 1,000 shares. During this period Collins & Aikman traded at prices ranging from 24⅞ to 26. The last sale before 1:41 was at 25⅜.

From 1:41 to 1:43 the specialist sold out his entire long position (100 shares at 25¼ and 900 shares at 25⅛). The price declined to 24½ on 700 shares before the specialist reentered the market as a buyer. The specialist acquired 1,500 of 1,900 shares that traded at 24½. He immediately sold 1,000 of these shares on the next trade at 24¾—up one quarter from the previous sale. The price then dropped one quarter and one half to 24 on the next 2 sales as the specialist bought 200 shares at 24½ and 1,300 shares at 24. The stock continued to decline, closing at the day's low of 22⅜. The decline from 24 to 22⅜ occurred on 6 sales totaling 1,500 shares, 1,300 of which were purchased by the specialist. The specialist had a long position of 3,300 shares at the close.

Nov. 26:	
Reported volume	9,900
Open	25⅞
High	26⅜
Low	25¾
Close	26⅜
Change (17.9 percent)	+4

On November 26, Collins & Aikman opened at 25⅞ on 7,100 shares up 3½ from the previous close. The specialist sold 5,500 of these 7,100 shares (3,200 shares short). The stock traded on additional 2,800 shares during the day at prices ranging from 25¾ to 26⅜ closing at 26⅜.

Floor trading, November 22.—One floor trader purchased 100 shares before 1:41 which were sold thereafter.

Crown Cork and Seal Co., Inc.

Nov. 22:

Reported volume	14,200
Open	30¼
High	30⅜
Low	24¾
Close	24¾
Change (19.2 percent)	−5⅞

The specialist in Crown Cork & Seal was long 4,200 share sat the opening. From the opening until 1:41 the specialist increased this position to 4,800 shares. Crown Cork & Seal traded at 30 immediately before 1:41.

After 1:41 the price went down to 29 on 7 trades totaling 2,800 shares. The specialist sold 1,300 of these shares and made no purchases. After an additional 4 trades totaling 1,100 shares, during which he did not participate, the specialist became a buyer. Thereafter, reported volume in Crown Cork & Seal was 5,000 shares on 18 sales from 28⅛ to the low and closing price of 24¾. During this period of the decline the specialist reported purchases totaling 5,900 shares. In one trade at 25¾, the specialist purchased 1,800 shares. Most price changes were of one quarter point during the decline; two changes were of one half point on 500 share sales.

Nov. 26:

Reported volume	46,000
Open	30
High	32
Low	30
Close	32
Change (29.3 percent)	+7¼

At the opening, the specialist was long 9,400 shares. The stock opened at 2:15 p.m. on 35,500 shares at 30. The specialist was almost the sole seller, supplying 31,000 of these shares (21,600 shares through a short sale). The stock traded up to 32 at the close as the specialist bought 2,900 and sold 2,200 shares during the remainder of trading.

Delta Air Lines, Inc.

Nov. 22:

Reported volume	16,200
Open	62
High	63
Low	52
Close	52
Change (17.8 percent)	−11¼

At the opening the specialist in Delta Air Lines was short 300 shares. From the opening until 1:41, 8,700 shares traded in a range of 61½ to 63. The last sale prior to 1:41 was at 62. During this period the specialist purchased 3,000 and sold 2,900 shares.

From 1:41 until the close, Delta Air Lines traded down to 52 on 37 sales totaling 7,500 shares. During the decline the specialist purchased 3,000 shares and sold 100 shares, resulting in a long position of 2,700 shares at the close. These purchases were not at closely related prices. For example, he purchased 300 shares at 60½; after 9 trades totaling 1,800 shares at prices down to 58, the specialist participated again by purchasing 300 shares at 58. Three downward 1 point changes occurred on trades of 100 to 300 shares; one change of three-fourths point occurred on 200 shares.

Nov. 26:

Reported volume	32,000
Open	62
High	62
Low	62
Close	62
Change (19.2 percent)	+10

Delta Air Lines opened at 3:30 p.m. on 32,000 shares traded at 62. The specialist supplied 22,000 shares.

General Motors Corp.

Nov. 22:	
Reported volume	70,400
Open	77½
High	78¼
Low	74¾
Close	74¾
Change (2.9 percent)	−2¼

There are two specialist units in General Motors. At the opening specialist A was long 2,300 and specialist B was short about 200 shares.

From the opening until 1:41 General Motors traded 40,600 shares in a price range of 76¼ to 78¼. The last sale before 1:41 was at 78. During this period specialist A purchased 600 shares and sold 5,500, while specialist B purchased 1,000 and sold 1,000 shares. At 1:41 specialist A was 2,700 shares short and specialist B's position was unchanged.

From 1:41 to the close 29,800 shares were traded as the price declined to a low of 74¾ at the close, as follows: The stock traded down to 76½ on 6,000 shares. Neither specialist traded during this time. 3,100 shares traded at 76. Specialist A purchased 2,800 of these shares. The price then declined to 75⅛ on trades totaling 4,800 shares with specialist A purchasing 200 shares at 75⅛. 15,200 shares sold at 75—14,000 of these shares were sold in large blocks of 6,000, 5,000, and 3 of 1,000 shares; specialist A purchased 9,300 of these shares and specialist B purchased 2,000 shares; 600 additional shares sold a prices down to 74¾ when the trading was halted. Specialist A purchased 300 of these shares.

Nov. 26:	
Reported volume	142,900
Open	77¾
High	79⅛
Low	77
Close	79⅛
Change (5.8 percent)	+4⅜

General Motors opened at 11:25 a.m. on sales of 78,000 shares at 77¾. Specialist A sold 17,300 of these shares and Specialist B sold 3,000 shares. During the remainder of the day Specialist A purchased 8,300 and sold 5,800 shares; specialist B purchased 2,200 and sold 700 shares.

Floor Trading, November 22.—From the opening until 1:41 floor traders purchased 3,700 and sold 6,400 shares of General Motors. After 1:41 floor traders' activities were confined to sales of 2,000 out of 3,300 shares on the first 6 sales of this period at prices ranging from 77⅞ to 77⅜. The next trade occurred at 77⅛. The closing price of the stock was 74¾.

General Refractories Co.

Nov. 22:	
Reported volume	5,500
Open	15½
High	15½
Low	12
Close	12
Change (21.3 percent)	−3¼

At the opening the specialist in General Refractories was long 3,400 shares. From the opening until 1:41, 1,400 shares were sold, of which the specialist purchased 500 and sold 500 shares, at prices from 15⅛ to 15½. The last sale before 1:41 was at 15⅛.

Between 1:41 and the close, General Refractories traded 4,100 shares down to the low, and closing price of 12. Transactions occurred during this period as follows: The stock sold down to 14½ on 1,000 shares in 7 sales; the specialist sold 300 shares and purchased none. The next sale was at 13¾. The specialist purchased 400 shares at that price as 1,500 shares traded in two sales. On the next sale the specialist purchased 200 shares at 13; 1,400 shares traded in four sales at 12⅛ and 12; the specialist acquired 700 of these shares. None of the specialist's purchases during this period occurred until the price declined 1⅜. The two largest changes took place on 1,000 shares and 900 shares and amounted to three-fourths and seven-eighths points, respectively.

Nov. 26:

Reported volume	10,900
Open	15
High	15
Low	15
Close	15
Change (25.0 percent)	+3

General Refractories opened at 1:30 p.m. on 10,500 shares at a price of 15. The specialist sold 8,700 shares at the opening. Later in the day the specialist sold 200 of 400 shares that traded at the same price in two sales.

Great Northern Paper Co.

Nov. 22:

Reported volume	2,400
Open	50¼
High	50¼
Low	46
Close	46
Change (9.4 percent)	−4¾

At the opening the specialist in Great Northern Paper was long 700 shares. From the opening until 1:41 there were four trades of 100 shares each at 50¼; the specialist did not participate in these trades. After 1:41 the specialist made two sales—300 shares at 50 and 400 shares at 49¾—liquidating his position. Subsequently, 1,300 shares were reported on the tape at prices down to 46. The specialist purchased 800 and sold 100 of these shares. At the close the specialist was long 700 shares.

Nov. 26:

Reported volume	2,200
Open	49¼
High	49⅞
Low	49
Close	49
Change (6.5 percent)	+3

Great Northern opened on a sale by the specialist of 900 shares (200 shares short) at 49¼. At the end of the day the specialist covered the 200 shares short at 49¼ and went long 100 shares at the close at 49.

High Voltage Engineering Corp.

Nov. 22:

Reported volume	45,500
Open	40¾
High	41½
Low	27½
Close	28¼
Change (28.9 percent)	−11½

The specialist in High Voltage Engineering was long 2,200 sahres at the opening. During the period from the opening until 1:41, High Voltage Engineering traded 21,300 shares on 187 sales at prices ranging from 39½ to 41½. The last sale before 1:41 was at 41¼. The specialist purchased 2,700 shares and sold 4,200 reducing his position by 1:41, to long 700 shares.

From 1:41 until the close High Voltage traded 24,200 shares on 189 sales at prices down to a low of 27½ and closed at 28¼. Immediately after 1:41 the stock declined 1¼ points on 4 sales totaling 1,000 shares, of which the specialist purchased 200 shares. The stock declined to 39¾ on a sale of 700 shares by the specialist. The specialist sold 100 shares at 39¼ before becoming a purchaser. The specialist started purchasing at 39⅛ and continued to do so down to 27½ and 27⅝. During the decline from 39⅛ to 33½ the specialist purchased 2,400 shares; he then purchased 7,200 shares at prices between 32 and the low of 27½. He bought 9,600 of 10,800 shares sold during this portion of the decline. During this period there were seven downward changes of one-half point and more on 100 and 200 shares. These price declines amounted to 4⅛ points on a total volume of 900 shares. The price of High Voltage firmed between 28 and 28¾ to close at 28¼ as 7,400 shares were traded, of which the specialist purchased 1,000 and sold 1,300 shares.

Nov. 26:

Reported volume	105,000
Open	38
High	38
Low	38
Close	38
Change (34.5 percent)	+9¾

High Voltage opened at the close on a block of 105,000 shares at a price of 38; 36,400 shares were supplied by the specialist.

Floor trading, November 22.—From the opening until 1:41 floor traders purchased 2,100 shares of this stock and sold 3,500 shares. During the period after 1:41 the price declined from 40⅜ to 32⅛; floor traders sold 100 shares at 40¼ and purchased 200 shares at 32⅛. During the decline from 32 to 29, of 3,600 shares traded, floor traders purchased 500 shares (200 at 32, 200 at 31¼, and 100 at 29). Subsequently, 1,000 shares traded at 28½; 400 shares traded at 28, of which one floor trader purchased 200 shares. 300 shares traded at 27½; 1,600 shares traded at 27⅝ in 14 sales. Floor traders reported purchasing 2,200 shares at 27⅝; i.e., they bought a greater quantity than was reported at this price. At this point, the price had declined over 33 percent since 1:41. Thereafter, 100 shares sold at 28; 5,800 shares sold at 28⅛ and 28¼ of which 4,600 shares were purchased by floor traders.

International Telephone & Telegraph Corp.

Nov. 22:

Reported volume	16,700
Open	48¾
High	48¾
Low	43½
Close	43½
change (11.40 percent)	−5⅝

The specialist in this stock was long 12,300 shares at the opening. The stock traded within range of 48¼–¾ prior to 1:41. Between the opening and 1:41 the specialist purchased 1,500 and sold 3,300 shares, reducing his position to 10,500 shares.

Trading apparently was halted about 1:57. During this 16-minute interval the stock traded down to 43½ on 18 sales totaling 7,300 shares. The specialist purchased 3,400 and sold 2,000 shares during this period. The specialist's sales occurred within the first 10 minutes of this period. A total of 3,900 shares were traded at prices down to 46¾. No purchases were made by the specialist until 1:54.

Between 1:51 until trading was halted at 1:57, the stock traded from 46¼ on 43½ on 10 sales totaling 3,700 shares, 3,400 of which were purchased by the specialist.

Nov. 26:

Reported volume	40,900
Open	49
High	50
Low	48¾
Close	50
Change (14.9 percent)	+6½

International Telephone & Telegraph opened at 49 on 31,000 shares, 19,400 of which were supplied by the specialist (7,600 shares through short sales). The specialist purchased 4,600 shares during the remainder of the day and sold 900 shares short. The specialist purchased 1,700 of the last 2,100 shares traded in the closing minutes of trading. He purchased 1,000 shares (out of 1,100 sold) at 50.

Korvette, (E. J.), Inc.

Nov. 22:

Reported volume	34,200
Open	35¼
High	36
Low	27½
Close	28
Change (18.8 percent)	−6½

From the opening until 1:41 Korvette traded 14,700 shares within a range of 34⅜ to a high of 36 just prior to 1:41. During this period the specialist, who was long 7,500 shares at the opening, purchased 2,900 and sold 3,000 shares.

Immediately after 1:41 the price fell from 35½ to 33½ on 10 sales totaling 5,100 shares. While the specialist did not participate as a buyer in any of these transactions, he sold 2,900 shares at prices ranging from 35 to 33½. On the next 11 sales, 6,400 shares traded down to 31½, of which the specialist purchased 2,200 and sold 100 shares. 8,000 additional shares traded on 33 sales until trading was halted at 1:59; the specialist purchased 2,300 and sold 1,700 shares. From 1:41 to the close, the specialist's position was reduced by 200 shares.

Nov. 26:

Reported volume	62,000
Open	37½
High	37½
Low	37½
Close	37½
Change (33.9 percent)	+9½

At the opening at 3:30 p.m. 62,000 shares traded at 37½; the specialist sold 19,400 of these shares.

Floor Trading—November 22.—Floor traders purchased 1,400 and sold 700 shares of Korvette from the opening until 1:41. The last sale prior to 1:41 was at 35½. Thereafter the stock declined to 27½ and closed at 28. Floor traders purchased 3,300 shares during this period and sold none; 2,200 shares were purchased at 30⅛; the remaining 1,100 shares were purchased at prices ranging from 28¼ down to 27⅝.

Mueller Brass Co.

Nov. 22:

Reported volume	4,800
Open	42⅝
High	42¾
Low	37½
Close	37½
Change (12.8 percent)	−5½

There are two specialist units in Mueller Brass. At the opening specialist A was long 1,600 shares and specialist B was long 1,400 shares.

Between the opening and 1:41 Mueller Brass traded 1,100 shares at prices ranging from 42¼ to 42¾. The last sale before 1:41 was at 42⅛. During this time specialist A purchased 200 shares and specialist B purchased 300 shares, increasing their positions to 1,800 and 1,700 shares respectively.

Between 1:41 and the close Mueller Brass traded 3,700 shares on 27 sales down to the low at the close of 37½. During this time specialist A purchased 700 and sold 200 shares, while specialist B purchased 900 shares and sold 300 shares, resulting in an increase in their positions of 500 and 600 shares respectively. The two largest declines amounted to five-eighth point on 200 shares and one-half point on 200 shares. Most trades were of 100 shares at ¼-point declines.

At the end of the day each specialist was long 2,300 shares.

Nov. 26:

Reported volume	11,800
Open	40½
High	42
Low	40½
Close	41
Change (9.3 percent)	+3½

Mueller Brass opened at 10:05 a.m. on 2,700 shares at 40½. Each specialist supplied 1,100 shares.

During the trading after the opening specialist A purchased 700 shares and sold 1,400, and specialist B purchased 1,000 shares and sold 1,600. At the close specialist A was long 500 shares and specialist B was long 600 shares.

National Airlines Co.

Nov. 22:

Reported volume	15,100
Open	35½
High	35¾
Low	28½
Close	28½
Change (20.3 percent)	−7¼

Between the opening and 1:41, National Airlines traded 6,400 shares at prices ranging from 34¾ to 35¾. At the opening the specialist was short 300 shares, and between the opening and 1:41 he purchased 500 and sold 800 shares, thereby increasing his short position to 600 shares. The last sale before 1:41 was at 35.

During the period from 1:41 until the close National Airlines traded 8,700 shares down to 28½ at the close. The specialist purchased 6,300 shares during this decline; 3,000 shares were purchased between 34½ and 32, and 2,000 shares were purchased at 30½. The decline in National Airlines contained two half-point changes on 100 and 200 shares, respectively. The specialist's last purchase was at 29½; 600 shares sold down to 28½ with no specialist participation.

Nov. 26:

Reported volume	33,700
Open	35
High	36
Low	34⅞
Close	35¾
Change (25.4 percent)	+7¼

National Airlines opened at 35 at 2:25 p.m. on 27,000 shares, 18,400 of which were suplied by the specialist (12,700 shares through short selling). The stock traded an additional 6,700 during the remaining hour of trading at prices ranging from 34⅞ to 36, and closed at 35¾. The specialist bought 1,200 and sold 2,600 shares during this period. His closing position was short 14,100 shares.

Perkin-Elmer Corp.

Nov. 22:

Reported volume	6,300
Open	49¼
High	50¾
Low	43
Close	43
Change (12.7 percent)	−6¼

At the opening the specialist in Perkin-Elmer was long 1,600 shares. Between the opening and 1:41 Perkin-Elmer traded approximately 2,300 shares at prices ranging from 49¼ to 50¾. The last sale before 1:41 was at 50¾.

Between 1:41 and the close, Perkin-Elmer traded 4,000 shares on 26 sales down to a price of 43. During this time the specialist purchased 2,000 and sold 400 shares—the specialist sold 300 shares in his first transaction after 1:41 at a price of 50. His next sale of 100 shares occurred at 48. The specialist purchased 700 shares at 43½ and 43¼. Most changes amounted to one-half point in 100 and 200 share transactions.

At the close the specialist was long 3,000 shares.

Nov. 26:

Reported volume	6,900
Open	47
High	49
Low	46¾
Close	49
change (14 percent)	+6

Perkin-Elmer opened on 3,300 shares at 47. The specialist supplied 2,700 shares.

During the remainder of the day the specialist purchased 300 shares and sold 1,100 shares (700 shares short).

Polaroid Corp.

Nov. 22:

Reported volume	40,500
Open	171¾
High	174½
Low	155
Close	155
Change (9.4 percent)	−16⅛

The specialist in Polaroid was long 400 shares at the opening. From the opening until 1:41, the stock traded 31,900 shares at prices ranging from 166 to 174½; the last sale before 1:41 occurred at 170. During this period the specialist purchased 6,800 and sold 7,500 shares, resulting in a short position of 300 shares at 1:41.

During the 8-minute interval until trading was halted at 1:49, 8,600 shares traded in 39 sales at prices ranging down to the close at 155. During this period the specialist purchased 2,500 shares and made no sales. The specialist was long 2,200 shares at the close.

Nov. 26:

Reported volume	42,400
Open	165
High	172½
Low	163¼
Close	172½
Change (11.3 pecent)	+17½

Polaroid opened up 10 points at 165 on a block of 12,000 shares of which the specialist provided 8,700. During the remainder of the day the stock traded 30,400 shares, the specialist bought 8,200 and sold 5,900 shares.

Radio Corp. of America

Nov. 22:

Reported volume	120,600
Open	90½
High	92
Low	85
Close	85
Change (6.1 percent)	−5½

The specialist in Radio Corp. of America was long 136,900 shares at the opening. From the opening until 1:41 Radio Corp. of America traded 81,300 shares at prices ranging from 89 to 92; it traded at 91¾ just prior to 1:41. During this time the specialist bought 19,700 shares and sold 17,000 shares, increasing his long position to 139,600 shares.

During the 11-minute interval from 1:41 until trading was halted at 1:52, Radio Corp. of America traded 39,300 shares in 68 sales at prices ranging down to the close of 85. The specialist acquired 11,700 shares during this period and sold 100 shares.

The stock traded down to 90 on 25 sales totaling 15,200 shares (4,700 shares sold at 90⅛, and 6,600 shares sold at 90—the sales at 90 were in blocks of at least 1,000 shares and over, as were 4,000 of the shares traded at 90⅛). The specialist purchased 1,700 and sold 100 shares of the 2,900 shares traded above 90⅛; he then purchased 2,300 shares at 90⅛ and 1,700 shares at 90. The specialist apparently reinforced the buying power on the book by buying at prices at which the book contained many orders. The stock broke through 90 and declined to 85 on 24,100 shares of which the specialist purchased 6,000 shares and sold none. At the close the specialist was long 151,200 shares.

Nov. 26:

Reported volume	151,000
Open	89¾
High	94¼
Low	89
Close	93¾
Change (10.3 percent)	+8¾

Radio Corp. of America opened at 89¾ on 31,000 shares of which the specialist sold 27,700 shares. The stock continued to rise to a high of 94¼ and closed at 93¾ on a volume of 120,000 shares; the specialist purchased 18,700 and sold 44,100 shares during the remainder of trading.

Floor trading, November 22.—Floor traders were very active in RCA from the opening until 1:41; during this time they purchased 11,100 and sold 20,400 shares. The price of RCA just prior to 1:41 was 91¾. After 1:41 the price declined to the close at 85. Floor traders purchased 200 and sold 1,300 shares as the price declined to 90. They then purchased 1,600 and sold 400 shares at prices ranging from 88¾ to 88. During the remainder of trading, floor traders purchased 1,500 shares (including 500 at 85) and sold none.

Rockwell Standard Corp.

Nov. 22:	
Reported volume	5,100
Open	39½
High	39½
Low	34½
Close	34⅝
Change (12.6 percent)	−5

At the opening, the specialist in Rockwell Standard Corp. had an even position. Between the opening and 1:41, Rockwell Standard Corp. traded 1,200 shares in a range of 38⅞ to 39½. The last sale before 1:41 was 38⅞. The specialist did not participate in any of this trading.

From 1:41 until the close, 3,900 shares traded down to the low of 34½, and closed at 34⅝. During this period, the specialist bought 2,200 and sold 100 shares. Several declines in price of ½ point, and greater, occurred on trades of 100 and 200 shares.

Nov. 26:	
Reported volume	15,300
Open	39
High	39½
Low	39
Close	39⅜
Change (13.7 percent)	+4¾

Rockwell Standard Corp. opened, at 2:20 p.m., on a block of 11,500 shares at 39. The specialist supplied 8,800 of these shares.

During the remainder of the trading day, 3,800 shares sold at prices ranging from 39 to 39½. During this period, the specialist purchased 1,100 shares, and sold 1,400. At the close, the specialist was short 7,000 shares.

Smith-Douglas Co., Inc.

Nov. 22:	
Reported volume	7,700
Open	41
High	41
Low	31
Close	31
Change (23 percent)	−9¼

There are three specialists in Smith-Douglas. One specialist unit did not trade on November 22. Among the other two, at the opening, Specialist A was long 1,800 shares, and Specialist B was long 900 shares. Between the opening and 1:41, Smith-Douglas traded 3,000 shares, at prices ranging from 39¾ to 41. The specialists purchased 400 and sold 600 shares during this period. The last sale before 1:41 took place at 39⅞. At 1:41, Specialist A was long 1,700 shares, and Specialist B was long 800.

Between 1:41 and the close, Smith-Douglas traded 4,700 shares down to a price of 31 at the close. Specialist A purchased 1,900 shares, and sold 200 shares.

The sales occurred at the beginning of the decline. Specialist B bought 1,400 shares, and sold none. The price variations were large. During the last 5 minutes of trading, Smith-Douglas traded 1,400 shares as follows:

Time	Volume	Price
2:02	300	34½
2:02	200	34
2:03	300	33
2:05	600	31

The specialists purchased all of these shares.

Nov. 26:	
Reported volume	19,300
Open	40¾
High	40¾
Low	40¾
Close	40¾
Change (31.4 percent)	+9¾

Smith-Douglas opened at 3:26 p.m., on 18,000 shares at 40¾. Specialist A supplied 4,400 shares, Specialist B 3,100 shares, and Specialist C 100 shares. An additional trade, comprising 1,300 shares supplied by the specialists, occurred at 40¾.

Sperry Rand Corp.

Nov. 22:	
Reported volume	198,200
Open	17¼
High	18
Low	15½
Close	15½
Change (8.8 percent)	−1½

The specialist in this stock was long 21,700 shares at the opening. From the opening until 1:41, 103,000 shares traded at prices ranging from 17⅛ to 18. The last sale prior to 1:41 occurred at 17¾. During this period, the specialist purchased 4,600 and sold 9,000 shares, reducing his position to 17,300 shares long.

From 1:41 until the close, Sperry Rand traded 95,200 shares, at prices ranging down to the low, at the close, of 15½. The specialist purchased 24,600 and sold 1,000 shares. All price changes occurred at ⅛ point.

Nov. 26:	
Reported volume	192,100
Open	17¾
High	18¼
Low	17¼
Close	18⅛
Change (16.9 percent)	+2⅝

Sperry Rand opened at 17¾ on 62,000 shares, of which 25,000 were supplied by the specialist. During the balance of trading, 130,100 shares were traded; the specialist purchased 15,500 shares and sold 3,000 shares.

Floor trading, November 22.—From the opening until 1:41, floor traders purchased 7,300 and sold 1,800 shares. The price ranged from 17⅛ to 18, and the last sale before 1:41 occurred at 17¾. From 1:41 until the close, 9,500 shares traded at prices ranging down to 15½ at the close. Floor traders purchased 31,600 shares, and sold 3,400 shares during this period; 26,800 shares (85 percent) were purchased by two floor traders of the same firm which had a large opening position of 40,200 shares.

Technical Materials Corp.

Nov. 22:	
Reported volume	8,600
Open	20⅛
High	20½
Low	14¾
Close	14¾
Change (28 percent)	−5¾

At the opening, the specialist was long 1,200 shares. From the opening until 1:41, Technical Materials traded 1,500 shares in a range of 20⅛ to 20½. The specialist purchased 600 shares and sold 200 shares during this period. At 1:41, he was long 1,600 shares.

The first sale after 1:41 was at 20⅛, unchanged from the previous trade. At 1:50, the specialist purchased 200 shares at 19⅛, and continued buying down to the low and close of 14¾. The specialist purchased 500 additional shares out of 3,200 shares traded down to 18⅛ and 1,100 out of 1,300 down to 17. The specialist then purchased 2,800 shares, of which 2,400 shares were reported, at prices down to 14¾ at the close. Price changes frequently were of ¼ and ⅜ point.

Nov. 26:

Reported volume	29,500
Open	20½
High	20⅝
Low	20⅛
Close	20½
Change (39 percent)	+5¾

The stock opened at 2:53 p.m. at 20½ on 27,000 shares. The specialist supplied 15,900 shares—as he liquidated his long position of 6,200 shares and sold 9,700 shares short. During the remainder of trading 2,500 shares were traded at prices ranging from 20⅛ to 20⅝. The specialist purchased 1,000 shares, and sold short an additional 200 shares, resulting in a closing short position of 9,000 shares.

Twentieth Century-Fox Film Corp.

Nov. 22:

Reported volume	16,900
Open	26⅛
High	26⅞
Low	20
Close	21½
Change (18.9 percent)	−5

The specialist was long 200 shares of Twentieth Century-Fox Film Corp. at the opening. Between the opening and 1:41 he purchased 3,700 and sold 2,100 shares, as Twentieth Century-Fox traded 11,100 shares at prices from 25¾ to 26⅞. The last sale in Twentieth Century-Fox before 1:41 was 26⅞. The specialist's position was long 1,800 shares.

The first trade after 1:41 occurred at 26¼. The stock traded down to 25 on 3,000 shares, 1,000 of which were sold by the specialist who acquired no shares during this decline. The decline resumed at 24½ when the specialist made his first purchases totaling 500 shares. The stock then declined to the close of 20. During this decline the specialist purchased another 1,700 and sold 600 shares resulting in a closing position of 2,400 shares long.

The decline in Twentieth Century-Fox was marked by a number of half-point and full-point price changes on small volume.

Nov. 26:

Reported volume	28,000
Open	25½
High	27¼
Low	25¼
Close	27
Change (25.6 percent)	+5½

Twentieth Century-Fox opened late at 1:42 p.m. at 25½ (up 4) on transactions totalling 18,000 shares, 9,700 of which were supplied by the specialist (7,300 shares through short sales). The specialist bought 600 and sold 4,700 shares short during the remainder of the day's trading. The specialist was short 11,500 shares at the close.

United Airlines, Inc.

Nov. 22:

Reported volume	12,100
Open	39¾
High	40¼
Low	34⅝
Close	34⅝
Change (13.2 percent)	−5¼

At the opening the specialist in United Airlines was long 2,400 shares. Prior to 1:41 the specialist purchased 800 shares and sold 900, resulting in a position of 2,300 shares long at 1:41. Between the opening and 1:41 United Airlines traded 7,100 shares at prices ranging from 39½ to 40¼. The last price at 1:41 was 40¼.

From 1:41 to the close United Airlines traded 5,000 shares in 29 sales. The specialist purchased 1,400 shares and sold none. These purchases were of 100 and 200 shares at ⅜ to 1⅛ point price intervals from 39¼ down to 34⅝. All price changes during the decline were of one-eighth to one-half point with most occurring on 100 and 200 share transactions.

Nov. 26:

Reported volume	21,700
Open	39½
High	40¼
Low	39
Close	40
Change (15.5 percent)	+5⅜

United Airlines opened at 39½ on 10,500 shares, of which the specialist supplied 7,600 shares.

On trading during the remainder of the day of 11,200 shares in a range of 39 to 40¼, the specialist purchased 4,600 and sold 800 shares.

United States Steel Corp.

Nov. 22:

Reported volume	88,900
Open	49¾
High	51
Low	45¼
Close	45¼
Change (8.8 percent)	−4⅜

There are two specialist units in United States Steel. At the opening, Specialist A was short 200 shares and Specialist B was long 1,000 shares.

From the opening until 1:41, 32,000 shares traded at prices ranging from 49⅝ to 51. Specialist A purchased 3,300 and sold 3,000 shares and Specialist B purchased 1,200 and sold 2,300 shares, resulting in positions of 100 shares long and 100 shares short, respectively, at 1:41.

From 1:41 until trading was halted at 2:05, 56,900 shares traded. During this interval, Specialist A purchased 4,500 and sold 3,500 shares; Specialist B purchased 9,900 and sold 100 shares. Shortly after 1:41, 13,000 shares traded with no specialist participation—5,000 shares of total specialist purchases were purchased at 49. Purchases by Specialist B were made at reasonable intervals during the decline; trading by Specialist A was marked by relatively heavy selling. Most price changes occurred in one-eighth and one-quarter points; larger changes occurred on heavy volume.

Nov. 26:

Reported volume	234,600
Open	51
High	53
Low	50½
Close	52⅞
Change (16.8 percent)	+7⅞

United States Steel opened at 51 on transactions totaling 125,000 shares; 78,800 shares were supplied by the specialist at the opening, 26,000 shares by Specialist A, 52,800 shares by Specialist B. During the remainder of the day, 109,600 shares traded, at prices ranging from 50½ to 53. Specialist A purchased 14,400 shares and sold 1,100 shares; Specialist B purchased 23,100 and sold 2,000 shares.

Floor trading, November 22.—Floor traders purchased 1,200 and sold 1,400 shares of United States Steel between the opening and 1:41. After 1:41 floor traders sold 400 shares at the beginning of the price decline from 50⅜ to 49¾, and purchased 200 shares at 49¾. They traded again near the end of the decline by purchasing 300 shares at 45⅜ and 45⅝. The closing price of United States Steel was 45¼.

Wilcox Oil Co.

Nov. 22:

Reported volume	4,700
Open	28¾
High	28¾
Low	22
Close	22
Change (23.5 percent)	−6¾

The specialist in Wilcox Oil was long 900 shares at the opening. From the opening until 1:41 the stock traded 400 shares at prices of 28⅝ and 28¾. The specialist sold 100 of these shares.

After 1:41, 300 shares sold at 28½, which were supplied by the specialist. The stock then traded down to 26½ on 5 sales totaling 900 shares in which the specialist did not participate; 1,000 shares traded at 26½ were purchased by the specialist; 2,100 shares traded in 10 sales at prices ranging from 26 down to the low and close of 22. The specialist purchased 1,300 of these 2,100 shares; 900 of the 1,300 shares were purchased at prices of 22 and 23. Six of the seventeen transactions which occurred after 1:41 took place on price changes of one-half point—4 of these 6 trades only involved 100 shares. Two trades were made at price changes of 1 point on 400 and 300 shares, respectively.

Nov. 26:

Reported volume	10,700
Open	26½
High	28¾
Low	26¼
Change (28.4 percent)	28¼
Close	+6¼

Wilcox Oil opened at 12:44 p.m. at a price of 26½. The specialist sold 3,300 shares at the opening. During trading after the opening the specialist purchased 900 shares and sold 2,400 shares.

APPENDIX B

Letters of the Securities and Exchange Commission, New York Stock Exchange, and American Stock Exchange concerning the procedures used to halt trading on November 22, 1963, and to review the financial condition of specialists.

[Letters addressed to the presidents of the New York and American Stock Exchanges]

DECEMBER 31, 1963.

DEAR ——— ———: In connection with a study the commission is making if the activities of specialists on November 22 and 26, 1963, we would appreciate receiving certain information from your exchange. Specifically we are interested in the followng items:

(*a*) The closing time of the exchange on November 22, 1963;

(*b*) The name of the official or group directing the closing of the exchange on November 22, 1963;

(*c*) Was trading halted in certain stocks prior to the close on November 22, 1963? If so, the name of the official or group halting such trading.

(*d*) During the period between November 22 and 26, 1963, did the exchange review the financial condition of each specialist unit? If such a review was undertaken and the need for additional capital by some specialist units was shown, did the exchange take any action to assure that adequate financing would be available upon resumption of trading?

Since the commission is attempting to complete its study as soon as possible, your earliest response would be appreciated.

Sincerely yours,

RALPH S. SAUL, *Director.*

NEW YORK STOCK EXCHANGE,
New York, N.Y., January 7, 1964.

Mr. RALPH S. SAUL,
Director, Securities and Exchange Commission,
Division of Trading and Exchanges, Washington, D.C.

DEAR MR. SAUL: In your letter of December 31 you asked us for certain details with regard to the events that transpired on November 22 and 26, 1963. Among the items about which you inquired were the closing time of the exchange on November 22 and the officials or groups who closed it, information with regard to suspension of trading in certain stocks prior to the close, and the financial condition of the specialist units.

On November 22, after the board of governors at a special meeting had decided to close the exchange, the vice chairman of the board at 2:07 p.m. rang the bell and suspended trading. Prior to 2:07 p.m. trading had been halted in 146 of 1,385 stocks traded at the active posts. Prior approval of a floor official or floor governor had been obtained in 56 stocks. In 44 stocks trading was halted by governors who were registered in these stocks as specialists. Under ordinary conditions, the prior approval of an independent floor official would have been required. In the remaining 45 stocks trading was halted by the specialists and the exchange closed prior to the arrival of a floor official or floor governor in the particular crowds. In 12 of these 45 instances, however, a floor official or floor governor was informed of the facts after 2:07 p.m.

On November 25, the day before the market reopened, the exchange checked with each specialist unit to determine its financial condition as of that time. Two units were informed that they were undermargined because of the market action that transpired on November 22. One of these undermargined units deposited a check on Tuesday morning to make up the difference. The other unit, which was a single specialist who operates a combined book with another unit, was away on vacation. When he returned on Tuesday morning, he satisfied his clearing firm that he had ample assets with another firm and sufficient securities were transferred from the other account to his specialist account during the day to make up the difference.

I hope the above fully answers your questions. Please feel free to call upon us for further details if they are needed.

Sincerely yours,

G. KEITH FUNSTON, *President.*

AMERICAN STOCK EXCHANGE,
New York, N.Y., January 14, 1964.

Mr. RALPH S. SAUL,
Director, Division of Trading and Markets,
Securities and Exchange Commission,
Washington, D.C.

DEAR MR. SAUL: The information requested in your letter of December 31 concerning the events of November 22 and 26 last year is as follows:

(1) The closing time of the exchange on November 22, 1963, was 2:10 p.m.

(2) The decision to end the trading session for the day on November 22 was reached by a special committee of governors (the chairman, the president, and Mr. Solomon Litt) under emergency powers delegated by the board of governors pursuant to article II, section 1(b), of the constitution.

It happened that the board of governors was assembling for a special meeting, called for another purpose, at the time news of the shooting of the President reached the exchange. The metting was held at a location contiguous to the trading floor so that governors active on the floor could participate and return to their other duties with a minimum of delay.

(3) Trading was halted in a number of securities prior to the close of the session on November 22, 1963. The decision in each case was made by a floor official appointed pursuant to provisions of rule 21 of the board of governors.

(4) The exchange did institute an immediate review of the financial condition of each specialist unit on the afternoon of November 22 as part of a broader program related to the emergeny conditions recognized in the action of the board of governors. Several senior operating officials and related personnel were at work on both November 23 and November 25, although the exchange was not open for trading on either day. Specialists or their personnel were on hand as

necessary on those days to support the efforts of member organizations and the staff looking toward an orderly resumption of trading on November 26.

The steps taken to check on the capital condition of specialists during the weekend and on Monday were simplified because of an existing system, instituted about a year ago, which facilitates the identification of potential problem areas. The precise measures followed in this unusual situation were as follows:

(1) The schedule of reported capital and capital requirements of specialists and specialist joint accounts maintained by the exchange was reviewed in detail on November 22 (a) to make sure that the latest figures available to the exchange indicated that adequate capital was available to the specialist or the joint account in each case, and (b) to locate any possible weak spots.

In all instances the specialists and specialist units were adequately financed and met the capital requirement of rule 170(b).

(2) A telephone call was then made to every firm clearing for one or more specialists or specialist units. Inquiry was made as to whether the clearing firm had detected any weak spots among its specialist accounts or had found it necessary to make a margin call.

It was found that one margin call had been issued to a specialist. Although the exchange was confident the specialist in question would be able to meet the call promptly, the situation was watched closely. The action of the market on Tuesday morning following the President's death eliminated any need for additional margin.

(3) The exchange also contacted a number of representative member organizations on the following points to try to determine what might be expected when the market opened on Tuesday morning following the President's death:

(*a*) Do orders received indicate, on balance, more buy orders or more sell orders?

(*b*) Are orders received predominately market or limit orders?

(*c*) Do prices of limit orders received appear to be above or below closing prices?

The firms reached were in general agreement that orders received were predominantly on the buy side with a preponderance of limit orders, both below and above the close on November 22. Although this indication of a market recovery on Tuesday morning was reassuring from the point of view of specialist finances, no unwarranted assumptions were made. The specific check on specialists' finances was made as a proper basis for the location of any potential problems.

All specialists were alerted to be at their positions at 8:30 a.m. on Tuesday, November 26, the day trading resumed. An orderly situation was assured well in advance of the opening. During the morning, members of the exchange staff responsible for floor operations kept in constant touch with specialists to be sure they had adequate physical assistance for handling particular active stocks or difficult openings.

I hope this letter answers your questions satisfactorily and that you will let me know if there is further information you may find useful.

Sincerely,

EDWIN D. ETHERINGTON, *President.*

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., December 2, 1963.

Hon. WILLIAM L. CARY,
Chairman, Securities and Exchange Commission,
Washington, D.C.

DEAR MR. CHAIRMAN: As you know, on November 22 the prices of securities traded on the New York Stock Exchange dropped severely and on November 26 these prices increased very sharply and are reported in terms of the Dow-Jones averages to have arisen higher in one day than in any time previously.

In your special study report you set forth certain recommendations concerning the specialist, which you have indicated you intend to carry out through the rulemaking power of the Commission, although it appears from testimony before our committee last week the exchanges are opposed to many of these particular recommendations. The special study group made an analysis of the work of the specialist on the May 28 selloff and had several comments to make concern-

ing the effectiveness of certain specialists and the seeming inactivity of others. Among the specialist's activities the special study considered was that in the share of American Telephone & Telegraph.

I note that on Tuesday last American Telephone & Telegraph did not open until 12:30 and then up 10 points from Friday's close. It would seem interesting to me were the facts developed regarding specialist activity on this stock on the preceding Friday and on Tuesday, the 26th, namely, what purchases they made on Friday; what sales they made on Tuesday; and what may have been their profit in this connection.

I trust that this is a question that the Commission is going into and will develop for I think it of sufficient moment that it would be worth the committee's making inquiry directly of the exchange in the event that you are not developing this question.

Thanking you for your assistance,

Sincerely yours,

HARLEY O. STAGGERS,
Member of Congress,
Chairman, Subcommittee on Commerce and Finance.

(Whereupon, at 3 p.m., the subcommittee recessed until 10 a.m., Thursday, January 23, 1964.

INVESTOR PROTECTION

THURSDAY, JANUARY 23, 1964

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE
OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to recess, in room 1334, Longworth Building, Hon. Oren Harris (chairman of the committee) presiding.

Mr. HARRIS. The committee will come to order.

This morning we have a panel that has been arranged, I understand, by the Honorable Peyton Ford in order to discuss from the standpoint of life insurance companies the proposal with reference to H.R. 6789 and S. 1642.

Mr. Ford, if you will bring your panelists around and we can get them lined up in a manner to have them identified and proceed I think we can expedite this matter this morning. Let these gentlemen have their seats and, Mr. Clerk, if they don't have enough chairs there put some more chairs around.

I would like to recognize at this time the Honorable Peyton Ford, counsel, National Association of Life Companies, Inc., 1000 Connecticut Avenue, Washington.

Mr. Ford, if you will first identify each of the members of the panel for the record, including their names, whom they represent, and address, we will get this part of the record to start with.

STATEMENT OF PEYTON FORD, COUNSEL, NATIONAL ASSOCIATION OF LIFE COMPANIES, INC.; DeWITT ROBERTS, EXECUTIVE SECRETARY, NATIONAL ASSOCIATION OF LIFE COMPANIES, INC., ATLANTA, GA.; WILLIAM E. LONG, FIRST UNITED LIFE INSURANCE CO.; C. C. YOST, VICE PRESIDENT AND CHAIRMAN OF THE EXECUTIVE COMMITTEE; LEONARD ROSENBERG, CHESAPEAKE LIFE INSURANCE CO.; D. J. HUNDAHL, JR., NATIONAL SECURITY LIFE & ACCIDENT CO.; AND FRED DEERING, SECURITY LIFE & ACCIDENT CO.

Mr. FORD. First is Mr. DeWitt Roberts.

Mr. HARRIS. I wish you gentlemen would identify yourselves by holding up your hand or something. Your name is Mr. DeWitt Roberts?

Mr. ROBERTS. Yes.

Mr. FORD. He is the executive secretary of the National Association of Life Companies, Atlanta, Ga.

Next is Mr. William E. Long of Gary, Ind. He is a director of the National Association of Life Companies and president of the First United Life Insurance Co. of Gary, Ind.

Next is Mr. C. C. Yost, who is vice president of executive committee of the National Association of Life Companies and is with the Union Bankers Life Insurance Co., Dallas, Tex.

Next is Mr. Rosenberg, who is president of the Chesapeake Life Insurance Co. of Maryland.

Next is Mr. D. J. Hundahl, Jr., who is a representative of the Texas Legal Reserve Association, of which I am also counsel.

Mr. HARRIS. I have here he is with the National Security Life & Accident Co.

Mr. FORD. That is right. That is his company, but he is appearing on behalf of the Texas Legal Reserve Association too.

Mr. HARRIS. All right.

Mr. FORD. Next is Mr. Fred A. Deering, of Denver, Colo. He is vice president and general counsel of the Security Life & Accident Co.

Mr. HARRIS. He is also representing a Colorado association?

Mr. DEERING. That is correct.

Mr. HARRIS. What association?

Mr. DEERING. The Colorado Life Convention.

Mr. HARRIS. All right. Very well. Mr. Ford, you may proceed. You may be seated if you like, if it will help out.

Mr. FORD. I just have a brief statement and I will be through. These gentlemen will testify as to the adequacy of State regulations, the effect of the merger provisions of the bill under consideration, the adequacy of reports to stockholders, the cost that might result from enactment of this legislation, the number of companies involved, and the situation of the mutual companies with reference to this legislation. I will let Mr. Roberts at this point make his statement.

Mr. HARRIS. Very, well, Mr. Roberts, you may proceed.

Mr. ROBERTS. Thank you, Mr. Chairman, this statement is made on behalf of the National Association of Life Companies, a trade association with members in 32 States. A list of the members is attached to this statement, marked "Exhibit A." All the member companies of this association, whether mutual or stock, are legal reserve life insurance companies, domiciled in one of the 50 States.

This appearance, directed by the association, is for the purpose of urging that the Congress shall exempt insurance companies from the application of this pending legislation.

The life insurance industry is the only financial group that would be made subject to his bill. Although it is the most closely supervised and regulated enterprise in the United States, it has been singled out for treatment that is both unusual and seriously detrimental.

Over half of the citizens of the United States are insured in life insurance companies. Eight out of ten married men and six out of ten married women are covered by life insurance. Of $730 billion life insurance in force, $676 billion is with legal reserve companies; $80 billion of life insurance was bought in 1962, nearly seven times as much as 20 years ago. One million one hundred and forty-two thousand are employed in this industry.

Of the savings of American citizens, $141 billion, approximately one-third, is entrusted with safety to the care of these companies. Last year alone legal reserve companies paid almost $4 billion in death benefits to the widows and orphans of policyholders and over $5½ billion to living annuitants and policyholders, as well as $3¼ billion in accident and sickness benefits.

These figures are given you, not to attempt to impress you with the size of the industry, with its dimensions, with its impact upon our economy, but simply to attest the confidence that the American people have in the insurance industry. And so you will see why in the past Congress has always treated the life insurance industry as a separate entity because of its peculiarity, as to why we have always had, or at least since 1920, a special tax provision for life insurance companies, and why it is a little different from a corporation engaged in manufacturing or trade.

Singled out by the SEC as the only financial group in America to require their supervision, the insurance industry points, if not with pride, certainly without shame, to its record in the hazardous depression years. Life insurance companies may not have a good name with SEC, but in 1932, and 1933, and 1934, they were about the only institutions in the United States that did have a good name with the people of this country.

Compare the losses, which were almost negligible to policyholders in the depression, with the losses in any other kind of business. Compare the eventual losses of stockholders in life insurance companies and determine whether they were well run in those dubious years. Remember that the life insurance companies did not have to come to the Federal Government to be bailed out.

I do not wish to be offensive even to those who think that this industry needs one more pair of eyes looking over its shoulder, but I remind this committee that when the Federal Government was looking for a name with which to bolster up public confidence in other financial institutions, it did not select the word "guarantee," but twisted semantics to the breaking point to borrow the name of our industry and refer to savings and loan insurance, and bank insurance, and mortgage insurance, because the people of the United States knew that the one thing they could rely on was the sheet of paper bearing the name of a legal reserve life insurance company.

The Securities and Exchange Commission rests its entire case for its supervision of the life insurance industry upon five points:

(1) It asserts that inadequate reports are supplied to stockholders. We shall fully refute that statement.

(2) It charges there is insufficient information available to the general investor. We shall fully refute that statement.

(3) It is asserted that there is wholly inadequate notice of merger procedures and inadequate information to stockholders about mergers. We shall fully refute that statement.

(4) It is complained that there has been too rapid a recent growth of the life insurance industry in the southcentral, southwestern and southeastern parts of the country. We shall represent that this growth is both necessary and desirable and that it is not the province of the Securities and Exchange Commission to seek to preclude the development of these areas.

(5) It is stated that there is inadequate reports upon stock purchases and sales by officers and/or directors of life insurance companies. This statement is quite probably correct and the National Association of Insurance Commissioners, through its spokesmen, have assured that this matter will be given prompt attention and quick solution, pointing out that this is the first time that this problem has been drawn to their attention or regarded by anyone as of serious consequence.

We are informed that the National Association of Insurance Commissioners has taken complete, adequate, and full steps to see that such reports are available.

The National Association of Life Companies represents in general the medium sized and smaller companies, which would be most seriously jeopardized by this bill. They therefore examined, not merely what the spokesmen for the Securities and Exchange Commission and others favoring this bill have said, but what they did not say. On three matters silence speaks with great clarity and force:

(1) They make no claim that there has been general damage to the investing public.

(2) They make no claim that there is a lack of general and meticulous supervision of the industry.

(3) They make no claim and cite not a single instance, because they would be hard pushed to find a single instance, of conflict of interest in the operation of a stock life insurance company.

This association shall set out four major objections to the inclusion of life insurance companies within the scope of this bill:

(1) It will effectively impair, thwart, and hamper existing State regulation.

(2) It will be intolerably expensive to small companies.

(3) It will reverse policies established by Congress 50 years ago and reiterated as recently as last October in the passage by the House of the District of Columbia Act (H.R. 8355) and the statements of the Senate Judiciary Committe with reference to the Dodd bill.

(4) It will disrupt the equilibrium of the industry, to establish which the Congress made a substantial contribution in 1921. To disrupt the existing relationship between stock and mutual life insurance companies can only hazard the welfare of the entire industry and lead to confusion that would impair its service to the public.

While this is intended as a discussion of the measure itself, the first portion of this statement will be directed to answering the issues raised in a letter to the Honorable Oren Harris, chairman of the House Interstate and Foreign Commerce Committee, by the Honorable William L. Carey, Chairman, Securities and Exchange Commission, dated August 30, 1963, and in response to Mr. Harris' letter of August 14.

S. 1642 was introduced June 4, 1963. Hearings were speedily conducted by a subcommittee and the report of the full committee (Banking and Currency) was printed July 24, 1963. Very little legislation of such impact, except of an intensely emergency nature, has ever moved so rapidly through either branch of Congress.

For convenience, in this communication, the pending legislation will be designated as S. 1642.

The first five subdivisions refer expressly to similarly numbered segments of Mr. Cary's letter of August 30, 1963.

I

Since 1920, it has been the established practice of the Congress, reiterated categorically in 1955 and 1958, to provide as nearly identical treatment of mutual and stock insurance companies, especially life companies, as is possible.

The history of this policy is well known; to all members of the committee; it was adopted, primarily, to prevent regional concentration of overwhelming financial power and to permit the growing stock companies in the Midwest, Southeast, and Southwest—and subsequently in the Mountain States—to compete against the eastern giants, most of whom had been forcibly mutualized following the Hughes investigation in New York.

Not only has Congress acted to this end, but it is the expressed policy in almost all of the States to whom, by appropriate congressional action, the regulation of insurance has been delegated.

S. 1642 (H.R. 6789) imposes upon small- and medium-sized life insurance companies a financial and administrative burden that will affect their competitive position.

While it is true that mutual companies have dominated the field of life insurance for a great many years, the trend has been reversed of late. In spite of their preponderance of assets, mutual companies have dropped from 63 percent of the life insurance in force in 1958 to 60 percent in 1962, which would indicate that stock companies in the past 5 years have sold just over 50 percent of new life insurance in the United States.

There are 156 mutual companies in the United States, of which 120 or more are small local or regional operations, predominately in the Middle West. The others, with few exceptions, are located in the Eastern States of New York, Connecticut, Massachusetts, and New Jersey.

The policyholders in mutual companies, presumably, are investors in the company through the retention of a portion of their premiums for purposes other than the maintenance of reserves and the payment of expenses. This has been recognized by the Congress repeatedly in the structure of its tax legislation in this field. Let me illustrate. My company's surplus in a mutual company in which I have held a policy for some 25 years, not a very large one either, now exceeds the average investment of the average stockholder in more than half of the companies in our association that would be subject to this bill.

Yet SEC errs in stating, "* * * the same need for investor protection does not exist for [mutuals]." Directors and officers of mutual companies, without any personal investment whatsoever, are retained in office solely through control over and the exercise of proxies.

In some instances some mutuals solicit proxies for 3 years without even bothering to supply any statement at all to their policyholders and yet that same need for investor protection is in no sense less.

(In some States, it is rendered almost impossible for policyholders to make any nominations for directors or to vote against the "slate" proposed by the incumbent directors.)

Not only is the imposition of this exceptional cost, which will be discussed appropriately below, discriminatory against a class of insurance companies, but it is regionally discriminatory.

The small, growing stock companies and the small, growing local and regional mutuals exist because of needs in broad areas of America. The concentration of financial power in a handful of companies in a single section of America is dangerous. Much of the expansion, growth, and recent prosperity of "backward areas" of the United States has been a result of the decentralization of life insurance and banking.

The SEC gravely errs in the number of companies that will be affected by the bill. We have been unable to research the number of non-life insurance companies that would be affected, although estimates place this at approximately 525.

However, we have been able to ascertain the approximate number of life companies that would be affected by the SEC's proposal.

There were on June 30, 1963, 1,347 stock life insurance companies actively engaged in business.

This figure does not include service companies, which may or may not maintain their reserves upon a "legal reserve basis" but which pay off in services—namely, funerals—nor does this include stipulated premium companies, which do not maintain reserves upon a legal reserve basis. Some estimates of the number of companies that would fall within the provisions of the act exceed 2,000.

After a survey of its own membership, which we think is representative in every respect of the industry, the National Association of Life Companies estimates that 780 legal reserve life insurance companies have more than 500 stockholders and more than a million dollars in assets, and that the number is growing steadily annually.

A random check suggests that there are only about 200 service associations and stipulated premium companies that would be subject to the act. The combined total of all insurance companies, we therefore place somewhat below other estimates, or at about 1,500. The strong possibility is that the number falls somewhat short of 2,000 and substantially in excess of 1,500.

We also desire to clarify the statement in the second paragraph of Mr. Cary's I. By lumping together all categories of companies making any kind of report to SEC, there is the possibility of misinterpreting and assuming that the present 150 companies reporting to SEC, of which about 96 are life companies, are subject to regulations comparable to this set out in this bill. This is not the case. Very many of these companies are making reports wholly incidental to some secondary offering, and SEC's authority over them is extremely tenuous.

II

Mr. Cary's researchers have erred in this paragraph. It is true that life companies or other insurance companies must and do comply with the Securities Act of 1933.

However, in his recapitulation of "about 100 life insurance companies * * * having made a registered offering of securities," there is complete inaccuracy, because many such offerings were secondary offerings and not offerings by the company.

Existing State regulation is adequate. The investments of insurance companies, unlike investments of almost any other corporation of any kind in America, are expressly set out in the statutes of the 50

several States. This protects stockholders as completely as it protects policyholders.

Moreover, the valuation methods of securities, specially designed for the insurance industry and uniform throughout the Nation, prevent any tampering with assets. It is one of the concerns of the industry and the regulatory bodies that the control over security valuation would pass to SEC under this bill. This will be referred to later.

In no other industry is there such complete disclosure of every phase of a company's operations. The annual reports and periodic examinations of life companies to and by State regulatory agencies are available to every stockholder. These disclose the minutest details of the company's operation.

In addition, all of the companies whose stock is widely distributed, and almost all companies whose stock is traded over the counter at anytime, are listed in both Best's Life Insurance Reports and Dunne's Reports, with the most comprehensive analysis of operations, unparalleled for any other type corporation in America. (Please refer to exhibit B and the attached exhibits.)

If you will glance at the exhibits I have attached, and they are very typical, I have in exhibit B a statement of condition of the American Foundation/Pioneer Western, a copy of its midyear report, a copy of the reprint from Best, and a copy of the reprint from Dunne's. The Best publication is of this size in which almost every legal reserve company in the Nation is meticulously analyzed for the benefit of investors.

Dunne's is a similar reporting organization. Most companies provide to their policyholders and stockholders alike a short form, a reprint of either Best or Dunne for their information.

If you will examine these exhibits you will find a most comprehensive analysis of company operations of almost any industry in existence, the statement that the reports to stockholders of stock life insurance companies are inadequate is rather absurd. One of the trade publications, Spectator Life Index, in the field, has conducted for many years competition for completeness of the reports of life insurance companies to stockholders and last year more than 600 campanies entered that competition.

In addition to the general reports available, Best and Standard and Poor's have another volume even more anayltical going back many years into the history of company's operations that covers all the companies in which there are any great market activity. Those guidebooks are available almost anywhere in the country and nearly every investment firm has them on file.

In addition now the question arises, reasonably though, "Well, these reports cover the stocks that are traded upon the market. The principal market for life insurance stock in this country is Chicago. Some investors would consider the more limited New York list as more indicative of trends, but there are also regional markets of importance, of which Atlanta, Dallas, Indianapolis, and Nashville probably handle the greatest volume." I have attached as an exhibit C photostats of the market lists on the markets in Chicago, New York, Atlanta, Dallas, Indianapolis, and for your conveniene Washington because you see them in your daily paper.

I have also attached an exhibit that shows the pages in Best on which the reports of these companies appear. Every stock traded on these markets is reported on fully in Best. The analysis of the companies you will see from the other exhibits.

Now, Mr. Cary's statement refers to an annual report of the Commission 7 years ago, that is not applicable to present conditions, and he cites someone who somehow had either animus or concern about the situs of the new companies, and he refers to their high concentration in the South and Southwest. I just seriously ask is this bill designed to protect investors, or is it an act to prohibit mice from nibbling the toes of elephants.

Mr. Cary also speaks about the cost of reporting and he cites the figure of Mr. Day that the cost of reporting would be but $1,500 to $2,000 and then examination of the text shows he is talking about industrial companies.

We have carefully examined the cost, and for a company with less than $250 million in force, that is to say with average probable assets of around $15 million, it would cost from $12,000 to $18,000 a year. We have gone ahead and had that meticulously verified by a veritable fellow of the Society of Actuaries who made exhaustive inquiries among actuarial and accounting firms. In this connection it is true that Mr. Cary says that his proposed forms could be dealt with internally, would not require a CPS, and that is possibly true.

However, this does not prevent the cost from accruing because it will be a very expensive matter to adjust the accounting system of life companies to his proposed forms. That this is true and that they would have dual accounting systems is made very clear in testimony before you by a witness from Arthur Andersen & Co., Mr. Spacek, who said:

> In some major respects, insurance companies do not keep their accounts and report to their stockholders in accordance with practices that conform with generally accepted accounting principles. The resulting financial statement can be misleading to investors.

As a matter of fact, the opposite is precisely true because investors are permitted to be paid under State regulations only in accordance with the accounting system set out and Mr. Spacek merely was setting out the objection of security dealers in many instances who don't understand this method of bookkeeping and who desire very much that such things be done is a capitalization of acquisitions, which is illegal. It would be very nice for companies because it would show a profit for the company very much earlier in its history, but it would also destroy the protection to the policyholder that he has under the existing system, and a dual system, and if you kept books as Mr. Cary proposes, far from leading the investor to know what he might expect from a company, would lead the investor to believe that he had a profit under State law when he did not have a profit available for the payment of dividends.

Finally, Mr. Cary says, and I went over this very carefully:

> No provision under State regulations for timely disclosure of events of major importance to investors, such as mergers, acquisitions, and the issuance of substantial amounts of stock * * *.

Now, the word "acquisitions" has special and technical meaning in the life insurance field and I do not know what Mr. Cary means by

"acquisitions." The issuance of stock is very meticulously safeguarded. In most States, for example, the promotion of a stock life insurance company is far more meticulously safeguarded than any other organization of a corporation.

The promotion expense is limited to 10 percent, a third less than is permitted for industrial and general corporations. The money paid by prospective stockholders must be escrowed until the actual amount is raised and none of the promotion expense can be taken out of that until the corporation is completed, which means the promoter has to put up his own money to get the operation going, but, and in addition, in most States, though not in all of them, the operating management of the new company must be approved as to qualifications, fitness, character, and experience by the insurance department. Actually Congress dealt with this matter in October when they passed the District of Columbia insurance bill, and while the bill is less drastic in those particulars than about 35 of the States, we don't criticize because the whole effects of some of the others go, we think, a little far.

There may be seven or eight States left which are a little careless about the completion of original offerings after business is commenced, but this is generally most carefully supervised.

One of his statements is almost an absurdity. I am not a technical specialist in that field and one of the witnesses following me will testify about it because he has a great deal more knowledge, but in instances of mergers Mr. Cary's ghost writer didn't know what he was talking about.

Merger agreements, first, have to be set out in complete detail and approved by the board of directors of each of the companies involved. Then the complete details in most States, involving a copy of the complete agreement, must be sent to every stockholder of record, together with a notice of the stockholders' meeting to consider the matter.

In most States it cannot even be considered at an annual meeting but must be considered at a special meeting called for that purpose. Then after both groups of stockholders have approved it, usually by two-thirds majority, the merger must be submitted to the insurance commissioner in most every State affected and he must approve it dependent upon three factors.

The merger must safeguard policyholders; it must be completely fair to the stockholders of both companies; and it must be in the public interest.

I have attached as an exhibit a very short merger form of one of the very simpliest ones—there are more complex ones—involving Guaranty Savings and Skyland, which shows you what those policyholders know which Mr. Cary or one of his staff said didn't even know their company was going to be merged until they found out about it in the papers.

Actually nothing in business is as carefully supervised as a merger of a life company. The SEC agreed fully with the removal of all of the financial institutions from this bill. We think it was reasonable to ask four questions:

Are the reports to stockholders by banks and stock savings and loan institutions of comparable size superior in their details to those insurance companies provide?

Is the general information available to investors the same? Can you go down and look at the examination of a bank?

Is the process of merger of State banks more carefully supervised than the merger of life companies?

Has the growth of banks and savings and loans institutions in the south central, southwestern, and southeastern parts of the country, and the increase in the assets of those, shown a substantial parallel to the growth of the life insurance companies and the increase in the insurance in force in those areas?

I think that if there is a negative answer to the first three questions or an affirmative to the fourth the entire Commission's case falls flat. We want to just make these four points:

That it is the expressed policy of Congress to treat mutual and stock life insurance companies in a manner as nearly identical as possible; that it is the expressed policy of Congress to leave regulations of the insurance industry to the States; that the only complaint seriously raised in the SEC argument about "insider transactions" has already been met adequately in the last month, as soon as the point was raised; and that this measure is opposed by all those affected by it—by the State regulatory agencies, by the trade associations in the industry, by the companies affected, and by the chief opponent outside of the bill, the Chamber of Commerce of the United States—because it would damage the industry and imperil the savings of the American people.

Thank you so much.

(Remainder of statement and exhibits A and B follow.)

STATEMENT OF DEWITT ROBERTS—Continued

An examination of the stocks traded on the markets in Chicago and New York, the only national markets for insurance stocks of genuine importance, and four other cities, shows that every life company over 1 year old whose stocks were sold there was included in these reports. (Please refer to exhibit C and attached exhibits.)

The only existing weakness that has been disclosed in the reporting system of life companies is in the so-called field of insider trading and representatives of the National Association of Insurance Commissioners have proposed that a report on such transactions be made a part of the annual report of the companies. No reporting system, incidentally, that can be defined can disclose the "true value" of a life company's stock, because its most valuable assets, its inventory, may not be carried as an asset.

III

In spite of Mr. Cary's references to an annual report of the Commission made 7 years ago and not applicable to present conditions, it is obvious that someone's real concern is with the situs of the young, growing companies and with their "high concentration * * * in the South and Southwest."

Is this bill truly designed to protect investors or could it be more accurately described as "an act to prohibit mice from nibbling the toes of elephants"?

Its obvious effect, if not its designed effect, is to prevent the development of such financial institutions in areas of the country that need them.

IV

This section of Chairman Cary's letter deals with the cost of reporting.

Mr. Cary predicates his opinions upon matters not in the proposed legislation and upon citations that do not refer to the life insurance industry. (It is admitted by SEC that the cost to non-life-insurance companies would be many times greater than to life companies, but we have not examined this phase of the issue.)

First, Mr. Cary cites Mr. Edwin D. Etherington, president of the American Stock Exchange, who says that the cost to smaller industrial companies would be $1,500 to $3,000 annually.

Then he cites Mr. James E. Day, president of the Midwest Stock Exchange, who places the estimate to $1,500 to $2,000.

These obfuscating references are to industrial companies.

Estimates of the cost to small life insurance companies—that is, companies with less than $250 million in force, indicating probable assets of around $15 million—range from $12,000 to $18,000 a year.

(Please refer to exhibit D.)

As an incidental commentary upon the impact of these changes upon the small, local, and regional companies, a study recently made shows that 64 percent of the companies that would be subject to the bill have operating gains of less than $50,000 annually. The cost of complying with this proposed law will exceed substantially their taxes to the Federal Treasury.

V

It is impossible to comment upon all portions of item V of Mr. Cary's letter. Certainly, if the Congress appropriates very substantially increased amounts of money to SEC, it can administer this or any other act.

The present cost to companies reporting under existing regulations ranges, in the case of a small company, between $12,000 and $35,000 a year. Article 7–A of regulation S–X has been discussed with no segment of the industry with which the writer is acquainted, nor has it been discussed with the National Association of Insurance Commissioners.

Without doubting the good faith of any Commissioner or employee of SEC, the statute sets out what the Commission may and may not do and the courts have persistently held that the statute and not some letter written by an administrative officer is governing.

(If special treatment of the insurance industry is necssary, if the insurance industry is so important a part of American finance, SEC should be willing to present special legislation dealing with its regulation. This will be treated later.)

However, the Commissioner's researchers are singularly in error about there being "no provision under State regulations for timely disclosure of events of major importance to investors, such as mergers, acquisitions, and the issuance of substantial amounts of stock."

Since the word "acquisitions" has a special and technical meaning in the life insurance field, which probably is not the meaning in the Commissioner's letter, we are unable to discuss the item "acquisitions." The issuance of stock is most meticulously safeguarded. In most of the States, the promotion of a stock life insurance company is far more meticulously safeguarded than any other organization of a corporation. In almost all of them the promotion expense is limited to 10 percent, a third less than is permitted for industrial and general corporations. In a preponderance of them, all the money paid by prospective stockholders must be escrowed until the proposed stock issue has been sold, and in the event that the stock issue is not sold, the promotional expense would be a loss to the promoters and 100 percent of the premiums by prospective stockholders must be refunded. It is infeasible to cite insurance code sections of the 50 States with reference to this matter.

In a majority of States, the operating management of a new company must be approved, as to qualification, fitness, and character, by the insurance department. Congress dealt again with this problem last month when the House acted upon H.R. 8355. While the District of Columbia provisions are less stringent than in many States, they are generally adequate and not subject to criticism.

While there is a certain laxity in perhaps seven or eight States about the sale and issuance of stock from the original offering after business has been commenced, in most States this is meticulously supervised, both by the insurance department and the State securities department. Of course, all interstate issues must be registered with SEC under existing laws. In almost every State, affirmative stockholder action is required to authorize the issue or sale of additional stock.

Nothing is more closely safeguarded, both as to the interests of stockholders and policyholders, than the merger of two life insurance companies.

The following is the procedure:

First, the merger agreement must be set out in complete detail and approved by the board of directors of each of the companies involved.

Second, the complete details, in most States involving a copy of the complete agreement, must be sent to every stockholder of record, together with the notice of the stockholders' meeting to consider the matter. (In very many States, the question of merger may not be considered at an annual meeting, but only at a special meeting, but the notifications about merger are almost completely uniform.)

Third, if the stockholders of both corporations shall have approved the merger agreement, usually by a two-thirds majority, the terms of the agreement are submitted to the insurance commissioner of the State and/or the States in which the companies are domiciled. The insurance department examines meticulously the proposals and approval must depend upon three factors: (1) The merger must safeguard the interest of policyholders; (2) the merger must be completely fair to the stockholders of both companies; (3) the merger must be in the public interest (see exhibit E).

VI

The Securities and Exchange Commission concurred in the exemption from this measure of all other types of financial institutions.

This was in response to aggressive objections made by the affected financial institutions, the regulatory bodies supervising them; and the United States Chamber of Commerce. Identical groups oppose the inclusion of insurance companies.

It therefore becomes important that the Chairman of the Securities and Exchange Commission disclose to this committee his answers to four pertinent questions. If his answers, substantiated by adequate and convincing evidence, are not affirmative in the first three instances, and negative in the fourth, then it is obvious that there exists no argument whatsoever for the inclusion of insurance companies in this bill:

1. Are reports to stockholders by banks and stock savings and loan institutions of comparable size superior in their details to the reports issued to shareholders in life companies?

2. Is the general information available to investors, i.e., the reports of examinations of banks, available to the general public?

3. Is the process of merger of State banks more carefully safeguarded than the merger procedures for life companies?

4. Has the growth of banks and savings and loan associations in the South Central, Southwestern and Southeastern parts of the country, and the increase in the assets thereof, shown a substantial parallel to the growth of life insurance companies and the increase in insurance-in-force in these same areas?

Any single negative answer to the first three questions, or an affirmative to the fourth, should serve completely to dispose of the Commission's arguments.

The preceding portion of this statement has been devoted to the correction of certain errors in statements provided by the SEC and to an explanation of some aspects of the bill raised by that agency.

The remainder of this statement is an affirmative argument in favor of the position assumed by the National Association of Life Companies that insurance companies should be exempted from the bill as presently drawn and that, if the Congress and the regulatory agency feel that they should be brought in some particulars under SEC supervision, a bill treating specifically with them should be prepared and developed as parallel measures always have been developed affecting the insurance industry.

To develop this thesis, we respectfully set out:

1. That it is the expressed policy of the Congress to treat mutual and stock life insurance companies in a manner as nearly identical as possible.

2. That it is the expressed policy of the Congress to leave regulation of the insurance industry to the States.

3. That the only complaint seriously raised in the SEC argument, that of so-called "insider transactions" can be met adequately by State regulation.

4. That this measure is universally opposed by all those affected by it: by the State regulatory agencies, by the trade associations representing

the industry, by all the companies affected, because it would impose an undue hardship upon the industry and destroy State control over it.

Since 1913, it has been the policy of the Congress to make no difference in application between stock companies and mutuals.

While this was the tax policy of the Nation from 1913 until 1921, it became the formal policy of both the legislative and executive branches of the Government in 1921. The theory upon which it rests was developed in 1921 by Dr. T. S. Adams, Tax Advisor of the Treasury Department, and meticulously embodied in the reports on the Revenue Act of 1921.

Extensive hearings in 1954 resulted in a reaffirmation of this principle.

Again, in 1958, in the House, and in 1959, in both House and Senate, this policy was expressly set out.

Behind this policy is a carefully developed body of facts, so extensive that its oversimplification in this statement would be inappropriate. The objective, however, was not to reduce competition in the most competitive field of enterprise in America, but to prevent Government weighting of competition in favor of one or another type of company. It is sufficient to say that the Congress determined that it would not lend advantage to the immense financial resources of the eastern mutuals on the one hand, nor enforce the standard theories regarding insurance to the overwhelming advantage of the smaller stock companies, but would endeavor, both in regulation and taxation, to treat them precisely identically.

As a corollary of this decision that dates back a half century, the Congress also effectively reversed the action of the U.S. Supreme Court, in a decision under the commerce clauses, by the passage of the McCarran Act (Public Law 50). This gave to the several States complete jurisdiction over the insurance industry—fire, casualty, life, and title.

In addition to sustaining the precedents of previous years, Congress considered the wealth of material developed in the TNEC investigation and the immense amount of material developed in the hearing on the McCarran Act in both House and Senate.

Congress took into account all of the regional economic differences that existed in America and overwhelmingly determined that the insurance industry could best be regulated at the State level.

It is significant that SEC proposals to invade the insurance field were rejected by the legislative branch of Government in 1946.

Every point raised by the able Chairman of the Securities and Exchange Commission in his letter to Chairman Harris has been completely refuted, with one exception. It is now necessary to deal with his reference to so-called insider transactions. The matter can be best dealt with by the inclusion of reports on such transactions in the annual report. That this has not been done previously is because no request for such information has been made to any State insurance department in the United States, so far as it has been possible to ascertain, and in consequence, the matter has never been referred to the blanks committee of the National Association of Insurance Commissioners. SEC has been assured, and this committee will be assured, by NAIC that inclusion of this material will be required if, in the committee's judgment, need for it exists.

It may be pointed out that where there are some outside stockholders in a closely controlled corporation, no reporting system would preclude majority stockholders from selling their stock. Existing laws, both Federal and State, are certainly strong enough to safeguard against fraud.

This measure may be necessary in other fields, but it is certainly neither necessary nor desirable in the field of insurance. It is true that, tacitly admitting that SEC is not well equipped to exert much supervision over insurance companies, but desires only to deal with a few, or rather one specific item—that SEC has offered by regulations to be drawn at some future date to ameliorate its interference with State regulation. It is, however, noteworthy that they have not even made this offer with reference to security valuations, the most important single aspect of projected interference.

Certainly, it is as reasonable for this committee to accept the promise of the State regulatory agencies to provide a report in the one field in which SEC has made out at least a shadow case as it is for the committee to accept the rather vague promises of the Commission.

It is significant that everyone affected by the inclusion of life companies in this bill stands in opposition to it: the State regulatory agencies, the trade associations, the U.S. Chamber of Commerce, the companies and their stockholders.

Long experience has demonstrated that State regulation of the insurance industry is essential. This bill would, in its present form, effectively destroy it.

If there are specifics that must be dealt with at the national level, with which SEC is concerned, giving to that agency the limited supervision that they propose to exercise as indicated in their communications to members of the Senate and House committees dealing with the subject matter, then it should be the matter for appropriate and specific legislation. If this is the case, SEC could not conceivably find a legitimate reason for objecting to exempting the insurance industry from the operation of the present bill and the preparation of a specific piece of legislation dealing with the insurance industry.

EXHIBIT A

MEMBERSHIP ROSTER, OCTOBER 18, 1963, NATIONAL ASSOCIATION OF LIFE COMPANIES

Acme United Life Insurance Co.; Springfield, Ill.
Alaska Western Life Insurance Co.; Anchorage, Alaska
Allservice Life Insurance Co.; Colorado Springs, Colo.
American Buyers Insurance Co.; Phoenix, Ariz.
American Capitol Insurance Co.; Houston, Tex.
American Foundation Life Insurance Co.; Little Rock, Ark.
American Guaranty Life Insurance Co.; Portland, Oreg.
American Preferred Life Insurance Co.; Birmingham, Ala.
American Public Life Insurance Co.; Jackson, Miss.
American Standard Life Insurance Co.; Fort Worth, Tex.
American Trust Life Insurance Co.; Wichita Falls, Tex.
Appalachian Life Insurance Co.; Huntington, W. Va.
Bankers Fidelity Life Insurance Co.; Atlanta, Ga.
Bankers Life Insurance Co.; Indianapolis, Ind.
Bankers Service Life Insurance Co.; Oklahoma City, Okla.
Centennial Life Insurance Co.; Portland, Oreg.
Central National Life Insurance Co.; Jacksonville, Ill.
Charter National Life Insurance Co.; St. Louis, Mo.
Charter Oak Life Insurance Co.; Phoenix, Ariz.
Cherokee Credit Life Insurance Co.; Macon, Ga.
The Chesapeake Life Insurance Co.; Baltimore, Md.
Christian Foundation Life Insurance Co.; Little Rock, Ark.
Citizens National Life Insurance Co.; Indianapolis, Ind.
Coastal States Life Insurance Co.; Atlanta, Ga.
Commerce Insurance Co.; Chicago, Ill.
Commercial Travelers Life & Accident Insurance Co.; Dallas, Tex.
Continental Service Life & Health Insurance Co.; Baton Rouge, La.
Cotton States Life Insurance Co.; Tuscaloosa, Ala.
Dixie Life Insurance Co.; Little Rock, Ark.
Empire Life Insurance Co. of America; Little Rock, Ark.
Farm & Home Insurance Co.; Phoenix, Ariz.
Farmers National Life Insurance Co. of Georgia; North Augusta, S.C.
Federal Old Line Insurance Co.; Federal Way, Wash.
First Colony Life Insurance Co.; Lynchburg, Va.
First Continental Life & Accident Insurance Co.; Houston, Tex.
First National Life Insurance Co.; Atlanta, Ga.
First Pyramid Life Insurance Co. of America; Little Rock, Ark.
First United Life Insurance Co.; Gary, Ind.
Foundation Life Insurance Co.; Atlanta, Ga.
General Bankers Life Insurance Co.; Denver, Colo.
Georgia Life and Health Insurance Co.; Atlanta, Ga.
Girardian Insurance Co.; Dallas, Tex.
Globe Assurance Co.; Columbus, Ohio
Globe Life & Accident Insurance Co.; Oklahoma City, Okla.
Grand Pacific Life Insurance Co., Limited; Honolulu, Hawaii
Great American Life Insurance Co.; East Orange, N.J.
Great Commonwealth Life Insurance Co.; Dallas, Tex.
Great Plains Life Insurance Co. of Wyoming; Casper, Wyo.
Great Southwest Life Insurance Co.; Dallas, Tex.
Greensboro National Life Insurance Co.; Greensboro, N.C.
Guaranty Income Life Insurance Co.; Baton Rouge, La.

Guaranty Savings Life Insurance Co.; Montgomery, Ala.
Gulf Union Life Insurance Co.; New Orleans, La.
Hamilton National Life Insurance Co.; Indianapolis, Ind.
ICOA Life Insurance Co.; Salem, Oreg.
Intercoast Mutual Life Insurance Co.; Sacramento, Calif.
Investment Trust & Assurance Corp.; Phoenix, Ariz.
Investors Insurance Corp.; Portland, Oreg.
Investors Preferred Life Insurance Co.; Little Rock, Ark.
Investors Security Life Insurance Co.; Arlington Heights, Ill.
Lee National Life Insurance Co.; Shreveport, La.
Legal Security Life Insurance Co.; Dallas, Tex.
Life Insurance Co. of Kentucky; Louisville, Ky.
Life Insurance Co. of the South; New Orleans, La.
Lincoln American Life Insurance Co.; Memphis, Tenn.
Madison Life Insurance Co.; New York, N.Y.
Madison National Life Insurance Co.; Chicago, Ill.
Mid-Western Life Insurance Co.; Enid, Okla.
Missouri Fidelity Life Insurance Co.; St. Louis, Mo.
Missouri National Life Insurance Co.; Kansas City, Mo.
Modern Security Life Insurance Co.; Springfield, Mo.
Municipal Life Insurance Co. of America; Elgin, Ill.
National American Life Insurance Co.; Baton Rouge, La.
National Foundation Life Insurance Co.; Oklahoma City, Okla.
National Insurance Co. of America; Grand Forks, N. Dak.
National Investors Life Insurance Co.; Little Rock, Ark.
National Investors Life Insurance Co. of Louisiana; Baton Rouge, La.
National Investors Life Insurance Co.; Oklahoma City, Okla.
National Life & Casualty Insurance Co.; Phoenix, Ariz.
National Masonic Provident Association; Mansfield, Ohio
National Preferred Life Insurance Co.; Atlanta, Ga.
National Security Life & Accident Insurance Co.; Dallas, Tex.
National Security Life Insurance Co.; Indianapolis, Ind.
National Security Life Insurance Co.; Madison, Wis.
National Trust Life Insurance Co. of America; Hollywood, Fla.
National Western Life Insurance Co.; Denver, Colo.
Old Equity Life Insurance Co.; Evanston, Ill.
Permian Basin Life Insurance Co.; Odessa, Tex.
Perpetual Security Life Insurance Co.; Boise, Idaho
Preferred Risk Life Assurance Co.; Fayetteville, Ark.
Producers Life Insurance Co.; Phoenix, Ariz.
Professional Life Insurance Co.; Fort Smith, Ark.
Provident Security Life Insurance Co.; Houston, Tex.
San Francisco Life Insurance Co.; San Francisco, Calif.
Southeastern Life Insurance Co.; Hattiesburg, Miss.
Southern Equitable Life Insurance Co.; Little Rock, Ark.
Southern United Life Insurance Co.; Montgomery, Ala.
Southwest Security Life Insurance Co.; San Antonio, Tex.
Standard Life Insurance Co. of Indiana; Indianapolis, Ind.
Standard Security Life Insurance Co. of New York; New York, N.Y.
Standard Union Life Insurance Co.; Montgomery, Ala.
State Life of Illinois; Springfield, Ill.
States General Life Insurance Co.; Dallas, Tex.
Stonewall Jackson Life Insurance Co.; Huntington, W. Va.
Sturdivant Life Insurance Co.; North Wilkesboro, N.C.
Union Bankers Insurance Co.; Dallas, Tex.
Union Life Insurance Co.; Little Rock, Ark.
Union Reserve Life Insurance Co.; Minot, N. Dak.
United American Insurance Co.; Dallas, Tex.
United Bankers Life Insurance Co.; Dallas, Tex.
United Founders Life Insurance Co.; Oklahoma City, Okla.
United Reserve Life Insurance Co.; Billings, Mont.
Washington Independent Life Insurance Co.; North Little Rock, Ark.
Washington Life Insurance Co. of America; Lafayette, La.
Western Empire Life Insurance Co.; Denver, Colo.
Western Life Insurance Co.; St. Louis (Clayton), Mo.
Western & Southern Life Insurance Co.; Cincinnati, Ohio
West Virginia Life Insurance Co.; Huntington, W. Va.

EXHIBIT B

The attached exhibits are:

B–1. Annual report to stockholders, December 31, 1962, American Foundation Life Insurance Co.
B–2. Midyear report, 1963, American Foundation Life Insurance Co.
B–3–a. Report on American Foundation Life Insurance Co., Best's Life Insurance Reports, page 58, et seq.
B–3–b. Dunne's International Insurance Reports, page 44 et seq., report on American Foundation Life Insurance Co.
B–4. Short form, Best's Reports 1963, American Foundation Life Insurance Co.
B–6. Report to stockholders, Standard Life Insurance Co. of Indiana.
B–7–a. Report on Standard Life Insurance Co. of Indiana, Best's Life Insurance Reports, page 1104 et seq.
B–7–b. Dunne's Report on Standard Life Insurance Co. of Indiana, page 609, et seq.
B–8. Short form, Best's Report 1963, Standard Life Insurance Co. of Indiana.
B–9. Annual statement (miniature), Union Bankers Insurance Co., Dallas, Tex.

In addition, in single copies, we desire to present: (1) An annual statement of Coastal States Life Insurance Co. for 1962; (2) a statement of Union Bankers Insurance Co. for 1962.

(Because communication between company and stockholder is the life of a stock life insurance company, the National Association of Life Companies will offer as a technical witness Mr. William E. Long, president of First United Life Insurance Co., of Gary, Ind. Mr. Long will discuss in detail the manner of reporting to stockholders and the information available to investors.)

Mr. HARRIS. Mr. Roberts, I observe you propose that you include with your statement a membership roster which you mentioned, and it will be included in the record at the appropriate place, and so will exhibit B. Exhibit B is the list of exhibits which you offer. That will be included in the record.

Mr. ROBERTS. Mr. Chairman, I did not think that you would include exhibit B in the record.

Mr. HARRIS. Pardon.

Mr. ROBERTS. I don't think you would include exhibit B–9 in the record because it is more voluminous than a record normally is.

Mr. HARRIS. No; I am talking about the outline of what the exhibits are.

Mr. ROBERTS. Yes, sir.

Mr. HARRIS. Just this one page marked exhibit B, so we know what list of exhibits you propose and offer here. Insofar as the exhibits related to in this outline, we will receive them for the files and they will be referred to by reference in case any member of the committee would be interested in them, because I have looked over these various exhibits and I think it would be a little difficult and somewhat burdensome to try to put this type of information as you have presented in the record as such, so it will be included in the record by reference, but we do want to know in the record just what you are offering as exhibits and that is the reason that one page will be included.

Mr. ROBERTS. Thank you.

Mr. HARRIS. Mr. Ford?

Mr. FORD. Yes, sir. Do you have any questions of Mr. Roberts?

Mr. HARRIS. No. We are going to let these gentlemen make their statements. Otherwise we never will get through here.

Mr. FORD. Mr. Long.

Mr. WILLIAM E. LONG. Since Mr. Roberts has made a lengthy statement I shall attempt to make mine rather brief. I will not read

the preamble since it largely covers what Mr. Roberts said in his statement.

Mr. HARRIS. Just a minute, please. This gentlemen who is about to testify now is Mr. William E. Long, a director of the National Association of Life Cos., and president of the First United Life Insurance Co. of Gary, Ind. I believe each one of us has a copy of his statement to follow, so, Mr. Long, you may proceed.

I also observe that you have several exhibits which you may refer to. You might endeavor to describe what you want to include in the record and which you want available for the committee's information You may proceed.

Mr. WILLIAM E. LONG. As I said a moment ago, I shall not refer to the preamble which is largely the same as Mr. Roberts used in his. However, in approximately 40 of the 50 States mergers follow generally the same procedure. They must first be discussed with the insurance department of the State in which the surviving company is domiciled. These preliminary hearings are held to determine whether such proposed merger safeguards the rights of shareholders and policyholders alike, and this is also true in most States regarding acquisitions.

After the department has given the green light and only then may the officials of the two companies get together to discuss the proposed merger in detail. When the officers and directors have come to a complete agreement, the matter is once again discussed with the State department for their tentative approval.

A 30-day notice is given to all shareholders of a special stockholders' meeting to discuss the merger, and I call attention to the fact that in most States of the 40, that I was able to determine, it cannot be discussed at a regular annual meeting. There must be a special meeting called specifically to deal with the merger.

The articles of merger, together with pertinent details, and I have listed at least two of these with the exhibits that are attached, are sent to each and every shareholder and his proxy solicited for the merger. It is necessary in almost every State to have a two-thirds majority of the shares outstanding voting for the merger to complete it.

An additional 30 days must elapse following the shareholders' meeting, then the matter is presented to the insurance department of both States, providing more than one State is involved, and upon their being satisfied that the interests of all concerned have been protected, they are approved and finally must be approved by the securities commission of both States before the merger becomes final.

We feel that the careful supervision exercised by the States, who for the most part have adequate knowledge of every life insurance company domiciled in their State, gives a special guarantee to every shareholder that his interests are always safeguarded.

Most of the criticism which we have had, and we have had free mergers, comes in stockbrokers who have little or no knowledge of the life insurance field and who cannot read nor understand a life insurance company's statement and who continually attempt to set a book value for our stock, failing always to realize that our main portion of business, our life insurance in force, has no book value.

It would seem that since this is a nationally accepted practice that the mere entrance of the SEC into our field of supervision will not

change this basic fact. I shall not cover the entirety of my statement since you gentlemen have it there and can look it over and I would not like to presume on your time.

We have discovered from personal experience when one of the Nation's largest CPA firms was called in at the beginning of our company to issue a statement, make our statement and sign it, when they completed our statement, which is necessary, our annual convention statement, to file with the department, our actuary and them came to several impasses which seemed almost impossible to resolve, but even after long conferences and the actuary finally signed the statements and they were filed with the department, in each of the 2 years that this large firm compiled our statement we had to send corrections to the State department.

In the succeeding 5 years in the statement compiled by our own internal technicians and supervised by an actuarial firm there have not been any errors and it has not been found necessary to correct one of them.

I personally do not feel from our experience with this very capable firm who does an excellent job in the CPA field that they are adequately trained to carefully make an insurance company statement, that when they make a statement it is completely inadequate, and at the time they were attempting to operate the company on those statements and giving them to our board from month to month, issued by the CPA, we were running into some very odd situations. Coming up to the yearend feeling that we were in the black and showing a great profit on a cash basis, when to use the term of an actuary, and I hope you gentlemen won't question me carefully about actuarial statement since I am not an actuary and sometimes I am a bit confused when I talk to ours—however, as our actuary uses the term "nebulous items," which deal with new and deferred and reserves, when these were posted we found the company was in the red.

Now, normally of course young companies operate in the red for a considerable period of time, but if these statements are to be based on those of a CPA—we operate on a cash statement and it is not handled by an actuary—we will be issuing false statements, which would certainly be misleading to the stockholders, policyholders, and the general public.

It has been said that there is inadequate information to stockholders. There may be isolated cases of this, but for the most part we find it absolutely necessary to keep our 5,500 stockholders advised from time to time of every progress of the company.

I have checked this carefully in our company and with several in the Midwest region, and I find that there is considerably less than one-half of 1 percent of our stockholders that ever complain about information, and in most cases we have learned that it is due to the fact that he filed it in the wastebasket without reading it, not realizing it was an important piece of information.

In summation I would say the past has proven that State regulations of the insurance industry is essential. This bill, if passed, in its present form will, in the near future, destroy State regulation. We have been exempt from the Securities and Exchange Commission by the McCarran Act and the general public, as a whole, has evidenced its confidence in life insurance company reports since life insurance com-

pany stocks continue to be among the most favored stocks in the Nation.

We humbly call your attention to the fact that everyone affected by the inclusion of life insurance companies in this bill have spoken out in opposition to it—the State regulatory agencies, the trade associations, the U.S. Chamber of Commerce, the companies and their stockholders. It would appear from this that it is then in the public interest for the Congress to again exempt life insurance companies from the provisions of this bill.

(The statement follows:)

STATEMENT OF WILLIAM E. LONG, ON BEHALF OF THE NATIONAL ASSOCIATION OF LIFE COMPANIES

This statement is made on behalf of the National Association of Life Companies, a trade association with members in 32 States. A list of the members has already been provided by Mr. DeWitt H. Roberts, executive secretary of the National Association of Life Companies.

This appearance, directed by the association, is for the purpose of urging that the Congress shall exempt insurance companies from the application of this pending legislation.

The insurance industry is the only financial group that would be made subject to this bill, although it is closely, and we believe adequately, supervised and regulated by the individual States. We believe that it has been singled out for special treatment that will be seriously detrimental to the industry as a whole. This statement shall deal entirely with the matter of merger procedures and information to stockholders about mergers.

In approximately 40 of the 50 States, mergers follow generally the same procedure. They must first be discussed with the insurance department of the State in which the surviving company is domiciled. These preliminary hearings are held to determine whether such proposed merger safeguards the rights of shareholders and policyholders alike, and this is also true in most States regarding acquisitions. After the department has given the green light and only then may the officials of the two companies get together to discuss the proposed merger in detail. When the officers and directors have come to a complete agreement, the matter is once again discussed with the State department for their tentative approval. A 30-day notice is given to all shareholders of a special stockholders' meeing to discuss the merger, and the articles of merger, together with pertinent details (exhibit A) are sent to each and every shareholder and his proxy solicited for the merger, it being necessary in almost every State to have a two-thirds majority of the shares outstanding voting for the merger to complete it. An additional 30 days must elapse following the shareholders' meeting, then the matter is presented to the insurance department of both States, providing more than one State is involved, and upon their being satisfied that the interests of all concerned have been protected, they are approved and finally must be approved by the securities commission of both States before the merger becomes final. We feel feel that the careful supervision exercised by the States, who for the most part have adequate knowledge of every life insurance company domiciles in their State, gives a special guarantee to every shareholder that his interests are always safeguarded.

Most of the criticism that arises in our area of mergers comes from stockbrokers who have little or no knowledge of the life insurance field, who for the most part cannot read nor understand a life insurance company's statement and who continually attempt to set a book value for our stock, failing always to realize that our main portion of business, our life insurance in force, has no book value. It would seem that since this is a nationally accepted practice that the mere entrance of the SEC into our field of supervision will not change this basic fact. We are, today, the most supervised business in the Nation. In each and every State where a life insurance company files a statement, it must meet that State's individual requirements and every statement must be signed by an actuary, since an actuary is to the life insurance business what a CPA is to other financial institutions, their word and theirs only is accepted. Should the Congress pass bill S. 1642, most of the small life insurance companies will find it impossible to continue to operate, thereby creating a monopoly in

the life insurance business, since the necessity of creating a new set of statements compiled by and certified to by a CPA will increase our annual costs from $12,000 to $25,000 per year, and if your own individual experience is of value, statements prepared by CPA's, even from some of America's largest firms are not nearly so effective or correct as those compiled by an actuary, who by training has learned to deal with the many nonledger items from which insurance statements are created. The companies in the Middle West, with which I am most familiar, send out continuous reports of progress to the stockholders (exhibit B) knowing that stockholder relations are of vital importance to the continuation of our business. In our company, with some 5,500 shareholders, the percentage of those complaining of lack of information would be considerably less than one-half of 1 percent.

The past has proven that State regulation of the insurance industry is essential. This bill, if passed, in its present form will, in the near future, destroy State regulation. We have been exempt from the Securities and Exchange Commission by the McCarran Act and the general public, as a whole, has evidenced its confidence in life insurance company reports since life insurance company stocks continue to be among the most favored stocks in the Nation.

We again call your attention to the fact that everyone affected by the inclusion of life insurance companies in this bill have spoken out in opposition to it—the State regulatory agencies, the trade associations, the U.S. Chamber of Commerce, the companies and their stockholders. It would appear from this that it is then in the public interest for the Congress to again exempt life insurance companies from the provisions of this bill.

Mr. HARRIS. Thank you, Mr. Long.

Mr. WILLIAM E. LONG. These exhibits I asked to consider are quite lengthy, gentlemen, and I do not know that they are necessary for the record. I wanted you men to have the opportunity to see at least a portion of what we give to our stockholders. They are very voluminous and certainly would probably be too much to put into the record, but I did want each of you to see so you would have personal knowledge at least of what we do give them.

Mr. LONG (presiding). Let's put them in the committee files and have them available, Mr. Long.

Mr. WILLIAM E. LONG. Yes, I think that is all right.

Mr. LONG. Thank you very kindly, Mr. Long.

Mr. FORD. Mr. C. C. Yost of the United Bankers of Dallas, Tex.

Mr. LONG. Mr. Ford, I don't know all the members of your panel personally, but I do say I have had over the years experience with Mr. Yost and if they all have as distinguished service in the insurance field as Mr. Yost has had you have a well qualified panel.

Mr. FORD. And a well qualified witness.

Mr. YOST. Thank you, sir. I am C. C. Yost, vice president of the Union Bankers Insurance Co., in Dallas, Tex. I am here in behalf of the National Association of Life Companies, of which I am a vice president and chairman of the executive committee. I have submitted my statement, which includes much material that has been presented by Mr. Roberts and Mr. Long. My statement was confined generally to the problem of mergers of insurance companies.

I would like to point out only the material which they did not include in their statements.

In most States, as has been pointed out, mergers are subject to specific parts of the insurance laws. In addition thereto, they are also subject to the general business corporation acts of each State. The laws in most States for consummating a merger require notices to stockholders of special meetings, approvals by the boards of directors of the two companies, approval by the insurance commissioners of

one or more States, and in many States a public hearing, which must be advertised in the newspaper and held for the benefit of everyone who might have any interest in such a merger.

In many States there is a provision in the insurance merger statute for fair treatment of a dissenting stockholder. The dissenting stockholder may vote against the merger and may request at the stockholders' meeting and thereafter that the value of his shares be paid to him in cash at a fair price as a part of the merger proceedings.

The insurance commissioners may approve mergers only if the plan and agreement is found to be fair and equitable to stockholders of the companies, that the merger does not impair the protection and service to policyholders, that the merger does not violate any provisions of the insurance law is not in violation of the antitrust or monopoly laws, and is not contrary to public interest.

The company that I am connected with has made several mergers. Once a merger plan has been agreed upon by directors it is essential that the transactions be completed in the shortest possible time permitted under State laws. To have any considerable delay in consummation of a merger results in a deterioration of the insurance business. Policyholders, agents, stockholders, all become greatly disturbed if there is long delay in finishing up the proposed merger. We fear that under the proposed legislation the securing of approval by the Securities and Exchange Commission would involve excessive delays which are not now required under State laws. We do not see the proposed legislation as offering any advantage to stockholders or policyholders, and the required additional procedure and delay would prevent many mergers which are advantageous to both stockholders and policyholders.

Thank you very much. I did not bring any exhibits to go with this statement.

Mr. HARRIS. That concludes your comments, Mr. Yost?

Mr. YOST. Yes, sir.

(The statement follows:)

STATEMENT OF C. C. YOST, VICE PRESIDENT AND CHAIRMAN OF THE EXECUTIVE COMMITTEE, ON BEHALF OF THE NATIONAL ASSOCIATION OF LIFE COS.

This statement is made on the behalf of the National Association of Life Cos., a trade association of legal reserve life insurance companies. This appearance, directed by the association, is for the purpose of urging that the Congress shall exempt insurance companies from the application of this pending legislation.

I wish to confine my statement to the generally adopted procedures for mergers or consolidations of legal reserve stock life insurance companies and to show that the proposed legislation will not offer any added protection to the stockholders or policyholders of such companies.

I have examined the insurance statutes of the various States in which my company is licensed and find that they generally provide for the following procedures:

1. Mergers or consolidations of stock of life insurance companies are subject to the general business corporation laws regarding mergers or consolidations. And, in addition thereto, are subject to specific laws related to insurance companies.

The insurance laws of the various States require that the plan of merger, consolidation, or reinsurance of total outstanding business of one company by another, or the purchase by one company of the controlling stock of another company, shall first be approved by the boards of directors of the two or more companies involved.

2. After approval by the directors, the proposal for merger or consolidation must be submitted to separate meetings of the stockholders of both companies for approval. The required percentage of stockholders varies among the various States from a simple majority to 80 percent of the outstanding stock of each company. In a number of States, the stockholders' meeting must be a special meeting called for this purpose, and a merger may not be considered at a regular annual meeting. The notice to stockholders shall present in detail the proposed plan of merger, including the ratio of exchange stock of the surviving company for the stock of the company that is being absorbed through merger, or such other data that will reflect the full details of the transaction.

3. After approval by directors and by stockholders of the companies involved, the insurance commissioner, director of insurance, superintendent of insurance, or such other State official having similar authority, shall advertise and hold a public hearing, at which time all details of the proposed merger shall be explained, and any person, stockholder, or policyholder may present objections and suggestions. After such public hearing, the insurance superintendent, director, or commissioner shall approve the merger provided:

(*a*) The plan and agreement is found to be fair and equitable to stockholders of the companies; and

(*b*) Protection and service to policyholders of both companies are not adversely affected; and

(*c*) Proposed merger does not violate any provisions of the law, and is not in violation of the antitrust or monopoly laws, and is not contrary to public interest.

4. Where one company merges with a company domiciled in another State, then the insurance commissioner, superintendent, or director of such other States shall have similar hearings, and the merger shall require his approval as well as the approval of the State in which the surviving company is domiciled.

5. Most State laws indicate reinsurance of total outstanding business or the purchase of controlling stock of one company by another shall be subject to merger statutes.

6. Many State laws provide a formal procedure by which a dissenting stockholder may vote against a proposed merger, and if the merger is approved by a required majority of stockholders, the dissenting stockholder may apply for and receive in cash the fair value of his stock as established in the plan of merger.

7. The laws of many States provide that no officer or director of any company that is a party to a merger or consolidation shall receive any commission, brokerage fee, or other consideration as a result of such merger or consolidation.

The company with which I am connected, has made several such merger transactions, and in every case, full information was distributed to the stockholders, either in the notice of the special stockholders' meeting called for the purpose of approving the merger or in the material presented to the stockholders at the stockholders' meeting.

Once an agreement has been reached by the directors of the two companies to merge or consolidate, it is essential that the transaction be completed in the shortest possible time permitted under State laws. To reach such an agreement on the part of the directors and then delay consummation of the transaction for many months would result in deterioration of the business of both companies, as neither agents nor employees would know what their ultimate situation would be under the consolidated companies. We greatly fear that under the proposed legislation, the securing of approval by the Securities Exchange Commission would involve excessive delays which are not now required under existing State laws. The proposed legislation would not offer any advantage to stockholders or policyholders, and the required additional procedure and delay in approval would prevent many mergers which are advantageous to stockholders and policyholders.

I might add that the establishment of a fair value of the exchange of stock has never been a problem in my experience. To estimate such fair value, we establish a set of yardstick values as to the worth of the insurance business in force, and apply the same formula to both companies. To this, we add the actual value of the capital and surplus accounts. These values, established by certified public accountants and qualified actuaries, are used to determine the ratio for the exchange of stock. All stock is treated alike and no bonuses paid for the shares representing the controlling interest.

Mr. HARRIS. Mr. Rosenberg.

Mr. ROSENBERG. I am Leonard H. Rosenberg, a board member of the National Association of Life Companies, president of Chesapeake Life Insurance Co., and most recently technical adviser to Governor Tawes' commission that revised the Maryland insurance company laws. For the record, I am going to ask you gentlemen to change the date at the head of my written material to today's date, which I believe is the 23d of January. I am also going to request that my exhibits be made available to the committee, but not necessarily be made part of the record, as I feel they are too bulky.

Mr. HARRIS. They will be received for the files and referred to.

Mr. ROSENBERG. My talk is going to be of a technical nature so anytime anyone wishes to interrupt me and ask any question I will attempt to clarify any point at anytime. It is my intention to point out to this committee a few of the technical aspects of the excellent control of life insurance companies already exercised by the individual State insurance departments of the United States.

The life insurance industry does not object to this subject bill as a whole. It has always stood for complete disclosure of financial dealings. I feel rather strongly that the Congress should exempt insurance companies from the application of this pending legislation, as has been done in the case of other financial institutions. The controls laid down by the bill are already in full effect to a greater degree, and any duplication of these controls would result in great expense and trouble to the industry, particularly the small companies.

The Securities and Exchange Commission, in presenting its case for supervision of the life insurance company, has stated that there is insufficient information available to the general investor. In exception to this, I would like to point out that there is no other industry where more information is available.

Once a year, each insurance company is required to file, with their home State and every State in which they are licensed to do business, a document known as the National Association of Insurance Commissioners' convention blank (exhibit B attached) hereinafter called annual statement. It is a rather large and bulky item. I think my previous colleagues have presented a miniaturized version, but this is the actual size of the convention blank. This 12-inch-by-19-inch 50-page annual statement is one of the most comprehensive financial statements prepared by any industry. Full disclosure is made of all investments, all expenses, all incomes, all liabilities, all assets. As a matter of fact, the life insurance industry discovered full disclosure long before the SEC existed.

With one exception, there is disclosure made of everything that the SEC requires under its new bill. This one exception is that of "insider stock transactions."

My written material refers to the fact that the NAIC committee was now working on it. Actually this has been done. The "insider transaction" questionnaire has already been printed and has been sent to the insurance companies and will be included in the 1964 statements.

This statement is on file with every State insurance commissioner in which the company is authorized to do business. Any member of the public is free to examine this on request. The "stock analysts" who advise the public on their purchase or sale of stock should, by all means, closely examine this document before attempting to analyze the value of the company.

In addition, many insurance commissioners, at company expense, annually publish extracts of pages 2, 3, and 4 of this statement in local newspapers (exhibit C). If you will refer to exhibit C, I have a photocopy of the abstract that was published for our company last year in the Daily Record in Baltimore.

This statement in its entirety is a complicated one. However, if you will refer to pages 2, 3, and 4 which are the key of exhibit B which is the abstract, you will see that it is a very simple statement that can be understood by anybody who can read a balance sheet. Two has the assets, three has the liabilities, and four has the statement of operations.

The beauty of the rest of the statement lies in its completeness and its balances. No industry that I know of files a complete inventory in its annual statement; we do. No industry that I know of breaks down its sales and its expenditures as closely as we do. No industry that I know of presents to the public the mathematical verification of all of its figures as we do.

I could not, in this short time, point out the checks and balances of this statement, which has been refined over a period of, I believe, 50 years solely for the benefit and protection of the public. This is the raison d'etre for the existence of the State insurance departments.

The biggest single liability of any legal reserve life insurance company is its reserve, that amount put aside to pay future claims. This reserve valuation is an actuarial computation, figured by the company actuary, and verified by the State insurance department actuary every year. It would be disastrous to introduce a certified public accountant into this specialized field of computation, which is the biggest item in the statement.

I do understand something about actuarial work, and, believe me, on the reserves even the law is set down very carefully as how they can be figured. They are complicated and the State insurance departments do check out these computations for the benefit of the public.

Preparation of this statement is now a 2-month job with most of the companies. If additional accounting were introduced into this process, it would be a costly and time-consuming item and would add no further information.

We have figured it for our company, and at a minimum, and we are a very small company. This would cost us $12,000 a year. If you gentlemen refer to page 4 of our statement in exhibit B, you will see that our net gain from operations before dividends to policyholders was $21,000.

In other words, our additional expense would be greater than half of our profit and it would have to come from somewhere, which would either be policyholder dividends or stockholder dividends.

Mr. KEITH. Where is this exhibit B you are referring to?

Mr. ROSENBERG. This is B, at page 4, about line 28.

This is the actual statement of operations. The $12,000 is a figure that we had prepared as to how much it would cost us to go through this extra work.

The bill you gentlemen have before you requires quarterly preparation of statements. In the preparation of our present statement, this exhibit B, our actuaries choose what we call an annual "mean reserve" system. This is a reserve figured on the average policy to be a half

year in force. To translate this into a quarterly mean reserve would be needlessly complicated, in addition to causing statement time to come up every 3 months instead of once a year and it takes 2 months now, so we would have very little time for anything else but statement. Actually, we do prepare a month-to-month statement. It is prepared by our actuary and it is based on our approximation of reserves so we do not get caught in the position that was just mentioned. We know exactly where we stand at the end of the year.

Life insurance accounting is unlike any other branch of accounting. We who work with it believe it is very simple. The CPA does not. The SEC would not be prepared to handle this without additional specialized personnel.

The foregoing is sufficient for the protection of the public. However, in addition to this closely analyzed annual statement, the individual State insurance departments completely and independently examine each life insurance company periodically. In Maryland this is done every 4 years. In most States I believe it is triennially. In some few States it is biennially.

If the company is particularly large, more than one insurance department participates in this examination.

Exhibit D, which is this yellow booklet which has been miniaturized, shows the report of an examination of our company as of May 27, 1959. The most recent examination has been completed, but has not come back from the printer as yet.

As you can see, this examination is most thorough, is made by examiners who are experienced life insurance accountants and actuaries, and covers the job fully. They have no ax to grind. It is not done by company people. Briefly, some of the major points in this little yellow booklet are:

A. All of the assets are physically counted and verified.

B. All the minutes and bylaws are completely reviewed as to legality of action.

C. Policy records, premiums, receipts, incomes, and expenditures are scrutinized.

D. Stockholder meetings are verified, as well as the proxies, and the stockholder actions.

E. All changes in bylaws and articles of incorporation are reviewed.

F. If there are any errors found or any insufficiencies are found, they must be corrected immediately.

As in the case of the annual statement, this report is filed with every State that we do business and becomes a matter of public record.

In addition to the State insurance department analysis of our statements, many well-known insurance statistical services analyze and publish books of reports on insurance companies. Mr. Roberts showed you "Best," which is probably the best known. We also have Dunnes, which he mentioned, and the Spectator Life Index.

As an individual closely associated with the insurance industry for more than 30 years, I can state that with the NAIC annual statement—that is the big blue one—and the latest examination report of any life insurance company I can completely evaluate the company involved. No further information is necessary. Any competent stock analyst should be able to do likewise. With the statement itself so closely checked by the insurance departments, the control on the bylaws and

the legal actions by the same departments and the publishing of the abstract, my stockholder or any potential stockholder can find out more accurate information about the insurance companies than he can about any other industry.

Because of this, gentlemen, the additional expense and administrative difficulty of unnecessary supervision, the excellent supervision already exercised by the States, I feel that this bill should be passed but with a specific exemption for the life insurance industry.

Thank you.

(Exhibit C follows.)

EXHIBIT C

[Extract of 1962 statement published in the Daily Record, April 1963]

CONDENSED STATEMENT AS OF DECEMBER 31, 1962, OF THE CHESAPEAKE LIFE INSURANCE CO., BALTIMORE, MD.

(Organized under the laws of Maryland)

CAPITAL PAID UP $394,042

Changes in policyholders' surplus for the year 1962

Net gain from operations before dividends to policyholders and excluding capital gains	$21,021.62
Less dividends to policyholders	30,147.78
Net loss from operations after dividends to policyholders	9,126.16
Net loss from nonadmitted and related items	21,815.09
Net capital losses	2,571.04
Increase in capital paid in	52,104.00
Increase in surplus paid in	91,284.50
Net increase in surplus for the year 1962	110,076.21
Surplus as regards policyholders at end of prior year	770,519.40
Surplus as regards policyholders Dec. 31, 1962	880,595.61
Liabilities and reserves	610,979.35
Total admitted assets	1,491,574.96
Insurance in force, Dec. 31, 1962	28,927,219.00

Maryland business during 1962

Business issued and paid for in Maryland during 1962 (ordinary)	10,022,560.00
Premiums in Maryland in 1952:	
Ordinary	301,142.73
Accident and health	12,144.81
Losses paid in Maryland in 1962 (ordinary)	38,162.27

STATE OF MARYLAND,
OFFICE OF THE STATE INSURANCE DEPARTMENT,
Baltimore, Md., March 1, 1963.

I hereby certify, that the above is a true abstract, taken from the annual statement of the Chesapeake Life Insurance Co., for the year ending December 31, 1962, now on file in this department.

F. DOUGLAS SEARS,
Insurance Commissioner.

Mr. HARRIS. I think, Mr. Rosenberg, we will include in the record with your statement the membership roster which is included together with the extract of the 1962 statement published in the daily record, which is exhibit C. That can be, I think, appropriate for the record.

Mr. ROSENBERG. As you wish, sir.

Mr. HARRIS. The other exhibits will be received for the files and included in the record by reference.

Mr. ROSENBERG. Thank you.

Mr. HARRIS. Is that the same roster?

Mr. ROSENBERG. The same list as Mr. Roberts.

Mr. HARRIS. Is it the same roster?

Mr. ROSENBERG. Yes, sir.

Mr. HARRIS. We don't need to have it in the record twice.

Mr. ROSENBERG. Not owning any stock in the paper company, you might as well leave it out.

Mr. HARRIS. Mr. Hundahl.

Mr. HUNDAHL. My name is D. J. Hundahl, Jr. I am president of the National Security Life & Accident Insurance Co., and I am appearing here as president of the Texas Legal Reserve Officials Association. This is a trade association of legal reserve life insurance company officials, representing 62 Texas life insurance companies. A list of the members is attached to my statement, marked "Exhibit A," and it is the only exhibit that I have attached to my statement.

My appearance in behalf of our association is to urge that life insurance companies be exempted from this pending legislation.

My remarks are based on the premise that the purpose of the legislation is to provide adequate control and regulation of life insurance companies for the benefit of the stockholders, policyholders, and the public generally. This objective is sought through the requirement that life insurance companies of sufficient size be required to give annual statements to the SEC and incidentally thereto, the SEC is given regulatory powers through the issuance of regulations which will be applicable to companies brought under SEC control through this proposed legislation.

It is the contention of this association of which I am president, that additional legislation to achieve these objectives is not necessary and would be detrimental to our companies and the persons for whom protection is sought. I offer the following reasons:

1. State regulation and control is adequate at this time.

2. The proposed legislation would enlarge the expenses of the affected insurance companies and would lessen the protection for policyholders and diminish the equity of the shareholders.

3. The trade associations have assumed a part of this burden in cooperation with governmental authorities.

I. State regulation and control is adequate: The history of insurance regulation in Texas is one of empirical growth. It is unquestionably the most highly regulated industry in the State. No less than three major portions of our statutes are applicable to insurance companies.

The Texas Insurance Code was adopted in 1951. This was a comprehensive compilation and revision of existing insurance laws at that time. It has been amended repeatedly since that date to cure various defects and to bolster the laws as inadequacies were discovered. No legislative session since that time has failed to make some change in this code. It was completely revamped again in 1955.

This code sets out in great detail organizational requirements for all life insurance companies as well as other types of insurance companies. It devotes an entire chapter to the board of insurance com-

missioners and sets out very broadly the duties and the responsibilities of the board in regulating and controlling insurance companies. It provides a licensing procedure for all insurance companies operating in the State of Texas and requires each of them to make annual financial statements to the insurance board. In addition, procedures are set up for examiners to examine in detail each company licensed to do business in Texas at the home office of the company.

Furthermore, the code sets out in great detail procedures for merger, consolidation, and total reinsurance of insurance companies. The consensus of insurance companies doing business in the State of Texas is that this is a most comprehensive code in regulating life insurance companies and provides a protection for stockholders, policyholders, and the public in general. It is designed to provide maximum protection for policyholders.

In addition, the Texas Business Corporation Act is applicable to all life insurance corporations doing business in the State of Texas in all situations where the Texas Insurance Code has not superseded the Business Corporation Act. This law is very similar to the Model Business Corporation Act.

In addition to these, the Texas Securities Act, enacted in 1957 covers nearly all new issues of life insurance stocks and governs and regulates the securities industry in general in the sale of life insurance securities and in the issuance of authorized shares as well as new issues.

The Texas Securities Board has broad police powers in supervising the sale and transfer of shares and has for all practical purposes eliminated from Texas questionable practices in securities transactions.

We have analyzed S. 1642 in great detail and are firmly convinced that this proposed legislation would not add one iota to the protection already afforded stockholders, policyholders, and the public at large.

On the contrary it could very well have the effect of lessening State controls because of dependence on newly enacted Federal controls or at the very least would be an unnecessary duplication of effort which could only result in conflicts and would be demoralizing to insurance companies in engulfing them in additional regulation.

Furthermore, our State legislature has taken very seriously the responsibility directed at them through the McCarran Act. We concur in the wisdom of the Congress in delegating to the States regulation of this very specialized industry and feel that enactment of this proposed legislation would be contrary to that intent.

I can certainly speak for the State of Texas in asserting that the legislature of our State has enacted laws which are designed, and have the effect of, achieving every objective sought by the SEC at this time.

To enlarge the SEC's responsibility in this field would result in diluting their efforts in industries that are not so well regulated at the State level as the insurance industry or would require an enlargement of their work force to include insurance specialists to assume this additional burden.

As already indicated we are unconvinced that this would add any protection whatsoever for those for whom protection is sought.

II. The proposed legislation would enlarge expenses of affected companies: Our companies in Texas have learned or are learning to

live under controls and regulations imposed upon us by the State of Texas. We have adjusted our operational facilities to comply with all statutory requirements and in many cases, of course, have gone beyond the letter of the law.

Most companies in our association are young life insurance companies which are just now reaching the point where we are experiencing operational profits. We have done so through operational economies as well as very strict underwriting practices. We have attempted to eliminaate from our budgets every unnecessary expense.

The proposed legislation would absorb as much as 25 to 50 percent of the operational gains of many of our companies and would in many instances extend the day when some of our smaller companies could begin to operate at a net profit. Of course we recognize that this, in and of itself, would not argue against such additional legislation except that when coupled with our previous arguments and contention that the regulation is unnecessary, it speaks strongly for the elimination of insurance companies from this proposed legislation.

III. The trade associations have assumed part of the burden: Furthermore, we feel it is our duty to speak out for more confidence from our Congressmen in our trade associations for the role that they play in the regulation of this vital industry in our economy. We recognize that voluntary associations cannot shoulder this burden alone but at the same time we recognize that we have a responsibility concomitant with the responsibility of the Government, in the prevention of illicit practices in our industry.

Our association maintains high standards in our industry for the selection of its officers and directors. They are continually reminded of their duties and responsibilities both legally and morally.

It is our belief that no one in the business world today is more conscious of public relations and the image of their industry as a whole than those in the insurance industry. We have learned, sometimes from bitter experience, that insolvency, fraud, and insurance scandals in one small insurance company, can have devastating results and detrimental effects on all other insurance companies whether they be innocent or guilty and we, therefore, for selfish reasons, if no other, are vitally interested in this aspect of our industry.

We feel very strongly and keenly about this subject and have taken the lead in the State of Texas in seeking for laws which would upgrade our industry.

At the same time we strike out against laws that would entangle and retard the growth of our companies.

If there are at this time open and obvious defects in laws affecting our industry, we ask for an opportunity to cure them at the local level.

For these reasons and because of our sincere belief that this legislation would be detrimental to our industry without any significant gains to the public, we urge this committee to exempt the life insurance industry from this proposed legislation.

(Exhibit A follows:)

EXHIBIT A

LIST OF MEMBER COMPANIES IN TEXAS LEGAL RESERVE OFFICIALS ASSOCIATION

Allied Bankers Life Insurance Co., Dallas, Tex.
American Bankers Insurance Co., Waco, Tex.
American Capitol Insurance Co., Houston, Tex.
American Guardian Insurance Co., Dallas, Tex.
American Savers Life Insurance Co., San Antonio, Tex.
American Standard Life Insurance Co., Fort Worth, Tex.
American States Life Insurance Co., Houston, Tex.
American Trust Life Insurance Co., Wichita Falls, Tex.
Bankers Commercial Life Insurance Co., Dallas, Tex.
Bankers General Life Insurance Co., Dallas, Tex.
Best Life Insurance Co., El Paso, Tex.
Central States Life Insurance Co., Houston, Tex.
Citizens Fidelity Insurance Co., Waco, Tex.
Colonial American Life Insurance Co., Corpus Christi, Tex.
Commercial Standard Life Insurance Co., Fort Worth, Tex.
Commercial Travelers Life Insurance Co., Dallas, Tex.
Consolidated General Life Insurance Co., Dallas, Tex.
Continental American Life Insurance Co., Houston, Tex.
Cosmopolitan Mutual Life Insurance Co., Houston, Tex.
Crockett National Life Insurance Co., Crockett, Tex.
Equitable Insurance Co. of Texas, Dallas, Tex.
Family Security Insurance Co. of America, Fort Worth, Tex.
Fed-Mart Life Insurance Co., San Antonio, Tex.
Fidelity National Life Insurance Co., Dallas, Tex.
Fortune Life Insurance Co., Abilene, Tex.
General Security Life Insurance Co., Bryan, Tex.
Great Commonwealth Life Insurance Co., Dallas, Tex.
Great Oil Basin Life Insurance Co., Odessa, Tex.
Great Plains Life Insurance Co., Abilene, Tex.
Great Southwest Life Insurance Co., Dallas, Tex.
Great United Life Insurance Co., Dallas, Tex.
Greenwood Life Insurance Co., Fort Worth, Tex.
Group Life & Health Insurance Co., Dallas, Tex.
Gulf Atlantic Life Insurance Co., Dallas, Tex.
Houston American Life Insurance Co., Houston, Tex.
Ideal Life Insurance Co., Kirbyville, Tex.
Independence Insurance Co., Pampa, Tex.
Justice Life Insurance Co., Dallas, Tex.
Legal Security Life Insurance Co., Dallas, Tex.
Life Insurance Company of the Southwest, Coleman, Tex.
Mid American Life Insurance Co., Houston, Tex.
The Morris Plan Life Insurance Co., Fort Worth, Tex.
National Bankers Life Insurance Co., Dallas, Tex.
National Security Life Insurance Co., Dallas, Tex.
North America Life Insurance Co., Houston, Tex.
Old National Insurance Co., Houston, Tex.
Permian Basin Life Insurance Co., Odessa, Tex.
Provident Security Insurance Co., Houston, Tex.
Rix Life Insurance Co., Lubbock, Tex.
Savings Life Insurance Co., Austin, Tex.
Shannon Life Insurance Co., Fort Worth, Tex.
Southern Fidelity Life Insurance Co., Marshall, Tex.
Southwest Security Life Insurance Co., San Antonio, Tex.
Southwestern Fidelity Life Insurance Co., Houston, Tex.
Standard Reserve Insurance Co., Gainesville, Tex.
Texas Continental Life Insurance Co., San Antonio, Tex.
Time Life Insurance Co., San Antonio, Tex.
Union Bankers Insurance Co., Dallas, Tex.
Union Standard Life Insurance Co., Houston, Tex.
United Bankers Life Insurance Co., Dallas, Tex.
Universal Guaranty Life Insurance Co., Dallas, Tex.
Universal Security Life Insurance Co., Houston, Tex.

Mr. HARRIS. Does that conclude your statement?

Mr. HUNDAHL. That concludes my statement; sir. I would like to say, however, that I wholeheartedly endorse everything that has been said by my predecessors before me.

Mr. HARRIS. Is the roster of the companies which you include with your statement the same that was included in the record already?

Mr. HUNDAHL. No, sir. This association is the Texas Legal Reserve of Officials Associations. I believe the other roster was the National Association of Life Cos.

Mr. HARRIS. I think this roster should be included with your statement then so we have that information.

Mr. HUNDAHL. Thank you.

Mr. HARRIS. Mr. Deering?

Mr. DEERING. I am vice president and general counsel of Security Life & Accident Co., in Denver.

I appear before this committee on behalf of the Colorado Life Convention, which is an association composed of 15 insurance companies based in Colorado, all of which are stock companies.

I am a little bit, at this point, in a "me too" position. I think that nearly everything that I intended to say has been said and very effectively. I second what has been said here and will not of course repeat it over again for the benefit of this committee.

I do, however, want to point up two or three factors that the committee should consider and to give you some idea of what we think this legislation will do to our association and the companies which comprise it.

Our association is composed of small companies. We do not have any giant insurance companies based in Colorado. The capital surplus of the companies making up our association varies from $516,000 at one end to a high of about $6½ million. The total assets of the 15 companies vary on the small side from less than a million dollars to over $63 million.

As you gentlemen are aware, I am sure, these are not large figures when you speak of life insurance companies and these companies are small companies. Like most small companies, their operating gains are not large. Our figures are consistent with those which have been mentioned here concerning the cost of doing business under this bill.

However, there is one additional item of expense which has not been mentioned here and that is the cost of originally registering the stock of each of the companies as required under this present pending bill. We estimate that it will cost us in the neighborhood of $25,000 to $30,000 per company simply to effectuate the registration of the stock which the bill would require. This is over and above the annual expense which will be necessitated by the reporting requirements which the bill would impose upon us. We estimate those costs, the annual expense to us, in the neighborhood of $15,000 to $20,000 for the average-size company in our convention.

Again this means a substantial percentage of the operating gain of each one of these companies will go toward the compliance with the provisions of this bill. As has been suggested earlier, this is going to have to come from someplace and there are generally only two places it can come from, either from the stockholders which this bill is designed to protect, or from the policyholders, through a reduction in their dividends or an increase in their premiums.

In Colorado 175 pages of our statute are devoted to the regulations of the insurance industry. In addition to our statutory regulations, the commissioner himself has promulgated extensive regulations which cover those areas not specifically spelled out in the statute.

We are also of course subject to the regulations imposed upon us by the National Association of Insurance Commissioners. We have just completed our triennial examination. Four examiners from four different States spent 4½ months in our office. It cost up $30,000, and attached to my statement as an exhibit is the results of that examination, 109 pages in length, covering every conceivable phase of our operations. I challenge anyone to find an industry which is more carefully and meticulously scrutinized than the insurance industry. The annual statement and the triennial examination are not confined to merely financial matters.

I have indicated in my statement—I won't go through them in detail here—the number and the variety and the type of areas which are examined and which are reported upon by the companies. As you can see, they range from the strictly financial and the strictly accounting to the conflict-of-interest situation involving directors and officers, to changes in the corporate structure, to stockholder dividends which have been paid over a period of years.

All of the information that a stockholder would be interested in is contained in the annual statement, and it has been indicated here earlier how the NAIC has adopted a requirement covering insider trading transactions and this will be included in the annual statement in the future.

Mr. HARRIS. It is not included in this?

Mr. HUNDAHL. It is not included now, Mr. Harris. It will be included in the annual statement for 1964.

Mr. HARRIS. Is this the 1963 statement?

Mr. HUNDAHL. The triennial examination which is attached to my statement is for the 3-year period ending December 31, 1962, and I believe this annual statement of Mr. Rosenberg's 1962 also, but in the 1964 statement, the one we will submit December 31, 1964, will contain the insider trading information which the SEC would require us to furnish.

Mr. HARRIS. You mentioned triennial statement and then you mentioned annual statement. Which do you do?

Mr. HUNDAHL. We do both. Annually we file the annual statement which has been discussed in detail. After 3 years the insurance commissioners of the various States in which we operate examine us and prepare from that examination a triennial report, so that report is not our work. That is the report of their examination, and that is what is attached to my statement.

Mr. HARRIS. In order that we may understand, I assume you operate in four States.

Mr. HUNDAHL. We operate in 36 States. The various commissioners normally have a representative from a zone which is established by the NAIC, that zone representing not one, but several States, so that instead of each State sending an examiner, it is usual for a zone, which is comprised of several States, to send one examiner to represent the entire zone.

Mr. HARRIS. In other words, out of 36 States you have 4 zones.

Mr. HUNDAHL. Well, I am not sure of the number of zones. We have more zones than that. I think there was one zone that did not send an examiner, but the report coming out of that examination will be filed in every State in which we do business.

Mr. HARRIS. I understand that, but I just wanted to get clear in my mind about this annual statement filed and the triennial statement which is developed by representatives of all the State commissioners in the States that you do business.

Mr. HUNDAHL. That is correct, although it is not customary for each State to send an examiner for each 3-year period.

Mr. HARRIS. I understand that, but with respect to the 4 that you indicate spent 4½ months, those 4 commissioners are representatives of the commissioners representing the entire 36 States?

Mr. HUNDAHL. That is correct.

Mr. HARRIS. I just wanted to get that straight.

Mr. HUNDAHL. We don't feel that any real need has been shown to include life insurance companies within the purview of this legislation and we feel, in light of the extraordinary regulations to which we are already subjected and the extraordinary additional expenses which would be put upon us to comply with this bill, that legislation of this type should only be enacted in the light of or with the showing of a clear need on the part of the proponents of the legislation.

Mr. HARRIS. Why didn't you make that showing in the Senate?

Mr. HUNDAHL. Why didn't I personally make that showing to the Senate?

Mr. HARRIS. Well, any of you in the industry.

Mr. FORD. Mr. Roberts will answer that.

Mr. ROBERTS. We had only 2 days' notice of the Senate hearings. We filed a very short brief at the Senate hearings on behalf of that association. We had no opportunity. The study by the SEC was released approximately 2 weeks, as I recall. The association didn't even have access to it at that time that the hearings began. It was impossible to be prepared for hearings in the Senate and the Senate hearing was rather abruptly adjourned and we were told to file briefs, which we did.

This association did. Mr. Deering was unable obviously because his material was not at that time available.

Mr. DEERING. And the American Life Convention I believe filed a statement and appeared at the Senate hearings. I think the SEC filed with this committee—I know they filed with the Senate—a document which attempted to make a showing that life insurance companies should be included within this legislation. It consisted of a summary of a number of reported court decisions involving life insurance companies where there had been some manipulation involving stock.

In every instance that the SEC cited the relief sought by the SEC, which by criminal conviction or injunction, was obtained. I believe this suggests that the existing framework of legislation is more than adequate to do the job that has to be done.

Where there have been abuses they have been corrected under the legislation we have on the books today, and of course, like any industry or like any corporation, life insurance companies, if they choose to sell their stock to the public, are required to comply with the present

regulations and the present statutes requiring registration of their securities, so we don't feel that the imposition of these additional requirements will achieve anything nor do we feel that any need has been shown for them.

It is very difficult for us now as stock companies to compete with the mutual companies. The competitive disadvantage will be increased by this legislation or legislation of this type that subjects stock companies to additional and burdensome regulations to which mutual companies are not subject.

Mr. HARRIS. Do you think the SEC would require more burdensome procedures of the stock companies than the Government agency which has control over banks and mutuals would require of them?

Mr. DEERING. I think we are already subject to the same type of rigid controls that banks and mutual companies are, and this would simply put an additional requirement on us. It would require additional reporting; it would require the furnishing of additional information; and it would require a change in our complete accounting system.

Mr. HARRIS. Had you completed?

Mr. DEERING. No, sir. I thought you had a question that you wanted to ask.

Mr. HARIS. Well, the bill, as I understand it, has provisions that the matters coming under the jurisdiction of the banking Commissioner is referred to the jurisdiction of that Commission.

Mr. DEERING. I believe that is correct.

Mr. HARRIS. My question is, Do you think that the SEC will impose greater burdens on the insurance business than the bank Commissioner would on the mutuals and savings and loan associations, banks, and so so forth?

Mr. DEERING. Unquestionably I think so.

Mr. HARRIS. Why?

Mr. DEERING. Because I don't think that the bank Commissioners intend to require the banks to provide them with the additional reports that the SEC will require us to file. I don't believe the banking Commissioners will require the banks to register their stock with them as the SEC would require us to do. I don't believe the bank Commissioners will impose the proxy rules on the banks that the SEC will impose upon us under this legislation.

Of course, there are some banks and savings and loans that are completely exempted from the bill, not covered in any way by it. As far as mutual companies are concerned, I don't believe there is any provision in the bill whatsoever which would impose any requirement on them because they have no stock outstanding.

Mr. HARRIS. I was going to ask Mr. Roberts later on if he was suggesting that mutuals be brought under this, too.

Mr. ROBERTS. I never suggested that anyone be subject to the hardships of filling out the forms that the SEC has indicated that it requires in that 19-page summary of the form they propose.

Mr. HARRIS. You may proceed.

Mr. DEERING. We are not wishing this bill on anyone. We are, however, pointing out the fact that we believe it is unfair to single out our industry as the only financial industry which is being subjected to the legislation and to thereby create an additional discrimination or

competitive disadvantage between ourselves, the stock companies, and the mutual companies.

So far as the life insurance companies are concerned, we don't believe the bill is needed and it certainly is not wanted. We have never had any complaints from the stockholders of our company concerning the failure to furnish adequate information.

I have never understood that this was a general complaint. I have never understood from what source the need for this particular regulation of our industry comes. As has been indicated here, I believe it is opposed by all the members of our industry. It is certainly opposed by the National Association of Insurance Commissioners.

They are, as you know, on record with a resolution opposing it. It is opposed by the U.S. Chamber of Commerce and it is opposed by all the trade associations involving the insurance industry.

We sincerely urge the committee to seriously consider amending the present bill to eliminate life insurance companies from the legislation. Thank you.

(Statement and exhibit 1 follow:)

STATEMENT BY FRED A. DEERING, JR., VICE PRESIDENT AND GENERAL COUNSEL, SECURITY LIFE & ACCIDENT CO., ON BEHALF OF THE COLORADO LIFE CONVENTION

This statement is made on behalf of the Colorado Life Convention, which is an association composed of most of the life insurance companies domiciled in the State of Colorado. The member companies, all of which are stock corporations, are:

Bankers Union Life Insurance Co., Denver, Colo.
Capitol Cooperative Life Insurance Co., Denver, Colo.
The Capitol Life Insurance Co., Denver, Colo.
The Denver National Life Insurance Co., Denver, Colo.
Howard Life Insurance Co., Denver, Colo.
National Farmers Union Life Insurance Co., Denver, Colo.
National Western Life Insurance Co., Denver, Colo.
Olinger Life Insurance Co., Denver, Colo.
Security Life & Accident Co., Denver, Colo.
State Life Insurance Co. of Colorado, Denver, Colo.
United American Life Insurance Co., Denver, Colo.
Western Empire Life Insurance Co., Denver, Colo.
Western Farm Bureau Life Insurance Co., Denver, Colo.
Western Reserve Life Insurance Co., Grand Junction, Colo.
Woodmen of the World, Denver, Colo.

This statement, and the testimony which will be given by the undersigned at the subcommittee hearings, is pursuant to the express authorization and direction of the members of the convention.

It is the position of the Colorado Life Convention that insurance companies should be excluded from the provisions of the pending legislation.

I. EFFECT ON COLORADO LIFE INSURANCE COMPANIES

The companies which comprise the membership of the Colorado Life Convention are comparatively small. Their capital and surplus ranges from $516,000 at one extreme to $6,611,000 at the other. A number of them commenced business since World War II. None of them are numbered among the "giants" in the insurance industry, with whom all of them must compete.

Earlier witnesses before this subcommittee have testified as to the estimated cost to the average company of complying with the accounting and other procedural requirements of the proposed legislation. It is submitted that most of the estimates are completely inapplicable to life insurance company operations. They were made by witnesses familiar with normal industrial or manufacturing companies which do not have accounting systems peculiar to insurance companies. Furthermore, the earlier estimates seem to ignore the initial cost of registering the stock with the Securities Exchange Commission.

Life insurance company accounting is, and always has been, unique, because of the involved actuarial problems encountered. This fact has long been recognized by the National Association of Insurance Commissioners (hereinafter called NAIC) in the requirements which it imposes in connection with the preparation and filing of life insurance company statements. The expense and complexity of certification of a life insurance company statement far exceeds certification of the balance sheet of any other type of corporation—financial or industrial.

Reliable independent estimates which we have received indicate that for the average member of the Colorado Life Convention the initial registration of its stock would require an expenditure of $25,000 to $35,000. Compliance with the annual reporting requirements thereafter would necessitate an additional annual expenditure in the neighborhood of $15,000 to $20,000 per year, and the cost of reporting for the first year would be substantially in excess of this figure. For many of the Colorado Life Convention companies this would constitute a substantial percentage of their yearly operating gains. The sharply increased cost to the small life insurance company cannot be ignored simply because the SEC has represented that it will not apply the same accounting standards to the insurance industry. The statute does not provide for special treatment of insurance companies and a letter from the SEC, or statements made before this committee, that the SEC will apply different standards to the insurance company reporting, do not have the weight of law, and are of little significance. If different rules are to be applied to insurance companies, as the SEC suggests, then the insurance industry should be the subject of separate legislation.

II. PRESENT REGULATIONS AND DISCLOSURE REQUIREMENTS ARE MORE THAN ADEQUATE

The Chairman of the SEC has stated that the function of the pending legislation is "to make available reliable financial and business data as a base for the exercise of informed investment judgment and to prevent abuse by insiders in security trading."

There is probably no industry in the United States more meticulously and completely regulated than the life insurance industry. This regulation has led to one of the highest degrees of financial stability and responsibility in the world.

It is common knowledge that a life insurance company is required to file in each State in which it is qualified to do business an annual statement reflecting its operations and financial condition for the preceding year. The form of the annual statement has been standardized by the NAIC, and now consists of a 51-page legal-size report. It is difficult to imagine a more comprehensive accounting of operations and conditions.

Each life insurance company is subjected to an exhaustive examination at least every 3 years by representatives of the insurance department of its home State. This examination is also participated in by representatives of the insurance departments of other States in which the company is qualified to do business. The triennial examination of the company by which the undersigned is employed has just been completed. The examination was participated in by representatives of the States of Colorado, Kentucky, Utah, and Wyoming (representing zones 3, 5, and 6). The examination was commenced in late June of 1963, and was not completed until 4½ months later. The cost to the company, direct and indirect, exceeded $30,000. The results of the examination are embodied in a 109-page report which the company will file with the insurance commissioner of each of the 36 States in which it is operating, and a copy of which is attached as exhibit 1. The report comprises not only an examination of the company's affairs but also contains specific recommendations concerning modifications in certain accounting and operational procedures.

In addition to filing an annual statement in all of the States in which each life insurance company is licensed to do business, and subjecting itself to the triennial examination described above, in almost every State the company is required to publish a summary of its annual statement in a newspaper of general circulation. A typical State form utilized for this summary is attached as exhibit 2. Furthermore, many independent insurance company analysts, of national reputation, annually publish accurate and complete financial and operating information on all life insurance companies doing business in this country. These analysts, which are completely objective in their reporting, include Best's Life Insurance Reports, Dunne's Reports, and Standard & Poore.

The information required to be furnished in a life insurance annual report is not limited to actuarial accounting and financial data. The report covers the entire scope of the company's operations. Illustrative of the comprehensive nature of the report are the following "nonaccounting" items which must be reported:

1. A statement as to the dividends and proportion of profits which the company may pay to stockholders.
2. The proportion of unassigned surplus held for stockholders.
3. The total amount paid in by stockholders since the organization of the company as surplus funds.
4. Total dividends paid stockholders since organization of the company, both cash and stock.
5. The interest, direct or indirect, which the company has in the capital stock of any other insurance company.
6. Whether personnel or facilities of the company are used by any other company or companies.
7. Whether the company is directly or indirectly owned or controlled by any other company, corporation, group of companies, partnership or individual.
8. Whether the company owns any securities of a real estate holding company or otherwise holds real estate indirectly.
9. Whether any officer, director, or trustee of the company received, directly or indirectly, any commission on the business transactions of the company.
10. Whether the company has an established procedure for disclosure to its board of trustees of any material interest or affiliation on the part of any of its officers, directors, trustees, or any responsible employees which is in, or is likely to, conflict with the official duties of such person.
11. The amount of compensation, if any, received by any officer, trustee, or director of the company for services rendered as a member of any bond or stockholders' organization or protective committee with which the company has deposited any securities, and the amount of such compensation retained by the representative.
12. Whether the company has a retirement plan for agents and/or staff employees.
13. The total amounts loaned during the year to directors or other officers and stockholders who are not officers.
14. Whether all stocks, bonds, and other securities were in the actual possession of the company at the end of the year covered by the report.
15. Whether any change has been made during the preceding year in the charter, articles of incorporation, or deed of settlement of the company.
16. The States, territories, or foreign countries in which the company is authorized to transact business.
17. The company department passing on purchase and sale of investments of the company.
18. All payment in excess of $1,000 which the company made to each trade association, service organization, statistical, actuarial or rating bureau or organization during the year.
19. All salaries, compensation and emoluments (except bona fide commissions paid to or retained by agents) received in the preceding year by each director or trustee, regardless of the amount thereof, each of the 10 officers receiving the largest amounts, and other person, firm, or corporation if the amount received was in excess of $20,000.
20. A summary of all insurance claims pending against the company, and a statement as to the reason why any claim was compromised or resisted.
21. A detailed statement of all legal expenses paid during the preceding year, listing individually all items of $500 or more.
22. A detailed showing of all expenditures in connection with matters before legislative bodies, officers or departments of government during the preceding year.
23. The names of the candidates for the board of directors or trustees of the company in the last annual election, and the number of votes cast for each candidate.
24. Whether any of the company's reinsurers are owned or controlled, either directly or indirectly, by the company, or by any representative, officer, trustee, or director of the company.

The triennial examination of each company, a matter of public record, also reports on extensive phases of the company's operations over and above the accounting aspects.

In addition to the reporting requirements of the various States, the legislatures and insurance departments of each State, and the NAIC, impose countless restrictions and regulations on the financial and other operations of life insurance companies. All of these regulations and statutes are designed to effectively prevent the abuse of their public trust by any life insurance company, its officers, trustees, directors, employees, and representatives. These statutory and regulatory restrictions range from prohibiting payment of commissions to officers and directors of a life insurance company to rigid control of the investments which the company is permitted to make. In Colorado alone, 173 pages of the statutes are devoted to the control and regulation of insurance companies.

Although it is true that there are presently no requirements for the control of "insider trading" in the stock of a life insurance company, this will shortly be rectified by the NAIC which is presently considering a regulation requiring disclosure of such information in a company's annual report.

To assert that the financial, operational, and other regulations to which life insurance companies are presently subjected is designed only for the protection of policyholders is patently absurd. In most instances the interests of policyholders and stockholders are closely parallel if not identical. Any regulation designed to protect and preserve the company's assets, scrutinize the company's financial activities, to insure elimination of conflicting interests on the part of officers, directors, and employees, and to require complete disclosure of all operations, must necessarily benefit investors in the company's stock.

To superimpose a new regulatory agency requiring still more reporting by life insurance companies, is not only completely redundant, it is economically foolish.

III. NO REAL NEED EXISTS FOR THE INCLUSION OF LIFE INSURANCE COMPANIES IN THE BILL

Legislation of the type proposed, which would impose onerous and expensive regulatory burdens on one of the most stringently regulated areas of our business economy, should only be predicated on a showing of real need. The proponents of this legislation have failed to show that such a need exists. In the few instances where life insurance companies, or their officers, have been involved in undesirable practices concerning life insurance company stock, the existing framework of Federal and State legislation has been fully adequate to meet the problem. The Securities Exchange Commission submitted a memorandum to the Senate committee during the hearings on this bill. Attached to that memorandum was a summary of fraud cases concerning insurance stock traded in the over-the-counter market. In every instance cited by the SEC in its memorandum the relief sought, whether by criminal conviction or injunction, was successfully obtained under State or Federal laws already in existence.

Insurance companies are already subject to, and must comply with, the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940 in connection with public offerings of their stock.

With regard to life insurance companies, the only real need for legislation of this type which has been shown concerns disclosure of insider trading transactions. As indicated, the NAIC is now engaged in drafting regulations which will require such disclosure in an insurance company's annual statement.

IV. CONCLUSION

The members of the Colorado Life Convention are not large companies. For many of them, the imposition of the additional expense which would be required to comply with this bill could very well mean the difference between a profit or a loss, particularly in the case of new companies.

It is already difficult for stock insurance companies to compete with the mutuals. This legislation would increase the competitive disadvantage since it would not affect the mutual companies.

So far as life insurance companies are concerned, this bill is not needed and is not wanted. It is opposed by every segment of the insurance industry, including the American Life Convention and the National Association of Insurance Commissioners, which has adopted a formal resolution in opposition to the legislation. We sincerely urge this committee to amend the bill so as to exempt insurance companies from its operation.

EXHIBIT I

SECURITY LIFE & ACCIDENT CO., DENVER, COLO., REPORT OF EXAMINATION AS OF DEC. 31, 1962

REPRESENTATION

Colorado	Zone 5
Kentucky	Zone 3
Utah	Zone 6
Wyoming	Zone 5

DENVER, COLO., *November 8, 1963.*

Hon. J. EDWIN LARSON,
Chairman, Committee on Examinations and Zone 3, National Association of Insurance Commissioners, Insurance Commissioner, Tallahassee, Fla.
Hon. HARVEY G. COMBS,
Chairman, Zone 5, National Association of Insurance Commissioners, Insurance Commissioner, Little Rock, Ark.
Hon. PAUL A. HAMMEL,
Chairman, Zone 6, National Association of Insurance Commissioners, Insurance Commissioner, Carson City, Nev.
Hon. SAM N. BERRY,
Commissioner of Insurance, Denver, Colo.
Commissioner of Insurance,
Denver, Colo.

SIRS: Pursuant to your respective instructions and in compliance with the insurance laws of the State of Colorado, a triennial examination has been made as of December 31, 1962, of the financial condition and affairs of the Security Life & Accident Co., 810 Fourteenth Street, Denver, Colo., hereinafter referred to as the "Company," and the report thereon is herewith submitted:

SCOPE OF EXAMINATION

The Company was last examined as of December 31, 1959, by the Colorado Insurance Department with examiners from the States of Kansas and Texas representing zone 5 of the National Association of Insurance Commissioners. This review embraces the next triennial ending December 31, 1962, and was conducted by the Colorado Insurance Department with participation by examiners from the States of Kentucky, Wyoming, and Utah representing zones 3, 5, and 6, respectively.

During the course of the examination, the transactions of the Company were reviewed or tested by methods and to the extent deemed appropriate which included a review of the general operations, treatment of policyholders, checking ledger balances to office copies of the annual statements for each of the 3 years under review, inspection of accounts and records, and determination of the financial condition as of December 31, 1962.

Explanation of and details pertaining to the various phases of the examination will be found under their respective captions hereinafter set forth.

HISTORY AND CAPITAL

The forerunner to the existing corporation was incorporated under the laws of Colorado, August 13, 1929, under the name of Gibraltar Life & Accident Co. and was licensed to sell insurance September 30, 1930. The name was changed to Colorado Life Co. on February 28, 1934, and to Security Life & Accident Co. on February 17, 1941.

During its years of operation, its business was increased from time to time through the assumption of policies in force in other companies as follows:

On January 1, 1931, the business of the Continental Mutual Insurance Co. was reinsured.

By reinsurance contract effective December 31, 1933, the insurance business of the former Colorado Life Co. was acquired. That company took the name Gibraltar-Colorado Life Co. on the same date that Gibraltar Life & Accident Co. became Colorado Life Co.

The State Reserve Mutual Insurance Co. was reinsured as of November 29, 1941.

On February 8, 1943, the business of Cosmopolitan Life Insurance Association of Salt Lake City, Utah, was acquired through purchase of a management contract.

The accident and health business of Guardian Central Life Insurance Co. was reinsured on July 30, 1957.

The Company was organized under the laws of the State of Colorado as a stock casualty company on November 14, 1949, and was licensed to transact insurance business on May 12, 1950. On October 16, 1957, the management reinsured all premiums in force and retired from the insurance business except as to the liquidation of outstanding claims.

In the latter part of 1958 new ownership acquired the capital stock and on December 19, 1958, the articles were amended increasing the authorized capital stock to $500,000 consisting of 50,000 shares of the par value of $10 per share. The articles were again amended on July 10, 1959, changing the name to Centennial Life Insurance Co. and increasing the authorized capital to $1 million. The purpose of the corporation was changed from casualty insurance to life insurance, accident and health insurance, and annuities.

Pursuant to the articles of merger approved by the respective groups of stockholders, the Security Life & Accident Co. was merged into the Centennial Life Insurance Co. with the transfer of insurance business on December 31, 1959, and the exchange of stock and filings of documents completed in January 1960. In accordance with the articles of merger filed with the secretary of state on January 18, 1960, the name was changed to its present style, Security Life & Accident Co.

Immediately following the completion of the merger, the authorized capital was $1 million consisting of 225,000 shares of series A common stock of a par value of $4 per share and 25,000 shares of series B common stock of a par value of $4 per share. Each share of series A stock having one vote per share and each share of series B stock having eight votes per share.

At the annual meeting of stockholders held February 21, 1961, the articles of incorporation were amended to provide an authorized capital of $1,250,000 consisting of 312,500 shares of $4 par value common stock divided into 281,250 shares of series A and 31,250 shares of series B. On the same date the board of directors declared a 25 percent stock dividend to stockholders of record on February 28, 1961, bringing the total issued and outstanding to the total authorized, except as to fractional shares purchased as treasury stock.

The articles of incorporation were again amended at the annual meeting of stockholders held February 21, 1962, to provide an authorized capital of $1,500,000 consisting of 375,000 shares of $4 par value common stock divided into 337,500 shares of series A and 37,500 shares of series B. On the same date the board of directors declared a 20 percent stock dividend to stockholders of record on February 28, 1962, which increased the issued and outstanding to equal the total authorized capital. Fractional shares were purchased by the Company as treasury stock.

Dividends paid on the capital stock of the Company for the period covered by this examination are summarized as follows:

Year	Cash	Stock
1960	$149,160.00	
1961	186,412.20	$250,000
1962	224,058.60	250,000

Treasury stock

As mentioned above, the company acquired treasury shares through stock dividends and the purchase of fractional shares when issued. Additional treasury shares were acquired through the purchase of stock owned by a dissenting stockholder. Treasury stock balances for the period covered by this examination are reconciled as follows:

	1960	1961	1962
Balance, Jan. 1	1,220	1,400.0	1,810
Add: Acquired from stock dividends		349.5	362
Purchases:			
Fractional shares		102.5	104
Other	192		
Subtotal	1,412	1,852.0	2,276
Deduct:			
Stock options exercised	2	42.0	924
Stock held pending settlements of estates	10		
Total deductions	12	42.0	924
Balance, Dec. 31	1,400	1,810.0	1,352

The company follows the practice of writing off the cost of Treasury stock and recording the sales as net gains. These transactions are reported in schedule X of the annual statement. It is recommended that in the future the company report its holding of Treasury stock through exhibits 13 and 14 of the annual statement in accordance with the requirements thereof.

Stock options

The company has from time to time granted stock options to certain officers and employees to purchase available Treasury stock under "option to purchase" agreements. No options were granted during the period covered by this examination. However, as reflected in the preceding tabulation, options for the purchase of 968 shares of stock were exercised during the 3 years under review from previous authorizations. According to company records one individual held options for the purchase of 822 shares of company stock at December 31, 1962.

MANAGEMENT AND CONTROL

The business of the company is conducted on the proprietary plan with its affairs under control of a board of directors who are elected annually by the stockholders.

Annual meeting

The annual meeting of the shareholders of the company for the election of directors and transaction of other business shall be held on the third Wednesday of February of each year. Special meetings may be called by the president or by the secretary or by resolution adopted at a meeting of the board of directors or on call signed by one or more shareholders holding an aggregate of not less than 10 percent of all votes entitled to be cast at meetings. Notice of the time and place of all regular and special meetings shall be prepared by the secretary, and may be delivered personally, or deposited in the post office, to each shareholder not less than 10 nor more than 50 days before such meeting.

A quorum shall consist of a majority of the votes entitled to be cast.

Board of directors

The bylaws provide that the property, interests, business, and transactions of the company shall be managed by a board of directors consisting of six members elected annually by the shareholders to serve a term of 1 year.

Directors duly elected and serving at December 31, 1962, together with their addresses and business affiliations, are as follows:

Name, address, and business affiliation:

J. M. Campbell,[1] Denver, Colo., chairman of the board emeritus, Security Life & Accident Co.

F. Burr Betts, Parker, Colo., president, Security Life & Accident Co.
Ira J. McGuire, Denver, Colo., executive vice president, Security Life & Accident Co.
J. F. Johns,[2] Sun City, Calif., retired.
Robert E. Warren, Denver, Colo., vice president, Security Life & Accident Co.
W. L. Baldwin, Denver, Colo., insurance consultant.

Officers

Officers duly elected or appointed and serving at December 31, 1962, are as follows:

Name and title:

J. M. Campbell, chairman of the board emeritus.
F. Burr Betts, president.
Ira J. McGuire, executive vice president.
Robert E. Warren, vice president.
Stuart C. Ferris, vice president.
Paul M. Bailey, vice president and actuary.
Marshall C. Pratt, vice president.
William W. Fralick, vice president.
Nelson Aregood, Jr., controller.
Fred J. Beck, agency secretary.
Donald S. Benny, underwriting secretary.
Florence Delaney, assistant secretary.
James M. Dutton, assistant vice president.
William R. Ernst, director of agencies.
Robert W. Gordon, M.D., medical director.
A. E. Joens, assistant actuary.
Ronald Ham, assistant actuary.
Willard J. Karcher, treasurer.
Robert W. Kershaw, director of sales.
Wm. C. Neu, secretary.
G. W. O'Shaughnessy, assistant vice president.
Donald F. Shea, assistant secretary.
Bernard Springer, director of sales promotion.
Herbert G. Wood, supervisor of training.

Committees

The following named individuals were named to the committees indicated at the annual meeting of the board of directors:

Executive committee:
J. M. Campbell
Ira J. McGuire
F. Burr Betts
Robert E. Warren

Securities committee:
J. M. Campbell
Willard J. Karcher
Donald Shea
F. Burr Betts
Paul M. Bailey
Ira J. McGuire

Building committee:
F. Burr Betts
Nelson Aregood, Jr.
Willard J. Karcher
Donald Shea

CORPORATE RECORDS

During the period covered by this examination the company acted as its own transfer agent. Individual stockholders' records were maintained on IBM punched cards from which stockholder lists were prepared periodically. During 1963 the company employed the services of an independent transfer agent and transferred individual accounts to the agent prior to this examination. For the

[1] Deceased July 1963.
[2] Deceased May 1963.

purpose of ths examination, stock outstanding was reconciled to a stockholder listing as of November 7, 1962.

Minutes of the meetings of stockholders, directors, and executive committee were reviewed for the 3-year period covered by this examination and found to be sufficiently broad as to cover most matters requiring recorded action. During the period covered by this examination the bylaws were amended in accordance with adopted procedures. Two amendments to the articles of incorporation were made at annual meetings of the stockholders in 1961 and 1962, both concerning the increase in authorized capital stock and previously noted herein under the caption "History and Capital."

BONDS AND OTHER INSURANCE COVERAGES

The company is protected by bonds and other insurance coverages as follows:

Life insurance company blanket bond insured against any loss through any fraudulent or dishonest act of any of the employees including general agents and financial correspondents at lesser amounts	$100, 000
Comprehensive liability:	
Bodily injury, except auto	$250, 000–500, 000
Property damage, except auto	50, 000
Bodily injury, auto	$250, 000–500, 000
Property damage, auto	50, 000
Fire, lightning, extended coverage:	
Home office building	$1, 440, 000
Contents on above	$318, 000
Rental value on above	$200, 000
Steam piping at above location	$50, 000
Comprehensive glass coverage at above location	ACV
Workmen's compensation and employers' liability	$25, 000
Group travel on employees	$250, 000
Professional malpractice on company doctor	$25, 000–75, 000

The company does not carry an errors and omissions policy.

EMPLOYEES AND AGENTS RETIREMENT PLAN

Employees

At a meeting of the board of directors held December 18, 1956, a retirement plan for employees of the company was adopted with an effective date of January 1, 1956.

The plan is administered by a retirement committee composed of the following company officers:

Wm. C. Neu, chairman.
F. Burr Betts.
Ira J. McGuire.
Paul M. Bailey.

Membership in the plan.—In addition to provisions for all employees of the company on the effective date of the plan who have not attained age 75, all persons who are 60 or under, becoming employees of the company after the effective date of the plan, other than service and maintenance employees, shall become members on the first day of the calendar month following the date on which they commerce their service.

Credited service.—Except as otherwise specifically provided, the credited service of a member shall consist of the service rendered on and after the first day of the calendar month next following the date on which his service began and prior to his normal retirement date.

Retirement and retirement annuity.—Each member of the plan shall retire on his normal retirement date.

After retirement a member shall be granted a monthly retirement annuity, the first payment of which shall be made at the end of the calendar month in which his normal retirement date falls, if he is then living, the last payment being made at the end of the calendar month prior to the calendar month of death. The amount of such monthly retirement annuity shall be determined as follows:

For a member retiring at his normal retirement date 1 percent of his final compensation for each year of credited service, plus an additional 1 percent of that portion of his final compensation which is in excess of $350, for each of the first 37½ years of credited service.

The plan also provides for early retirement, continuance of payments after death and disability retirement.

Contributions.—The entire cost of the plan is to be paid by the company. The company expects to continue the contributions to the plan but assumes no responsibility to do so and reserves the right to suspend or to reduce contributions at any time.

Agents

At a meeting of the board of directors held December 6, 1961, a retirement plan for agents and general agents of the company was ratified and approved effective January 1, 1962, subject to necessary amendments as may be required by the Internal Revenue Service. As of the date of this report the plan had not as yet been submitted for approval.

Membership in the plan.—An agent is eligible for membership on the earliest anniversary of the plan when he has completed 1 year of service, has not attained age 60, has earned at least $3,600 in commissions in the next preceding calendar year and has elected in writing to pay the company the required contributions.

Retirement and retirement annuity.—Each member shall retire on his normal retirement date, but the plan provides for earlier retirement under certain conditions.

Member's and company's contributions will be accumulated with compound interest at the rate of 3 percent per annum until the member's normal retirement date. Total accumulated funds arising from the member's contributions will be applied to purchase a single-premium immediate cash refund life annuity, payable monthly. Total accumulated funds arising from the company's contributions shall be applied to purchase an immediate life annuity with no death benefit.

Contributions.—The agent shall contribute a specified percentage of commissions earned to be matched by the company with provision for past-service contributions.

General agents

The general agents plan is similar to the agents plan except as to the requirements for contracts and commissions and the plan's approval by the Internal Revenue Service.

TERRITORY AND PLAN OF OPERATIONS

The company is licensed to transact business in the following States listed by zone, as evidenced by certificates of authority on file at the home office:

Zone II:
- Delaware
- North Carolina
- Ohio
- South Carolina
- Virginia
- West Virginia

Zone III:
- Florida
- Georgia
- Kentucky
- Louisiana
- Mississippi
- Missouri
- Tennessee

Zone IV:
- Illinois
- Indiana
- Iowa
- Minnesota
- North Dakota
- South Dakota

Zone V:
- Arkansas
- Colorado
- Kansas
- Nebraska
- New Mexico
- Oklahoma
- Texas
- Wyoming

Zone VI:
- Arizona
- California
- Hawaii
- Idaho
- Montana
- Nevada
- Oregon
- Utah
- Washington

The company's operations are departmentalized as to ordinary, group, reinsurance, and special risks with a vice president in charge of each department. The ordinary department operates under a general agency system with approximately 75 general agents, 156 agents, 20 agency supervisors, and 267 brokers at June 30, 1963. Supervision of the agency organization is under direct control of a vice president of the company who is assisted by a director of agencies, three regional sales directors, and an assistant vice president in charge of conservation and an assistant vice president who acts as supervisor of training. All contracts are made directly with the company, but general agents may appoint their own subagents subject to approval by the home office. Exclusive territorial contracts are not normally given, although in one instance an exclusive contract was made for the development of one State.

Writing agents, including brokers, are compensated on a commission which is graded according to plan of insurance with a maximum commission of 60 percent on first-year business and 5-percent commission on renewal premiums received on the 2d through the 10th policy year. A supplement to the writing agents contract provides for a bonus contingent upon sufficient volume of life insurance with a satisfactory quality rating.

In addition to the regular commission paid the writing agent, the general agent receives 20 percent of first-year commissions, including quality bonus paid, excluding single premium life, endowment, and annuity business on his own production and that of agents and brokers under his control, plus 1 percent of premiums received in cash by the company on single premium life, endowment, and annuity business. The contract further provides for a renewal overwriting commission of 2 percent of renewal premiums received by the company in cash for the 2d to the 10th policy years. A supplement to the agreement provides for an expense allowance of 15 percent of first-year premiums collected in cash on life insurance and annuity business and 1 percent of renewal premiums on such business. The supplement also provides for a production bonus on life insurance personal production.

All contracts provide for a vested interest in renewal commissions provided certain specified conditions are met.

GROWTH OF THE COMPANY

The following schedule is compiled from annual statements and examination reports and reflects figures taken at selected intervals in the company's history indicating its growth. Those figures shown before the year 1959 are for the old Security Life & Accident Co. only.

Year	Premium income	Admitted assets	Surplus and paidup capital	Insurance in force
1935	----------	$2,549,855	$431,704	$40,251,063
1940	----------	5,407,917	643,003	42,827,435
1950	----------	23,311,509	2,746,092	142,963,405
1959 [1]	$12,193.854	50,453,337	6,640,179	658,193,838
1960	13,638,684	53,604,459	5,390,195	716,322,481
1961	12,912,290	56,540,638	6,317,132	770,612,617
1962 [1]	13,683,968	58,875,269	6,584,425	891,323,059

[1] From examination report.

BUSINESS IN FORCE BY STATES

Business in force by States in which the company is licensed is shown in the following schedule. Number of policies includes reinsurance assumed and master group policies. The number of group life insurance certificates is shown separately. Accident and health premiums represent the direct premium income for the year 1962.

State	Number of policies	Number of group certificates	Life insurance in force	Accident and health premiums, 1962
Arizona	3,944	5,595	$22,374,070	$25,903
Arkansas	1,084	109	3,609,894	30,281
California	13,217	166,516	255,980,830	1,433,679
Colorado	24,571	74,527	208,386,846	1,123,116
Delaware	38	21	410,277	30
Florida	425	7,410	7,993,711	1,736
Georgia	372	324	4,087,776	273
Hawaii	5,826	192	30,229,209	72,112
Idaho	2,161	1,304	9,307,465	68,654
Illinois	716	687	9,849,416	14,129
Indiana	395	192	4,494,618	38,533
Iowa	346	108	2,419,989	329
Kansas	2,698	3,234	14,823,554	152,294
Kentucky	159	168	1,974,665	527
Louisiana	348	132	2,873,601	1,797
Maryland	206	864	6,978,732	248
Minnesota	582	243	5,020,371	3,241
Mississippi	122	93	1,122,284	1,463
Missouri	1,240	344	7,029,735	54,454
Montana	792	2,284	6,254,914	21,742
Nebraska	3,065	193	10,900,122	141,549
Nevada	354	38	1,735,781	8,146
New Mexico	3,895	2,870	21,717,077	126,072
North Carolina	569	166	4,410,659	149
North Dakota	769	33	4,507,399	2,385
Ohio	521	559	6,503,537	60,540
Oklahoma	1,928	354	16,966,147	14,425
Oregon	3,252	838	17,375,587	79,097
South Carolina	147	137	1,908,005	107
South Dakota	997	88	6,230,156	534
Tennessee	566	226	3,282,657	18,715
Texas	12,986	1,748	64,391,116	469,439
Utah	3,904	3,589	17,452,817	400,184
Virginia	353	900	8,432,575	457
Washington	3,901	468	23,645,100	49,852
West Virginia	332	62	2,202,334	12
Wyoming	2,829	1,099	16,231,022	39,613
All others	3,741	4,725	58,209,011	7,125
Total	103,351	282,440	891,323,059	4,462,942

MORTALITY EXPERIENCE

The company's mortality experience for the years indicated is as follows:

Year	Expected mortality	Actual mortality	Savings from mortality	Ratio of actual to expected (percent)
1959	$4,105,936	$2,460,678	$1,645,258	59.93
1960	4,964,194	2,424,826	2,539,368	48.85
1961	4,295,954	2,619,149	1,676,805	60.97
1962	4,769,196	3,291,786	1,477,410	69.02

POLICY FORMS AND UNDERWRITING PRACTICES

The regular forms of ordinary life, individual annuities, group life and accident and health, and personal accident and health coverages are written on the participating and nonparticipating plans. It also operates extensively in the life reinsurance field. The maximum net retention on one life is $50,000.

A few of the policy forms written by the company might warrant a brief description:

The security home protection policy has been referred to as a single plan mortgage redemption contract. Each unit of this plan provides $5,000 of life insurance the first year. This amount is reduced by $150 each year for the 10 succeeding years, and then by $200 each year for the following 10 years, reaching an amount of $1,500 at the beginning of the 21st year, and remaining level thereafter. The premium remains level throughout the lifetime of the policy owner.

The family security policy provides coverage for the entire family in the form of permanent insurance for the father and temporary insurance for all other members of the family unit.

Security's education plan is a juvenile 20-payment life policy which furnishes a flexible plan to provide $50 monthly over the 4 college years.

The security career builder policy provides a minimum amount of protection during childhood years when needs for protection are at a minimum. At age 21, when needs for protection have increased, the amount of insurance under the policy automatically increases from $1,500 to $5,000 for each unit in force. The premium remains level throughout the duration of the contract.

The salary savings plan provides a way for employees to pay premiums on their own and their families' lives through automatic deduction from their pay. The collection of the premium is handled directly between the company and the insured's employer.

Joint policies are issued on two lives providing for payment of the face amount upon the first death. These policies are issued on the following plans at nonpar rates: Ordinary life, 20-pay life, and 20-year endowment.

The company's nonmedical limits are as follows:

Ages	Regular	With term additions dividend option rider
0 to 25	$25,000	$15,000
26 to 35	15,000	10,000
36 to 40	7,500	5,000
Over 40	(1)	(1)

[1] Nonmedical not accepted.

Even though an applicant comes within the nonmedical limits, the company reserves the right to request an examination.

REINSURANCE

The company is protected on life risks in excess of its authorized retention through an automatic reinsurance agreement with the Connecticut General Life Insurance Co., Hartford, Conn. Coverage is automatic within the following limitations:

Standard life	Retention	Automatic facilities	Total
Age:			
0 to 9	$50,000	$50,000	$100,000
10 to 14	50,000	150,000	200,000
15 to 50	50,000	200,000	250,000
51 to 55	40,000	160,000	200,000
56 to 60	30,000	120,000	150,000
61 to 65	20,000	80,000	100,000
66 and over	10,000	10,000	20,000

NOTE.—Substandard reinsurance is automatic within scheduled limits.

Waiver of premium disability benefit coverage is automatic for an amount not greater than the corresponding life reinsurance. Accidental death benefits are automatically reinsured within scheduled limits.

In addition to the foregoing, the company has binding authority on two companies for reinsurance in excess of the above limits under reciprocal obligatory contracts. Facultative reinsurance is available under several agreements, four of which were active in the current year.

Accident and health risks are reinsured under an agreement with Employers Reinsurance Corp., Kansas City, Mo.

The company has assumption contracts in effect with approximately 250 companies. Of these, 64 are automatic agreements and of the remaining, 25 were active during the current year.

DIVIDENDS TO POLICYHOLDERS

The profit-sharing provisions of the company's participating policies provide generally as follows:

An annual dividend, as determined by the company, out of its surplus, will be payable hereon at the end of the second policy year, and at the end of each subsequent policy year, for the life of the insured, while this policy be in full force. Each such annual dividend will be payable in cash and will not be contingent upon payment of any premium next due.

Any dividend, when available, if not withdrawn in cash, may be used in any one of the following ways:

(*a*) Applied toward payment of any premium next due hereunder, if the balance thereof be duly paid; or

(*b*) Carried to the credit of this policy under the deposit provision hereof; or

(*c*) Applied to purchase paid-up life insurance as an addition to this policy.

If within 2 months after a dividend becomes payable the insured shall not have withdrawn it in cash, or filed written election as to the way in which it shall be applied, it shall be applied automatically under option (*b*) above, unless the laws of the State in which this policy is delivered require otherwise.

Of the $523,271,503 ordinary business in force, $89,921,867 is on the annual dividend or participating basis. The dividends to policyholders for the year 1962 amounted to $375,054.26.

TREATMENT OF POLICYHOLDERS

The treatment of policyholders was observed during a review of claims that had been resisted, compromised, or closed without payment during the 3-year period covered by this examination. In all cases the company's position appeared to be tenable. In addition, a review of paid claims indicated that the company settles just claims for death and other benefits promptly upon receipt of necessary proofs and in accordance with policy and contract provisions. The only exception: A few older claims remained open due to the lack of followup on the part of the company. This was brought to the company's attention and remedial steps have been taken to alleviate this situation.

Other various phases of the examination disclosed fair and equitable treatment of policyholders under the general provisions of the policy contract.

ACCOUNTS AND RECORDS

The company's general ledger is maintained by electronic data processing equipment. Entries into the general ledger are made either by summary punchcards, prepared from totals of daily transaction journals, or from punchcards prepared from individual transaction data. At the end of each month the new monthly totals of the general ledger are arrived at by preparing a run which combines the beginning of the month's year-to-date punchcards with the previously mentioned punchcards which reflect the transactions for the month. As this run is being prepared the electronic accounting equipment simultaneously punches new year-to-date cards which reflect the updated account balances of the general ledger. A run which constitutes the current trial balance of the general ledger is prepared from the year-to-date cards.

The company's general ledger and subsidiary expense records are not coded in many instances so as to allow the electronic accounting equipment to produce the various account categories required by the annual statement blank. Numer-

ous yearend adjustments to the general ledger and subsidiary expense records are required to prepare the annual statement. This necessitated preparing year-end trial balances of the general ledger, the subsidiary expense ledger, and the new account balances resulting from the yearend adjustments in order to trace the ledger accounts to the individual categories required by the statement blank.

A comprehensive review of the company's accounting procedures and internal controls was made at the outset of the examination. Individual transactions were reviewed on a test basis for proper distribution. The company's 1961 and 1962 summary of operations was reconciled to the ledger accounts. No exceptions were noted.

Employees' retirement trust

The trustee of the employees' retirement trust fund maintains accounting records of the transactions involving the income, disbursements, and corpus of the fund. Details of the transactions are reported monthly to the retirement committee which are summarized showing receipts and disbursements for the month and the aggregate for the year to date. At least once each year the trustee submits a detailed listing of all investments held for the fund.

FINANCIAL STATEMENTS

Financial statements are presented in the following pages of this report as follows:

Balance sheet—assets, liabilities, surplus, and other funds as of December 31, 1962.
Reconciliation of ledger assets for the year 1962.
Summary of operations for the year 1962.
Surplus account reconciliation at December 31, 1962.
Exhibit of taxes, licenses, and fees for the year 1962.
Exhibit of general expenses for the year 1962.
Exhibit of net investment income for the year 1962.
Exhibit of interest, dividends, and real estate income for the year 1962.
Exhibit of capital gains and losses on investments for the year 1962.

Balance sheet as of Dec. 31, 1962

ASSETS

	Ledger assets	Nonledger assets	Assets not admitted	Net admitted assets
Bonds	$15,847,092.37			$15,847,092.37
Stocks	867,315.95	$103,453.15		970,769.10
Mortgage loans on real estate	32,543,579.82		$6,463.00	32,537,116.82
Real estate	1,415,509.79			1,415,509.79
Policy loans	4,097,275.52		5,000.00	4,092,275.52
Cash and bank deposits	1,747,078.13			1,747,078.13
Amounts recoverable from reinsurers		10,343.16		10,343.16
Agents' balances	563,502.26		563,502.26	
Bills receivable	69,041.85		69,041.85	
Share of Federal employees group conversion pool fund	10,905.79			10,905.79
Company's equity in split-dollar plans	22,360.75			22,360.75
Life insurance premiums and annuity considerations deferred and uncollected		1,756,404.00		1,756,404.00
Accident and health premiums due and unpaid		141,071.00		141,071.00
Interest and other investment income due and accrued		323,909.70	5,143.00	318,766.70
Liens upon policy reserves		5,576.01		5,576.01
Special trust funds:				
Less reserve for mortgage... $467,238.58				
Escrow funds... 467,238.58				
	0			
Total	57,183,662.23	2,340,757.02	649,150.11	58,875,269.14

LIABILITIES

Aggregate reserve for life policies and contracts		$43, 860, 370. 00
Aggregate reserve for accident and health policies		1, 455, 946. 00
Supplementary contracts without life contingencies		489, 948. 00
Policy and contract claims:		
Life		420, 071. 00
Accident and health		333, 820. 00
Policyholders' dividend accumulations		2, 175, 829. 00
Policyholders' dividends due and unpaid		28, 488. 77
Provision for policyholders' dividends payable		235, 671. 28
Premiums and annuity considerations received in advance		110, 140. 00
Liability for premium deposit funds		775, 374. 00
Policy and contract liabilities not included elsewhere:		
Surrender values on canceled policies		95. 82
Provision for experience rating refunds, group and reinsurance		476, 260. 80
Cosmopolitan health benefit reserves		3, 084. 00
Life conservation benefit reserve		2, 167. 00
Annuity savings certificates		204. 00
Commissions to agents due or accrued		17, 820. 20
General expenses due or accrued		81, 138. 77
Taxes, licenses, and fees due or accrued		397, 897. 88
Cost of collection on premiums deferred and uncollected in excess of total loading thereon		18, 026. 00
Unearned investment income		98, 939. 69
Amounts withheld or retained by company as agent or trustee		173, 485. 34
Amounts held for agents' account		2, 133. 12
Remittances and items not allocated		44, 832. 20
Mandatory securities valuation reserve		306, 397. 70
Missouri group mass hazard reserve		215, 344. 81
Claim fluctuation reserves		547, 359. 04
Field force retirement plan		20, 000. 00
Total liabilities		52, 290, 844. 42
Contingency reserve	$2, 000, 000. 00	
Capital paid up	1, 500, 000. 00	
Unassigned surplus	3, 084, 424. 72	
		6, 584, 424. 72
Total		58, 875, 269. 14

Reconciliation of ledger assets, year 1962

Increases in ledger assets:	
Premiums on life policies and annuity considerations	$9, 274, 588. 49
Accident and health cash premiums	4, 247, 174. 19
Consideration for supplementary contracts with life contingencies	18, 710. 43
Consideration for supplementary contracts without life contingencies	96, 593. 97
Dividends left with the company to accumulate at interest	207, 548. 41
Interest, dividends, and real estate income	2, 738, 336. 94
Increase of paid-up capital during year	250, 000. 00
Deposits received, life	89, 858. 28
Mortgage loan reorganization, service and commitment fees, and parking lot	19, 451. 00
Considerations received for field force retirement plan	9, 722. 68
Unclaimed equities	8, 539. 01
Charges to agents on cancellation	448. 00
Net gain on sale of Treasury stock	33, 828. 00
From sale or maturity of ledger assets	13, 713. 63
Total increases in ledger assets	17, 008, 513. 03

Reconciliation of ledger assets, year 1962—Continued

Decreases in ledger assets:		
Policy and contract claims:		
Life		$4,278,230.09
Accident and health		2,760,221.32
For annuities with life contingencies, excluding payments on supplementary contracts		23,625.43
Surrender values		959,475.81
Group conversions		3,796.57
Interest on policy or contract funds		35,888.89
Dividends to policyholders:		
Life insurance and annuities		354,764.68
Accident and health		1,475.86
Total paid policyholders		8,417,478.65
Paid for claims on supplementary contracts:		
With life contingencies	$26,556.73	
Without life contingencies	95,975.95	
		122,532.68
Dividends and interest thereon on deposit disbursed during the year		237,796.15
Cash deposits disbursed		146,966.14
Commissions to agents:		
Life insurance and annuities	$1,098,515.70	
Accident and health	728,605.27	
Policy, membership, and other fees retained by agent	569.00	
		1,827,689.97
General expenses		2,266,327.84
Taxes, licenses, and fees		678,408.81
Paid stockholders for dividends (cash $224,058.60; stock $250,000)		474,058.60
Interest on borrowed money		944.44
Net decrease in Federal employees group conversion pool fund		750.85
Decrease in ledger liabilities	$377,542.50	
Coinsurance considerations allowed	105,779.83	
		483,322.33
Assets charged off	756.56	
Adjustments to ledger accounts	2,067.05	
Losses on foreign exchange	262.77	
		3,086.38
From sale or maturity of ledger assets		1,431.30
By adjustment in book value of ledger assets		29,504.09
Total decreases in ledger assets		14,690,298.23
Reconciliation between years:		
Amount of ledger assets Dec. 31, 1961		54,865,447.43
Increase in ledger assets during year		2,318,214.80
Total ledger assets Dec. 31, 1962		57,183,662.23

Summary of operations, year 1962

Premiums and annuity considerations:	
Life	$9,370,267.49
Accident and health	4,313,700.19
Considerations for supplementary contracts with life contingencies	18,710.43
Considerations for supplementary contracts without life contingencies and dividend accumulations and life deposits received	394,000.66
Net investment income	2,364,594.77
Miscellaneous income	38,160.69
Total	$16,499,434.23
Deduct:	
Death benefits	3,850,469.96
Matured endowments	378,098.78
Annuity benefits	23,625.43
Disability benefits	57,578.61
Surrender benefits	959,475.81
Group conversions	3,796.57
Benefits under accident and health policies	2,901,897.07
Interest on policy or contract funds	35,888.89
Payments on supplementary contracts with life contingencies	26,556.73
Payments on supplementary contracts without life contingencies and of dividend accumulations	480,738.24
Increase in aggregate reserve for policies and contracts with life contingencies	2,168,455.00
Increase in reserve for supplementary contracts without life contingencies and for dividend accumulations	5,563.00
Increase in other liabilities and adjustments	207,785.31
Subtotal	11,099,929.40
Commissions on premium and annuity considerations	1,826,927.13
General insurance expenses	1,981,189.89
Insurance taxes, licenses and fees	485,251.15
Increase in loading on and cost of collection in excess of loading on deferred and uncollected premiums	41,227.00
Total	15,434,524.57
Net gain from operations before dividends to policyholders and excluding capital gains and losses	1,064,909.66
Dividends to life policyholders	375,054.26
Dividends on accident and health policies	1,028.17
Total dividends	376,082.43
Net gain from operations after dividends to policyholders and excluding capital gains and losses	688,827.23

Surplus account, year 1962

Special surplus funds Dec. 31, 1961	$2,000,000.00
Unassigned surplus Dec. 31, 1961	3,067,131.52
Net gain on treasury stock	33,828.00
Net gain	688,827.23
Net capital gains	111,791.48
Increase in policy liens	3,326.01
Total	5,904,904.24
Dividends to stockholders	474,058.60
Coinsurance, considerations allowed	105,779.83
Net loss from nonadmitted and related items	107,339.72
Increase in mandatory securities valuation reserve	133,301.37
Special surplus funds Dec. 31, 1962	2,000,000.00
Unassigned surplus Dec. 31, 1962	3,084,424.72
Total	5,904,904.24

Taxes, licenses and fees, year 1962

	Insurance		Investment	Total
	Life	Accident and health		
Real estate taxes			$29,477.56	$29,477.56
State insurance department licenses and fees	$4,823.18	$2,015.70		6,838.88
State taxes on premiums	154,469.29	85,514.15		239,983.44
Other States taxes	6,759.89	3,309.35	670.05	10,739.29
U.S. Federal income tax	309,374.89	31,234.93		340,609.82
Other U.S. Federal taxes	28,521.53	11,467.95	2,393.14	42,382.62
All other taxes	5,419.18	2,541.16	416.86	8,377.20
Taxes, licenses, and fees paid, Dec. 31, 1962	509,367.96	136,083.24	32,957.61	678,408.81
Taxes licenses, and fees unpaid, Dec. 31, 1961	277,209.12	92,556.04	28,132.72	397,897.88
Taxes, licenses, and fees unpaid, Dec. 31, 1962	425,517.86	104,447.35	27,502.89	557,468.10
Taxes, licenses, and fees incurred, 1962	361,059.22	124,191.93	33,587.44	518,838.59

General expenses, year 1962

	Insurance		Investment	Total
	Life	Accident and health		
Rent	$24,458.87	$12,229.44	$4,065.10	$40,753.41
Salaries and wages	690,539.38	336,171.09	150,108.07	1,176,818.54
Contributions for benefit plans for employees	81,730.76	39,547.14	10,545.91	131,823.81
Contributions for benefit plans for agents	12,499.13	4,166.38		16,665.51
Other employee welfare	15,071.28	6,109.29	1,861.09	23,041.66
Other agent welfare	768.34	192.08		960.42
Legal fees and expenses	15,099.64	7,547.29	2,039.15	24,686.08
Medical examination fees	24,709.15	939.28		25,648.43
Inspection report fees	47,898.07	3,677.32	30.58	51,605.97
Expense of investigation and settlement of policy claims	1,543.35	5,365.95		6,909.30
Traveling expenses	66,375.07	23,489.64	1,179.34	91,044.05
Advertising	20,589.81	5,104.20		25,694.01
Postage, express, telegraph, and telephone	48,573.94	18,298.73	4,171.71	71,044.38
Printing and stationery	75,475.23	58,669.27	2,152.88	136,297.38
Cost or depreciation of furniture and equipment	32,342.08	7,278.09	807.43	40,427.60
Rental of equipment	(5,530.21)	(1,253.87)	(144.27)	(6,928.35)
Books and periodicals	5,704.27	1,219.53	1,491.44	8,415.24
Bureau and association dues	15,580.99	10,101.45	1,781.48	27,463.92
Insurance, except on real estate	3,056.73	1,109.37	193.58	4,359.68
Collection and bank service charges	2,340.65	770.36	3.79	3,114.80
Sundry general expenses:				
Miscellaneous, actuarial, and accounting expense	18,223.05	2,479.41	4,350.88	25,053.34
Donations	10,498.33	5,014.13	156.69	15,669.15
Entertainment	8,506.09	3,418.67	98.18	12,022.94
Group service and administration fees	2,471.48	506.75		2,978.23
Decoration, alterations, repairs, and maintenance	15,270.28	5,020.17	320.27	20,610.72
Agency expense allowance	9,058.12	9,680.30		18,738.42
Agents' balances charged off	60,185.09	15,046.27		75,231.36
Agency conferences other than local meetings	44,924.14	11,231.04		56,155.18
Real estate expenses			140,022.66	140,022.66
General expenses paid	1,347,963.11	593,128.77	325,235.96	2,266,327.84
General expenses unpaid, Dec. 31, 1962	62,874.21	15,551.82	2,712.74	81,138.77
General expenses unpaid, Dec. 31, 1961	30,589.13	7,738.89	3,398.13	41,726.15
General expenses incurred 1962	1,380,248.19	600,941.70	324,550.57	2,305,740.46

NET INVESTMENT INCOME YEAR 1962

Total interest, dividends, and real estate income	$2,753,181.31
Investment expenses	324,550.57
Taxes, licenses, and fees	33,587.44
Depreciation on real estate	29,504.09
Interest on borrowed money	944.44
Total deductions	388,586.54
Net investment income	2,364,594.77
Ratio of net investment income to mean assets (percent)	4.33

Interest, dividends, and real estate income, year 1962

	Collected during year	Unearned	Due and accrued	Previous year and nonadmitted	Earned during year
Interest on bonds	$582,100.05		$147,870.00	$148,612.00	$581,358.05
Dividends on stocks	10,606.36		438.71	380.62	10,664.45
				5,143.00	
Interest on mortgage loans	1,716,818.31	$5,353.00	172,544.00	146,627.00	1,732,239.31
Real estate income	197,570.02	292.00	638.00	538.00	197,378.02
Interest on policy loans	223,892.63	93,294.69	2,364.33	(91,262.90)	224,225.17
Interest on bank deposits	3,859.72		54.66	87.92	3,826.46
Miscellaneous	3,489.85				3,489.85
Total	2,738,336.94	98,939.69	323,909.70	210,125.64	2,753,181.31

Capital gains and losses on investments

	Profit on sale or maturity	Loss on sale or maturity	Net gain or (loss) from change in difference between book and admitted value	Net gains
Bonds	$11,687.98			$11,687.98
Stocks			$105,495.15	105,495.15
Mortgage loans			(5,986.00)	(5,986.00)
Real estate	2,025.65	$1,431.30		594.35
Total	13,713.63	1,431.30	99,509.15	111,791.48

ASSETS

Bonds, $15,847,092.37

The company's investment in bonds at December 31, 1962, comprised 26.92 percent of the total admitted assets. The bonds owned, having an admitted value of $15,847,092.37, are summarized by values and according to the general classification of the annual statement as follows:

Classification	Book value	Par value	Market value	Amortized or admitted value
Government:				
United States	$1,815,761.91	$1,831,000	$1,718,570	$1,815,761.91
Canada	170,563.61	170,000	147,000	170,563.61
Israel	5,000.00	5,000	5,000	5,000.00
States and Provinces: Canada	133,764.96	135,000	133,765	133,764.96
Political subdivisions:				
United States	831,452.91	825,000	831,451	831,452.91
Canada	88,959.08	90,000	88,960	88,959.08
Special revenue and assessment: United States	586,860.36	583,000	590,843	586,860.36
Railroads: United States	44,692.42	45,000	44,300	44,692.42
Public utilities: United States	10,626,436.47	10,539,000	9,623,960	10,626,436.47
Industrial and miscellaneous: United States	1,543,600.65	1,539,500	1,507,499	1,534,600.65
Total	15,847,092.37	15,762,500	14,691,348	15,847,092.37

In accordance with procedures specified by the Valuation Committee of the National Association of Insurance Commissioners, all bonds with the exception of one issue were eligible for amortization. The one issue was valued at 100, which had been purchased at par; therefore, the book value and admitted value remained the same.

The company used the scientific method for amortizing bonds. Increases and decreases in the amortized values were journalized monthly and included in the calculation of interest collected. Company computations were checked to the extent deemed essential, and a few minor discrepancies were noted. As the errors were of little consequence and, while called to the company's attention, did not warrant changes at this time.

The comparative quality of bonds as reflected by Moody's Investors Service is shown in the following schedule and summaries are based on book values:

	Book value	Percent
Rating:		
Aaa	$4,432,836.78	27.97
Aa	6,029,351.51	38.05
A	3,705,666.68	23.38
Baa	317,453.21	2.01
Ba	88,959.08	.56
B	25,000.00	.16
Not rated	1,247,825.11	7.87
Total	15,847,092.37	100.00

It should be noted that of the $1,247,825.11 not rated bonds, all but $43,000 are political subdivisions, special revenue and assessment, and industrial and miscellaneous bonds. Only a relatively small portion of bonds in these categories are rated because the Moody's Investors Services do not rate any bond where the gross debt is less than $600,000 on political subdivisions and $1 million on the remainders. Also, other issues are not rated by the services in which the debt exceeds these limits because the services do not have all the necessary information. Absence of a rating carries no implication as to the quality of the investment.

All bonds with the exception of two issues of direct placements were on deposit with various depositories. The bonds were accounted for as follows:

Location	Par value	Book value
State of Colorado	$15,093,000	$15,189,266.31
State of Georgia	30,000	28,747.69
State of South Carolina	25,000	25,331.74
Central Bank & Trust Co	400,000	389,246.63
Haskins & Sells	5,000	5,000.00
Home office	209,500	209,500.00
Total	15,762,500	15,847,092.37

The bonds on deposit were verified by direct confirmation from the various depositories. Bonds on deposit with the insurance commissioner of the State of Colorado, in compliance with the Colorado statutory legal reserve requirements, were held under a joint custodial agreement for the protection of all policyholders. The bonds in possession of the company were kept in the vault at the home office and were verified by physical count in the presence of authorized company personnel. Transactions prior to the date of the count were reconciled to December 31, 1962.

The following summary reflects the related percentage of each classification of bonds owned to the total admitted value reflected in the preceding and current examinations:

Classification	Dec 31, 1959		Dec. 31, 1962	
	Admitted value	Percentage	Admitted value	Percentage
Government	$3,135,904.20	18.10	$1,991,325.52	12.57
States and provinces	133,450.59	.78	133,764.96	.84
Political subdivisions	994,820.46	5.74	920,411.99	5.81
Special revenue and assessment	893,089.53	5.15	586,860.36	3.70
Railroads	44,007.60	.25	44,692.42	.28
Public utilities	10,860,777.51	62.67	10,626,436.47	67.06
Industrial and miscellaneous	1,267,244.58	7.31	1,543,600.65	9.74
Total	17,329,294.47	100.00	15,847,092.37	100.00

The following schedule reflects the activity in the company's bond portfolio during the period under review:

Book value, Dec. 31, 1959		$17,329,294.47
Add:		
Cost of bonds acquired	$7,619,512.50	
Transfers	77,000.00	
Profit on sales	34,086.07	
Increase by adjustment	43,467.87	
		7,774,066.44
Total		25,103,360.91
Deduct:		
Considerations	$9,234,654.63	
Decrease by adjustment	21,613.91	
		9,256,268.54
Book value, Dec. 31, 1962		15,847,092.37

Purchases and sales of bonds during the period under review were found to be supported by brokers' invoices and advices. Authorization for the transactions by the finance committee was verified by a review of the minutes of that body. The actions of the finance committee were, in turn, approved by the Board of Directors. The transfers reflected in the foregoing reconcilation represent direct placements which had been erroneously carried in the company's mortgage loan portfolio.

The following schedule reflects the interest earned and the ratio to the mean book value of bonds for each year of the period under review:

Year	Mean book value	Interest earned	Ratio (percent)
1960	$16,405,761.60	$561,159.49	3.42
1961	15,946,771.45	549,723.81	3.45
1962	16,231,693.20	581,358.05	3.58

There were no bonds in default as to interest or principal. Interest received during the 3-year period was tested to the extent deemed essential and was found to be properly based on the contractual rates. Interest accrued on bonds at December 31, 1962, was computed to be $147,870. This amount, which is the same as that reported by the company, has been reflected as a nonledger asset in the financial statement of this report.

Stocks, $970,769.10

The company's investment in stocks at December 31, 1962, comprised 1.65 percent of the total admitted assets. The stocks owned, having an admitted value of $970,769.10, are summarized by values and according to the general classification of the annual statement as follows:

Classification	Book value (actual cost)	Market value	Percentage of market value
Common:			
Banks, trust, and insurance companies	$770,133.41	$877,010.00	90.35
Savings and loan associations	33,664.10	33,664.10	3.45
Industrial and miscellaneous	63,518.44	60,095.00	6.20
Total	867,315.95	970,769.10	100.00

The market values, with the exception of one issue reflected in the foregoing schedule, were those published by the Committee on Valuation of Securities of the National Association of Insurance Commissioners as of December 31, 1962. The excess of the admitted over the book value in the amount of $103,453.15, which is $1,066 less than the amount reported by the company, has been reflected herein as a nonledger asset.

As of December 31, 1962, the company owned the entire outstanding capital stock of the Security Casualty Insurance Co., an affiliated company having a par value of $4 per share. The company valued the stock at the year end at its book value; however, for the purpose of this report, the stock was valued on the basis of the capital and surplus reflected in its 1962 filed annual statement. This represents a decrease in the admitted value in the amount of $1,066.

The company held 1 certificate (Life Companies Inc. in dissolution) representing 1,000 shares of common stock which had no admitted value at December 31, 1962. Two liquidating cash distributions were declared in the aggregate of $12,781.36 decreasing the book value to $1,343.64. In addition, the company received 40 shares of Leach Corp. and 90 shares of Insurance Securities, Inc., common stock having an aggregate admitted value of $2,745.20 at the year end. The company did not place a value on the stock distribution; therefore, no credit was given to the book value of the stock in dissolution which is waiting its final liquidating distribution.

All stocks, with the exception of two issues, were on deposit with the Colorado Insurance Department in compliance with the Colorado statutory legal reserve requirements and were held under a joint custodial agreement for the protection

of all policyholders. A confirmation from the insurance department verified the total market value of stocks so held as of December 31, 1962. The one issue in possession of the company was inspected in presence of authorized company personnel. The remaining issue in transit was verified and all subsequent transactions were reconciled to December 31, 1962.

The following schedule reflects the activity in the stock portfolio during the period under review:

Book value, beginning		$115,045.59
Add:		
Cost of stocks acquired	$826,128.88	
Profit on sale	224.10	
		826,352.98
Total		941,398.57
Deduct: Considerations		74,082.62
Book value, Dec. 31, 1962		867,315.95

The company erroneously reflected its investment in savings and loan associations under the caption "Cash and Bank Deposits." In accordance with annual statement provisions it has been included herein and reflected in the foregoing reconciliation.

Purchases and sales of stocks during the period under review were found to be supported by brokers' invoices and advices. Authorization for the transactions by the finance committee was verified by a review of the minutes of that body. The actions of the finance committee were, in turn, approved by the board of directors.

The following exhibit reflects the related percentage of each classification of stocks owned to the total book value reflected in the preceding and current examinations:

Classification	Dec. 31, 1959		Dec. 31, 1962	
	Book value (actual cost)	Percentage	Book value (actual cost)	Percentage
Common:				
Banks, trust, and insurance companies	$71,374.71	62.04	$770,133.41	88.80
Savings and loan associations	43,670.88	37.96	33,664.10	3.88
Industrial and miscellaneous	0	0	63,518.44	7.32
Total	115,045.59	100.00	867,315.95	100.00

The following schedule reflects the dividends earned and the ratio to the mean book value of stocks for each year of the period under review:

Year	Dividends earned	Mean book value	Ratio
1960	$3,866.84	$117,471.87	3.29
1961	4,849.52	160,765.07	3.02
1962	10,664.45	616,841.08	1.73

Dividends received during the years 1960 and 1961 were tested to the extent deemed essential. The dividends received during the year 1962 were verified in their entirety and found to be in agreement with published dividend declarations.

The company's investment in seven savings and loan associations at December 31, 1962, having a book and par of $33,664.10 were located as follows:

Location	Number	Invested
California	6	$28,142.44
Washington	1	5,521.66
Total	7	33,664.10

Certificates evidencing these deposits were inspected and in addition verification certificates were received from each of the depositories. Dividend rates on the savings and loan association certificates varied from 4.50 to 4.60 percent. Accrued dividends were computed to be $438.71 and allowed as a nonledger asset in the financial statement of this report.

Mortage loans on real estate, $32,537,116.82

The company's investment in mortgage loans on real estate at December 31, 1962, consisted of 2,803 loans with an admitted value of $32,537,116.82 which represented 55.26 percent of the total admitted assets. The general classification of these loans is as follows:

Classification	Number of loans	Principal balance	Unearned discount	Book value
City:				
FHA insured	562	$2,807,618.47	$13,782.55	$2,793,835.92
VA guaranteed	103	545,993.71		545,993.71
VA guaranteed (with FHA)	15	10,360.54		10,360.54
Conventional:				
Residential	1,677	10,684,028.38		10,684,028.38
Commercial	433	18,413,429.98		18,413,429.98
Purchase money	7	45,154.04		45,154.04
Total	2,797	32,506,585.12	13,782.55	32,492,802.57
Farm: Conventional	6	50,777.25	0	50,777.25
Total	2,803	32,557,362.37	13,782.55	32,543,579.82

The unpaid principal balance, set forth above, contains the sum of $13,782.55, representing the unearned discounts on mortgage loans owned by the company at the close of 1962. Discounts are accrued over a 5-year period, one-tenth for the first and sixth years and one-fifth for each of the intervening years. The sum of the earned portions in any one year is the amount journalized and included in the calculation of interest collected. The company follows the practice of fully amortizing the premium paid on the purchase of a loan at the time of acquisition.

As of December 31, 1962 the company owned six mortgage loans that exceeded 75 percent of the appraised values. The excess in the amount of $6,463, which is the difference between the book and admitted values, has been reflected as an asset not admitted in the financial statements of this report.

The number of loans and the principal balance at December 31, 1962, are shown in the following exhibit, classified by the geographical location of the mortgaged properties:

State	Number of loans	Principal balance	Percentage
Arkansas	41	$292,361.25	0.90
Arizona	3	312,290.64	.96
California	182	4,732,628.47	14.54
Colorado	817	13,759,893.92	42.26
Hawaii	78	986,599.05	3.03
Idaho	1	56,735.63	.17
Kansas	9	55,056.42	.17
Nebraska	1	6,738.23	.02
New Mexico	63	337,455.48	1.04
North Dakota	2	20,121.83	.06
Oklahoma	16	623,556.42	1.91
Oregon	62	713,302.02	2.19
Texas	1,391	9,597,360.15	29.48
Utah	107	663,404.93	2.04
Washington	20	386,826.31	1.19
Wyoming	10	13,031.62	.04
Total	2,803	32,557,362.37	100.00

Properties securing the company's city mortgage loan portfolio are classified as follows:

	Number of loans	Principal balance	Percentage
FHA insured:			
Residential	557	$2,767,001.97	8.51
Duplex	4	33,086.58	.10
Apartments	1	7,529.92	.02
VA guaranteed:			
Residential	117	554,199.87	1.70
Duplex	1	2,154.38	.01
Conventional:			
Residential	1,565	9,860,960.99	30.34
Duplex	112	823,067.39	2.53
Apartments	135	4,357,017.24	13.41
Commercial and others	298	14,056,412.74	43.24
Purchase money: Residential	7	45,154.04	.14
Total	2,797	32,506,585.12	100.00

The average range of the principal balance of all loans at December 31, 1962, is indicated by the following analysis:

	Number of loans	Principal balance	Percentage
$5,000 and under	1,290	$3,484,316.09	10.70
$5,001 to $10,000	786	5,427,855.70	16.67
$10,001 to $20,000	441	6,009,048.03	18.46
$20,001 to $30,000	121	2,962,144.77	9.10
$30,001 to $40,000	27	932,338.33	2.86
$40,001 to $50,000	25	1,102,113.35	3.39
$50,001 to $100,000	68	4,742,474.47	14.57
$100,001 to $300,000	41	6,532,530.78	20.06
$300,001 and over	4	1,364,540.85	4.19
Total	2,803	32,557,362.37	100.00

The following exhibit reflects the total unpaid principal balance of all loans as of December 31, 1962, classified by net interest rate:

Net rate (percent):	*Principal balance*	Net rate (percent)—Con.	*Principal balance*
3.50	$87,494.84	5.50	$7,318,000.75
3.75	300,644.90	5.75	2,019,435.55
4.00	2,326,827.01	6.00	9,818,738.43
4.25	176,020.34	6.25	2,614,500.70
4.50	916,484.32	6.50	1,239,663.64
4.75	411,845.10	7.00	36,013.94
5.00	3,895,970.91		
5.25	1,395,721.94	Total	32,557,362.37

The above rates are net to the company since the correspondents' fees are a percentage of the principal balance and normally are retained by the correspondents.

A machine listing of the city and farm loans outstanding at the year end was furnished by the company. The listing reflected the principal balance, interest paid to date, rate and mode of payment. The company's interest computations were checked in detail and have been accepted for the purpose of this report.

Due, accrued, and unearned interest is computed at the net rate after deduction of the servicing fee. Interest due, accrued, and unearned on mortgage loans is reflected in the following exhibit, classified by the status of payment:

Status	Number of loans	Principal balance	Interest		
			Unearned	Due	Accrued
Current	2,661	$31,086,221.83	$5,353	0	$151,374
Past due 3 months or less	138	1,226,938.02		$9,443	5,392
Past due in excess of 3 months	4	244,202.52		5,143	1,192
Total	2,803	32,557,362.37	5,353	14,586	157,958

Interest due and accrued, in the aggregate of $172,544 which is $5,143 in excess of the amount reflected by the company, has been reflected as a nonledger asset. Interest due in excess of 3 months past due, in accordance with company policy, amounting to $5,143 has been reflected as a not admitted asset. The company erroneously deducted this amount twice in its 1962 filed annual statement. Unearned interest, in the amount of $5,353, has been included as a liability.

During the period under review the company foreclosed and acquired title to 11 mortgage loans having aggregate unpaid principal balances and appraisals of $100,778.11 and $166,484, respectively. Of the 11 parcels of real estate, 4 parcels were transferred to the mortgage loan portfolio as purchase money, 4 parcels were sold and 1 parcel conveyed to the Veterans' Administration. The remaining two parcels were subject to the redemption period at December 31, 1962. As of that date there were no mortgage loans in the process of foreclosure.

The following exhibit reflects the net interest earned during each of the 3 years under review and the ratio of such interest to the mean book value of mortgage loans:

Year	Mean book value	Net interest earned	Ratio (percent)
1960	$26,981,736.77	$1,395,390.30	5.17
1961	29,508,366.83	1,591,956.77	5.40
1962	31,413,587.80	1,732,239.31	5.51

Interest earned includes adjustments for accrual of discounts and amortization of premiums.

As of the yearend, the company had on deposit with the commissioner of insurance of the State of Colorado, in compliance with the Colorado statutory legal reserve requirements, 1,603 mortgage loans having unpaid principal balances in the aggregate of $25,353,902.59. One bond issue in the amount of $11,000, which was erroneously reflected in the company's mortgage loan portfolio, was on deposit with a local accounting firm. The foregoing deposits were held under joint custodial agreements and were verified by direct confirmation from the depositories.

The activity in the company's mortgage loan portfolio and a reconciliation for the 3-year period under review is shown in the following analysis:

Book value Dec. 31, 1959		$24,526,720.34
Add:		
Cost of mortgages acquired:		
Direct loans	$18,707,225.11	
Purchases	1,103,768.85	
Additional cash loaned	1,676,715.17	
Accrual of discount	12,769.34	
		21,500,478.47
Total		46,027,198.81
Deduct:		
Considerations	$13,299,656.05	
Transfer	77,000.00	
Foreclosures	100,778.11	
Amortization of premiums	6,184.83	
		13,483,618.99
Book value Dec. 31, 1962		32,543,579.82

The transfer reflected in the foregoing reconciliation represents a direct placement which was transferred to the company's bond portfolio.

Mortgage loan records.—Generally speaking, the company's accounting for mortgage loans is maintained manually. Individual postings from the correspondents' bordereaux are made to the mortgage loan ledger cards and the totals posted to the daily cash receipts journal. On direct loans individual accounting tickets are used and the amounts posted to the loan ledger cards. Block entries are recorded in the cash receipts journal. Accounting cards are punched from the general journal entries and are used to update the general ledger control account. The mortgage loan department's manual control is periodically reconciled to the general ledger control account.

At the yearend, cards are punched on each mortgage loan outstanding reflecting all pertinent data which are used for statistical and annual statement purposes.

The mortgage loan correspondents' bordereaux, during the period under review, were chosen at random and checked to the individual loan ledger cards. The totals were reconciled with the daily cash receipts journal and the postings were traced to the general ledger. A machine listing of outstanding loans was checked against the individual loan ledger cards to the extent deemed essential and the total thereof reconciled with the general ledger control account.

Servicing of mortgage loans.—The majority of the mortgage loans are handled through service agreements with 46 servicing agents or correspondents in the various States in which mortgaged properties are located. The number of loans serviced by the correspondents and the home office are as follows:

	Number of loans	Principal balance
City loans:		
Home office	313	$9,512,299.72
Correspondents	2,484	22,994,285.40
Farm loans:		
Home office	3	24,530.65
Correspondents	3	26,246.60
Total	2,803	32,557,362.37

The correspondents are paid specified service fees based on a percentage of the unpaid principal balance. They also retain all late charges paid by the mortgagors. In consideration for such fees, the correspondents are responsible for the collection of principal, interest, and escrow funds for taxes and insurance on the loans they service. In addition, the correspondents conduct all foreclosure proceedings as directed by the company and attend to all settlements with the Federal Housing Administrator or the Veterans' Administration. The company indemnifies the corespondents for necessary costs and expense, including a reasonable attorney's fee and title charges.

The correspondents do not make scheduled inspections of mortgage properties. Upon request by the home office, inspections are made as evidenced by the inspection reports contained in the mortgage loan files. Immediate inspections are made in event of a continuing default, or if the property has become damaged or vacant, or otherwise adversely affected.

At December 31, 1962, total escrow funds held by the correspondents, as trustees for the company, aggregated $467,238.58. The amount of this balance was verified by confirmations obtained direct from the depositories and is reflected in the financial statement herein as a debit and credit for report purposes. These funds are subject to withdrawal by either the company or the correspondent. The company obtained sworn affidavits from all correspondents at the yearend which certified that all real estate taxes and assessments on properties securing loans serviced by them were current.

Escrow funds held by the home office at December 31, 1962, amounted to $127,753.85 and are included as part of the liability "Amounts withheld or retained by company as agent or trustee." A trial balance was taken from the escrow ledger cards and the balance thereof reconciled to the general ledger control account. The company serves as an agent for the mortgage loans owned by the S.L. & A. Employee's Retirement Fund. In addition, the company makes collections for a local insurance company. The escrow funds, interest and principal payments on hand at the yearend, in the amount of $8,901.27, have been included in the foregoing liability.

Insurance.—The company carries a commercial blanket fidelity bond which covers each loan correspondent in the amount of $100,000. However, it does not carry an errors-and-omission policy which affords protection against loss because of failure of insurance protection on mortgaged property due to error, or unintentional omission by the correspondent, employee, or agent.

Hazard insurance policies on mortgage properties are retained by the home office. The servicing agreements provide that there shall be no reduction in the amount and type of coverage without prior consent of the company. The insurance will be kept in force and placed with authorized companies and the standard mortgagee clause will be attached. It was noted that the insurance companies have a rating of A or better, and financial size rating of Ccc or higher in the Alfred M. Best Co., Inc., insurance guide (key ratings).

Review of loan files.—With the exception of the mortgage loans on deposit with the Commissioner of Insurance of the State of Colorado, files for all mortgage loans made during the period under examination were reviewed. The review comprised an inspection of all pertinent documents such as notes, mortgages, deeds of trust, title evidence, assignments, FHA and VA guarantees, appraisals, hazard insurance policies, etc. The correspondent submits a sworn affidavit that the payment of taxes and other assessments are current. Taxes on direct loans were paid as evidenced by current tax receipts. The document check was made against a detailed listing of all loans outstanding at December 31, 1962. Files on loans made prior to the period under review were examined to the extent deemed essential.

The loan files, including the appraisal and secondary papers on the loans on deposit with the Commissioner of Insurance of the State of Colorado, are retained by the company and are well maintained. It was observed that the conventional loans were based on appraisals by the company and/or correspondent. Six conventional loans exceeded 75 percent of the appraisal values, of which, five were made during the period under review. The excess has been reflected as an asset not admitted in the financial statement of this report.

Approval of loans.—The preliminary work on new mortgage loan applications is completed by members of the Securities Committee as evidenced by a worksheet "Security Committee Approval of Mortgage Loan Commitment" contained in the mortgage loan files. At the time of consummation of a loan, the report is submitted to the Securities Committee as evidenced by the minutes of that body.

Commitment fees.—In some instances the company makes commitments to builders on construction, and cash deposits at various rates are required. The commitment fees are nonrefundable and are credited to income at the time they are received. Miscellaneous income derived from commitment fees during the 3-year period is as follows:

	Amount
1960	$1,809
1961	5,963
1962	19,100
Total	26,872

The company had loan commitments outstanding at December 31, 1961, in the aggregate of $4,688,394.

Audits of correspondents' records.—The company does not maintain an audit program of the mortgage loan correspondents. The servicing agreement does provide for an examination of all books and records of the correspondent at the company's discretion.

Real estate, $1,415,509.79

The company's investment in real estate which represents 2.4 percent of its admitted assets as of December 31, 1962, is classified as follows:

Home office property	$804,196.01
Properties acquired in satisfaction of debt	54,180.02
Investment real estate	557,133.76
Total	1,415,509.79

Home office property.—The home office is located at 810 14th Street, Denver, Colo. It is an eight-story with basement and penthouse, fireproof structure of steel and masonry construction. The building was erected in 1925. The land includes six lots each approximately 25 by 125 feet in area. The building occupies four of the lots. The other two lots, which are at the rear of the building, are used by the company for parking facilities.

The property was purchased by the company in August 1942 for $285,000 which included $50,000 for the land. Subsequent changes in the book value are reflected in the following schedule:

	Cost	Depreciation	Book value
Original investment	$285,000.00		$285,000.00
Improvements, 1942-59	805,026.63	$219,376.28	585,650.35
Improvements, 1960-62	8,673.09	75,127.43	−66,454.34
Total	1,098,699.72	294,503.71	804,196.01

Improvements to the home office property since original acquisition include the extension of the rear wall of the building, addition of a penthouse, modernization of the entrance and lobby, installation of new heating and airconditioning systems and installation of wall partitions.

A depreciation schedule providing for complete depreciation of the building and all subsequent improvements over a 50-year period is in effect.

The following schedule shows the net income on the mean book value of the company's home office building for the 3 years covered by this examination:

	Mean book value	Gross income	Taxes, repairs, and expenses	Net income
1960	$860,650.13	$207,940.55	$176,708.38	$31,232.17
1961	839,455.92	207,429.35	172,204.55	35,224.80
1962	816,228.96	161,081.41	168,490.03	−7,408.62

In 1960 and in 1961 the percentage net return, before allowance for depreciation, was 3.63 and 4.20 percent, respectively. In 1962 there was a net deficit due principally to the failure of two major tenants to renew their leases.

The company's charge for its own occupancy is at the rate of $1.11 per square foot for office space and at the rate of 35 cents per square foot for basement space. Charges to tenants range from $3.50 to $4 per square foot.

A schedule of rates, as of July 1, 1963, indicates an anticipated annual rental of $214,684.08 on the 84,868 square feet of available office and basement space. Allocation of square footage and rentals therefrom is as follows:

	Space	Percent	Rental
Security Life and Accident Co	34,405	40.54	$35,427.24
Tenants	9,413	11.09	34,637.52
Vacant	40,352	47.55	143,719.32
Building manager	698	.82	0
Parking and garage, company use			900.00
Total	84,868	100.00	214,684.08

Under date of May 23, 1961, the company entered into a lease agreement with the Mid-America Building Corp., a Colorado corporation, lessor. The company agreed to lease the fourth, fifth, sixth and one-half of the seventh floor of a modern, 31-story office building currently under construction. The building is located at 16th Street and Glenarm Place in downtown Denver.

As part of the agreement the lessor granted to the lessee the right to select the name of the lessor's building. In conformity with this provision of the lease, the company has elected to have the building known as Security Life Building.

The entire leased area contains approximately 38,657.5 square feet together with 3,000 square feet of dead storage space on the third floor.

The primary term of the lease is for 15 years with an option to renew for 10 years. The lease also provides that the company may lease additional space on the seventh, eighth, and ninth floors at periodic intervals during the full term of the lease.

The company expects to occupy the new offices early in 1964.

Properties acquired in satisfaction of debt.—Included in the real estate asset at December 31, 1962, were two properties acquired by the company in satisfaction of debt as a result of two mortgage loan foreclosures during 1962.

The status of the loans at the time of foreclosure and the items capitalized by the company in connection therewith are indicated in the following schedule:

Principal balance at time of acquisition	$49,485.96
Due and accrued interest capitalized	1,676.21
Legal fees	3,000.00
Other expenses, net	17.85
Total	54,180.02

Investment real estate.—The investment real estate owned by the company at the examination date was comprised of the following:

(1) Real estate under contract of sale	$132,686.59
(2) Parking lots	241,129.48
(3) Service stations	183,317.69
Total	557,133.76

(1) There were unpaid balances of $132,686.59 under 11 contracts of sale at December 31, 1962. All of the contracts are accommodation loans to agents and other company employees. Interest rates range from 4½ to 5½ percent. The contracts provide for monthly payments of principal and interest and a deposit for real estate taxes and insurance. There was interest due and accrued of $96 and $542, respectively, at December 31, 1962. These amounts have been included as a nonledger asset in this report. Unearned interest amounting to $292 has been included as a liability in this report under the caption "Unearned Investment Income."

Deposits for taxes and insurance held in escrow amounting to $3,103.45 are included as a liability under the caption "Amounts Withheld or Retained by the Company as Agent or Trustees."

(2) The company's investment real estate includes two parking lots which are located at 1315 Stout Street and 822–842 14th Street in Denver, Colo.

The Stout Street property includes three lots approximately 25 by 125 feet in area. This property which was acquired in 1954 is located directly back of the home office building, five 25 foot lots separating the two properties. It is carried at the original purchase price of $60,000. Rental is $250 per month and, in addition thereto, the tenant pays the real estate taxes and carries public liability insurance. There is no formal lease arrangement.

The parking lot located at 822–842 14th Street includes four lots approximately 25 by 125 feet and is located directly west of the home office property, an alley separating the two properties. It is under lease at $900 per month plus a percentage of gross income in excess of $24,000 per annum. The property was acquired at a cost of $185,000. It is currently carried at a book value of $181,129.48.

(3) The executive committee of the board of directors at their February 6, 1959, meeting approved "the purchase of property and construction of gasoline service stations and executing of leases on said properties with the Phillips Petroleum Co."

The properties are located in Golden, Colo., Englewood, Colo., and McCook, Nebr. The investment value at December 31, 1962, is developed as follows:

	Book value	Land	Improvements	Depreciation
Golden	$56,530.17	$34,000	$22,530.17	$4,106.48
Englewood	61,787.50	37,500	24,287.50	4,712.50
McCook	65,000.02	37,000	28,000.02	3,999.98

The primary term of each of the leases is for 20 years with an option to renew for two extended terms of 5 years each. The lease covering the Golden, Colo., property gives the lessee the right to purchase the property for $138,000 during the primary term of the lease. Rentals are based on 7½ percent of the cost of the property and are payable monthly. Improvements are being depreciated over the primary term of the lease at 5 percent per annum. The leases provide for real estate taxes to be paid by the Phillips Petroleum Corp.

Transactions in the real estate account during the period covered by this examination are summarized as follows:

Book value, Dec. 31, 1959		$1,781,137.65
Plus:		
Cost of acquired	$199,906.09	
Cost of improvements	167,825.79	
Profit on sales	146,873.80	
		514,605.68
Total		2,295,743.33
Less:		
Decrease by adjustment	$92,281.23	
Received on sales	786,521.01	
Loss on sales	1,431.30	
		880,233.54
Book value, Dec. 31, 1962		1,415,509.79

Deeds, title insurance policies, and attorneys' opinions were reviewed in verification of ownership of the properties. Insurance policies in force were examined and appeared to be adequate. A more detailed discussion of the real estate insurance coverage is included in another section of this report captioned "Bonds and Other Insurance Coverages."

Policy loans, $4,092,275.52

The admitted value of policy and automatic premiums loans secured by the value of the policies involved amounted to $4,092,275.52 at December 31, 1962,

or 6.95 percent of the company's total admitted assets. This amount is determined as follows:

Amount of loans per ledger	$4,097,275.52
Less amount not admitted	5,000.00
Net admitted value	4,092,275.52

Policy loan accounting is maintained on mechanical equipment which is programed to set up automatic premium loans when the premium is not paid. Annual interest calculations are automatically computed and applied to the loans. A complete listing is made at yearend including a special calculation to determine the amount of due and advance interest for reporting in the annual statement. This listing was checked extensively against policy files with no major differences noted. The company periodically prepares a list of "critical loans" on which the cash value may be close to the loan amount. This list was examined disclosing that such excesses were nominal. The company has followed the practice for several years of deducting $5,000 as a not-admitted asset to cover any excess loans which appear to be adequate and is so reflected in the balance sheet of this report.

Loans on policies which were issued prior to January 1, 1948, bear interest at the rate of 6 percent per annum except in the State of Washington where the rate is 5 percent per annum effective October 1, 1947. All policies issued subsequent to January 1, 1948, provide for loan interest at the rate of 5 percent per annum.

Interest due on policy loans in the amount of $2,364.33 was verified and is included as a nonledger asset in the balance sheet of this report. Unearned interest amounted to $93,294.69 and is included as a liability in the balance sheet of this report.

The following shows the ratio of interest earned to mean book value of policy loans for each year under review:

Year	Mean book value	Interest earned	Ratio
			Percent
1960	$3,431,513.28	$193,558.21	5.6
1961	3,814,287.54	209,379.71	5.5
1962	4,021,703.51	224,324.22	5.6

Cash and bank deposits, $1,747,078.13

Cash and bank deposits at December 31, 1962, was comprised of the following:

Cash in office:	
Home office, Denver, Colo	$2,000.07
Branch office, Honolulu, Hawaii	250.00
Revenue stamps	300.00
Total cash in office	2,550.07
Cash in banks and trust companies:	
Checking accounts	1,599,511.20
Time deposits	130,000.00
Industrial banks	15,016.86
Total cash in banks and trust companies	1,744,528.06
Grand total	1,747,078.13

Cash in home office and revenue stamps were verified by physical count. Cash in the branch office was confirmed by certificate from the cashier. Cash in banks and trust companies was verified by direct confirmation from each of the depositories and reconciled with amounts reported by the company.

The amount of cash and bank deposits reported herein is $33,664.10 less than reported in the company's annual statement and represents the amount of deposits in savings and loan associations which has been transferred to the asset caption "Stocks" as required by the annual statement blank. It is recommended that the company follow this procedure in future annual statement reporting.

Accrued interest on industrial bank deposits amounted to $54.66, and this amount has been included as a nonledger asset in the balance sheet of this report.

Amounts recoverable from reinsurers, $10,343.16

The above admitted asset represents reinsurance recoverable on paid life and accident and health claims. The amount recoverable was verified by checking the reinsurance statements and the receipt of the various items subsequent to the year end.

Share of Federal employees group conversion pool fund, $10,905.79

This ledger asset represents the company's tentatively estimated share in the Federal employees group conversion pool assets. The amount was ledgerized on the basis of advice from the pool agent, Metropolitan Life Insurance Co., as of December 31, 1962.

Company's equity in split dollar plans, $22,360.75

During 1959 the company issued ordinary life policies in amounts ranging from $25,000 to $50,000 on the lives of 11 officers and employees. This asset represents the cash value of the policies which, under the plan, is paid by the company while the officer or employee pays the difference between the cash value and the actual premium. The amount paid by the company is charged to a ledger account and reflected in its financial statements as an asset with the cash value of the policy assigned as collateral. The company is primary beneficiary under the policy to the extent of the cash value so advanced. The officer or employee may designate his own beneficiary to participate in the excess over the company's share.

Life insurance premiums and annuity considerations deferred and uncollected, $1,756,404

The life insurance net premiums and annuity considerations deferred and uncollected amounted to $1,756,404 as of December 31, 1962, and are as follows:

1st-year premiums:	
Uncollected, excluding group and including $104 annuity	$7,353
Deferred, including $791 annuity	85,729
Uncollected group insurance	49,763
Reinsurance ceded deduction, ordinary	—4,286
Total	138,559
Renewal:	
Uncollected, excluding group and including $580 annuity	168,301
Deferred, including $1,207 annuity	1,094,949
Uncollected group insurance	180,353
Reinsurance accepted, uncollected	201,455
Reinsurance ceded deduction, ordinary	—27,213
Total	1,617,845
Grand total	1,756,404

The net premiums for this asset were determined by the application of factors to the gross premiums, which factors were the result of ratios developed based on the company's business. The loading on first-year ordinary deferred and uncollected was $159,967; on renewal deferred and uncollected, the loading totaled $307,373, and the loading on group life due premiums amounted to $16,295.

Tabulated totals were traced to the company's worksheets and to the annual statement. A listing of premiums applied to premium income accounts was obtained from which a sample was selected and compared with due premium items on the company listing.

A sample of policy jackets was pulled and the policy anniversary, annual premium and premium paid to date therein was compared to corresponding lines on the deferred premium listing. Tests were made also from a 1963 termination run to arrive at a determination of yearend 1962 uncollected premiums. Additional checks were made from the due and deferred listings against the reserve run to establish that the policies were in force as of December 31, 1962.

This asset includes $230,116 in group life due premiums which amount was determined by the company at the yearend by surveying the billings to group policyholders. Uncollected reinsurance totaled $201,455, and reinsurance payable was in the amount of $31,499.

Differences brought out in the test check were not of sufficient magnitude to warrant a change in the company's figures.

Accident and health premiums due and unpaid, $141,071.00

This nonledger asset represents the amount of accident and health premiums due and unpaid at December 31, 1962, for both individual and group business as follows:

Individual	$37,730
Group	103,341
Total	141,071

Individual business is maintained on mechanical equipment, and detailed listings are prepared at each yearend. A substantial number of these were test checked to basic records with no material differences being noted.

Group records are maintained manually. Selected items were reviewed and appeared to be correctly included in this asset.

Interest and other investment income due and accrued, $318,766.70

Interest and other investment income due and accrued at December 31, 1962, was determined in conjunction with verification of the following asset items:

Bonds	$147,870.00
Stocks	438.71
Mortgage loans	172,544.00
Real estate	638.00
Policy loans	2,364.33
Bank deposits	54.66
Total	323,909.70
Less not admitted on mortgage loans	5,143.00
Net	318,766.70

Liens upon policy reserves, $5,576.01

This asset originates with the issue of capital stock in a predecessor company, Colorado Life Co., under a stock subscription plan whereby the subscription price of the stock, until paid, became a lien against the "founders policies" of that company owned by the subscriber.

There are five such policies and agreements now in effect, the policies for which all became paid up during the years 1948 and 1949. Interest on these liens was previously waived until January 1, 1934, and by action of the executive committee at a meeting held October 5, 1960, interest on such liens was also waived from and after the date each such policy became paid up.

These liens are summarized as follows:

Policy No.	Insurance in force	Number of shares		Original loan	Accrued interest	Reserve
		Original	1962			
10942	$5,000	2	36	$500	$681.32	3,591
11783	2,000	1	18	250	373.11	1,193
12088	5,000	2	36	500	755.20	3,350
12308	5,000	2	36	500	749.20	3,872
12491	5,000	2	36	500	767.18	3,872
Total		9	162	2,250	3,326.01	

The aggregate amount of $5,576.01 is included as a nonledger asset in the balance sheet of this report and is $3,326.01 more than shown in the company's annual statement. This amount represents accrued interest from January 1, 1934, to the date the policy was paid up which was not reported by the company.

ASSETS NOT ADMITTED

Agents' balances ($563,502.26)

Agents' balances, as determined by a trial balance of individual accounts as of December 31, 1962, are summarized as follows:

Gross debit balances	$565,635.38
Gross credit balances	2,133.12
Net debit balances	563,502.26

The net debit balances are deducted as an asset not admitted in the balance sheet of this report. The gross credit balances are shown in the liabilities.

During the period covered by this examination net debit balances increased a total of $334,024.52. Changes in balances over the last 4 years are summarized as follows:

Year	Amount charged off	Amount recovered	Ledger balances		
			Debits	Credits	Net
1959	$4,376.56	$1,255.20	$242,921.10	$13,443.36	$229,477.74
1960	30,740.71	2,931.85	317,699.15	13,205.34	304,493.81
1961	43,463.88	13,294.79	458,142.25	11,822.02	446,320.23
1962	84,304.20	9,072.84	565,635.38	2,133.12	563,502.26

Bills receivable ($69,041.85)

This asset is comprised of the following:

Employee insurance premiums	$2,074.36
Employee loans	1,789.61
Employee stock options	15,887.41
Agent stock notes	1,646.62
Agents furniture and equipment	33,970.57
Employee advances	619.00
Airlines deposit	425.00
Miscellaneous advances	4,123.68
Employee disability program	8,505.60
Total	69,041.85

Most of the above items are self-explanatory. The item of employee stock options represents loans to employees under a stock purchase plan approved in 1958.

The company has a compulsory payroll contribution disability program in effect. Under the program the employee contributes a maximum of $1 per month and is entitled to receive up to 20 days compensation in excess of absences allowed by the company under its employment program. The amount of $8,505.60 reflected above represents the deficit in the fund at December 31, 1962.

The entire amount of bills receivable is deducted as an asset not admitted in the balance sheet of this report.

Other assets not admitted ($16,606)

Other assets not admitted are discussed under their respective captions and are summarized as follows:

Mortgage loans on real estate	$6,463.00
Policy loans	5,000.00
Interest due and accrued	5,143.00
Total	16,606.00

Special trust funds (none)

This item appearing on the asset page of the foregoing financial statement represents escrow funds held by mortgage loan correspondents. At December 31, 1962, these funds totaled $467,238.58, and this amount has been offset by a contra-liability and extended at a zero balance. Further comments appear under the caption "Mortgage Loans on Real Estate."

LIABILITIES

Aggregate reserve for life policies and contracts, $43,860,370

The aggregate reserve for life policies and contracts as of December 31, 1962, together with the mortality and interest bases, and valuation method is as follows:

	Amount
Life insurance:	
Am. Exp. Table at 3½ percent net level 1928–62 issues	$18,987,105
Am. Exp. Table at 3 percent net level 1934–60 issues	2,190,280
1941 CSO Table at 2½ percent net level 1948–62 issues	19,917,798
1941 CSO Table at 3 percent net level 1954–62 issues	979,793
1941 CSO Table at 2½ percent CRVM 1961–62 N.B. issues	204,868
1941 CSO Table at 3 percent CRVM 1961–62 N.B. issues	398,839
1958 CSO Table at 3 percent CRVM 1962 issues	10,592
Special (substandard extra juvenile pay or benefit, group conversion reserve and life insurance purchase option agreement)	138,347
Total (gross)	42,827,622
Reinsurance	307,394
Total (net)	42,520,228
Annuities:	
1937 SAT at 3½ percent	28,655
1937 SAT at 2½ percent	32,931
1937 SAT at 2 percent	29,137
Deferred life annuities not involving life contingencies prior to retirement	84,807
Total (gross)	175,530
Reinsurance	0
Total (net)	175,530
Supplementary contracts with life contingencies:	
Def. Life Portion—1937 SAT 3¼ percent	137,888
Def. Life Portion—1937 SAT 2½ percent	41,759
Period Certain Portion 3½ percent	71,829
Period Certain Portion 3¼ percent	29,353
Period Certain Portion 2½ percent	22,902
Total (gross)	303,731
Reinsurance	0
Total (net)	303,731
Accidental death benefits:	
50 percent net accidental death benefit premiums in force Dec. 31, 1962	114,685
Total (gross)	114,685
Reinsurance	15,463
Total (net)	99,222

	Amount
Disability—Active lives:	
1926 Class (3) Dis. Table 3 percent net level	$27,442
1926 Class (3) Dis. Table 2½ percent net level	67,495
Combined Dis. Tables 2½ percent net level	62,496
Period 2 Dis. Table with 1930–50 Grad. Term'n. Rates 2½ percent net level N.B	82,970
1926 Class (3) Dis. Table 2½ percent full prelim. Term	134
Total (gross)	240,537
Reinsurance	8,095
Total (net)	232,442
Disability—Disabled lives: 1926 Class (3) Dis. Table at 2½ percent	166,055
Total (gross)	166,055
Reinsurance	6,806
Total (net)	159,249
Miscellaneous reserves:	
Excess of valuation net premiums over gross premiums	309,249
Nondeduction of deferred fractional premiums	60,719
Total (gross)	369,968
Reinsurance	0
Total (net)	369,968
Grand total (net)	43,860,370

The company currently issues policies on the Commissioners 1941 Standard Ordinary Table of Mortality at 2½ and 3 percent interest and are valued on the net level premium and the commissioners reserve valuation method plans. Reserves for policies issued prior to January 1, 1961, are camputed on the net level premium plan.

Punchcards are maintained on insurance risks. Runs on the seriatim basis were test checked. Tests were made of calculations, and checks were made of reserve factors and resultant mean reserves. In addition, tests were made to determine that the valuation data correctly represents the business in force. To the extent of the tests made, the valuation data agreed with the information contained in the files against which these tests were made.

The reserve methods which have been used by the company consist of the net level premium method and the commissioners reserve method. The following is a distribution of the gross ordinary life reserves as of December 31, 1962, according to the reserve methods employed:

Net level premium	$42,074,976
Commissioners reserve	614,299
Other	138,347
Total	42,827,622

Methods employed in the valuation of policies issued at, or subsequently subject to, an extra premium or in the valuation of policies otherwise issued on lives classified as substandard for the plan or contract issued or on special class lives.

1. For life, endowment, and term policies issued on substandard, the standard reserve during the premium-paying period is increased by 50 percent of the gross annual extra premium. Standard reserves are held on paid-up limited-pay contracts.

2. For reinsurance accepted—

(*a*) With table rating, the reserve established is a multiple of the standard reserve corresponding to the table rating;

(*b*) With flat premiums the standard reserve is increased by 50 percent of the flat extra.

The amounts of life insurance reserves held at various assumed rates are: 2½ percent, $20,122,666; 3 percent, $3,579,504; 3½ percent, $18,987,105; other,

$138,347; total, $42,827,622, less reinsurance, $307,394; net life reserves, $42,520,228.

Policies issued on the American Experience basis after 1948 are conversions from policies issued on the American Experience Table of Mortality prior to 1948.

The company operates extensively in the life reinsurance field. The reinsurance in force totaled $255,001,696 and the reserve thereon was $1,056,909 as of the yearend 1962. The reinsurance ceded reserve is primarily on the yearly renewable term basis. A small amount of ceded reinsurance is on a coinsurance basis.

Group life insurance totaled $368,051,556, and the reserve liability amounted to $184,422. The reserve on group insurance is calculated on an unearned basis. On credit group life insurance the company's reserve basis is 50 percent of the premium based on the "rule of 78" disregarding ages. These group creditor contracts provide insurance to the extent of the unpaid balance of individual debtors. No benefits are paid beyond the maturity date of the loan. The purpose of the "rule of 78" method is to take account of the fact that the benefits are decreasing. The reserve on group conversions is based on $60 per thousand amortized over a 5-year period. The company participates in the Federal employees group which is administered by the Metropolitan Life Insurance Co.

The regular forms of ordinary life, individual annuities, and group life are written on the participating and nonparticipating plans. The amounts of insurance are as follows: Nonparticipating, $801,401,192; annual dividend, $89,921,867; total, $891,323,059 which is further classified: life and endowment of $195,391,499; term, $327,297,181; group, $368,051,556, and additions to policies by dividends, $582,823. The foregoing includes reinsurance ceded of $31,077,289 and paid-up insurance of $22,599,656.

The aggregate reserve, insurance written, and insurance in force for the period covered by this examination follows:

Year	Aggregate reserve	Insurance written	Insurance in force
1960	$39,683,325	$170,358,000	$716,322,000
1961	41,691,324	173,698,000	770,613,000
1962	43,860,370	273,752,000	891,323,000

The above insurance written and insurance in force is classified as follows:

Year	Whole life	Term	Group	Additions	Total
New business written:					
1960	$19,110,000	$74,640,000	$76,234,000	$374,000	$170,358,000
1961	24,138,000	90,781,000	58,279,000	500,000	173,698,000
1962	25,431,000	126,077,000	121,695,000	549,000	273,752,000
Insurance in force:					
1960	172,914,000	257,226,000	285,775,000	407,000	716,322,000
1961	183,780,000	283,854,000	302,447,000	532,000	770,613,000
1962	195,391,000	327,297,000	368,052,000	583,000	891,323,000

The reserve liability for annuities and supplementary contracts with life contingencies totaled $175,530 and $303,731, respectively. Individual annuities issued during the year numbered 13 and amounted to $7,262.40 in annual income. Annuities and supplementary contracts outstanding at the end of the year with income now payable amounting to $31,909.98 annual income, and deferred, fully paid amounted to $682.32. The deferred and not fully paid totaled $29,069.88 in annual income.

The company writes retirement income policies and single-premium annuities. The principal retirement income policy is an annual premium deferred annuity and contains three options, (1) a straight life annuity which provides an income for life, (2) a 10-year guaranteed life annuity providing income for life with payment for 10 years certain guaranteed, and (3) a 20-year guaranteed life annuity which provides an income for life with payments for 20 years certain guaranteed.

The reserves and values under the retirement income policy before the commencement of annuity payments are computed with interest at the rate

of 2½ percent per annum. At the commencement of annuity payments the reserves and values are computed upon the 1937 standard annuity table, based upon the attained age, nearest birthday, reduced 1 year for male lives and 6 years for female lives. The reserves are calculated on individual hand kept cards. The methods and calculations were reviewed, and information on a selected number of these card records was checked against application files.

Additional accidental death benefits included in life policies were in the amount of $194,897,186 as of the year end 1962. The reserve thereon totaled $114,685. This reserve liability was calculated on the basis of 50 percent of the net accidental death benefit premiums in force as of December 31, 1962. The reserve on reinsurance ceded in connection with this coverage totaled $15,463 resulting in a net liability for this benefit of $99,222. This features covers death within 90 days from specified accidents prior to age 60 and is written for the premium-paying period only except in a small number of paid-up cases. On these policies the reserve is based on the advanced premium.

The disability reserves on active lives included in life policies totaled a net amount of $232,422 after deducting $8,095 for reinsurance. On the active life disability benefits for policies issued after January 1, 1948, tables of mean reserves per $1,000 face amount for 20 years have been calculated for ages 17, 25, 35, and 45. This was accomplished for premium waiver and income disability on the ordinary life, 20-pay life, and the 20-year endowment plans. Therefore, ages at issue 15 to 19 the reserve for age 17 is used; ages at issue 20 to 29, age 25 is employed; 30 to 39, age 35 is used and for ages 40 through 50 the reserve for average age 45 is used. The three remaining valuation classes are: Endowment at 65, 20-pay endowment at 65, and others. Average premium waiver and income disability reserves per $1,000 face amount are applied to the totals of insurance in force for the remaining classes.

On waiver of premium issues since September 1955 the reserves are based on period 2 graduated rates of disablement and 1930–50 graduated termination rates from 1952 reports combined with CSO mortality 2½ percent interest. Between January 1, 1948, and September 1955 reserves are based on the 165-percent modification of the 1926 class (3) disability and 1941 CSO mortality table at 2½ percent interest, with disability occurring before age 55, and the waiting period being 6 months. Premium waiver reserves are net level reserves to waive the Commissioners modified net premium. Disability income reserves are on the net level basis for $10 monthly income to age 65 and $5 monthly for life thereafter, except for the endowment plans where the income ceases at maturity of the policy.

With reference to the active life disability reserves on polices issued before January 1, 1948, reserves are based on the 1926 class (3) disability table with 3 percent interest. Premium waiver reserves are on the net level basis for waiver of Illinois standard net premium. Income reserves are on the net level basis for the payment of income of $10 per month for life. Disability insurance ceases at age 60, or the maturity date of the policy on endowments or the expiry date on the term plans.

The reserve on disabled lives which represents the present value of future benefits is supported by a list of approved claims. Factors were tested and checks made to ascertain the adequacy of this reserve liability. This reserve is based on the 1926 class (3) disability table with 2½ percent interest, and as of the year end 1962 the total reserve liability on disabled lives totaled $159,249 after deducting $6,806 for reinsurance.

Miscellaneous reserves.—The company had $12,034,287 of insurance in force on which the gross premiums are less than the net premiums according to the accepted standard of valuation. The deficiency reserves thereon amounted to $309,249.

The reserve liability for nondeduction of deferred fractional premium at the death of the insured arises from the fact that reserves are maintained, which presupposes that the fractional premium payments to complete the policy year of death will be paid or deducted from the claim. Since this supposition is not true and the company waives deduction of the deferred fractional premium at the death of the insured, an extra reserve has been set up for this nondeduction benefit in the amount of $60,719 as of December 31, 1962. This liability was calculated by multiplying the total mean reserve on premium-paying policies by 0.002.

Aggregate reserve for accident and health policies, $1,455,946

The following tabulation shows a comparison of components of this reserve between those shown in the annual statement and those developed for the purpose of this examination:

	Annual statement	Examination report
Unearned premium reserve	$1,006,470	$961,486
Additional reserves for guaranteed renewable policies	73,048	73,048
Present value of amounts not yet due on claims	423,729	414,284
Reserve for future contingent benefits	9,369	9,369
Group rating refunds	66,451	66,451
Total	1,579,067	1,524,638
Reinsurance	68,692	68,692
Net reserve	1,510,375	1,455,946

Unearned premium reserve.—The unearned premium reserve is based primarily on a factor of 50 percent of the premiums in force as of December 31, 1962. The reserve as established for the purpose of this examination is $44,984 less than reported in the company's annual statement, as a result of adjustments in the group unearned where a large preponderance of monthly mode business with a first of the month date was noted in several blocks of business. In these instances daily pro rata factors were used producing the lesser reserve.

Additional reserves for guaranteed renewable policies.—Policies have been issued on a guaranteed renewable basis to certain maximum ages. On these contracts there has been established an additional reserve over and above the standard unearned premium reserve liability. The principal bases employed on other than the single-premium policies are the 1941 commissioners standard ordinary 2½ percent table of mortality combined with the 1939 conference table and the CSO 2½ percent table of mortality with the conference modification of the 1926 class 3 table.

On the single-premium policies where the attained age last birthday is less than 70 years the reserves were determined by first calculating a mean reserve for a temporary annuity to age 70 according to the American experience table at 3½ percent interest; if the attained age last birthday was 70 years or greater, then the reserves were determined by the calculation of a mean reserve for a life annuity based on the American experience table with 3½ percent interest. The cash value reserve on certain policies is the accumulation after the 20th policy year increased with interest from year to year at the current rate which is presently 4 percent.

Tabulation of policies with appropriate factors applied to indemnity amounts were reviewed. A reserve of $73,048 has been set up as an additional liability for guaranteed renewable policies as of the yearend 1962.

Present value of amounts not yet due on claims.—This amount represents the apportionment of continuing accident and health claims to the aggregate reserve. The procedure followed is discussed under the liability caption "Policy and contract claims—accident and health."

Reserve for future contingent benefits.—On group and individual policies providing for maternity benefits a reserve for future contingent benefits has been set up in the amount of $9,369. This reserve liability consists of $8,369 for the group policies and is based on 3 percent of the unearned premium reserve and $1,000 is the estimated amount for the individual policies. This reserve then is for contingent benefits having their inception while the insurance policy was in force, however, where the claim occurs after the policy contract has terminated.

Group rating refunds.—Certain group accident and health contracts are written on a retained percentage basis. The amount included hereunder represents the liability at December 31, 1962, for profit on this business over the maximum amount allowed the company, and refundable to the group policyholders. Although a majority of the group contracts are on a fiscal year basis, experience rating refunds were computed according to their status at yearend 1962. Test checks made of settlements during 1963 indicate the liability is substanti-

ally correct and the company's figure has been accepted for the purpose of this report.

Reinsurance.—This represents the amount of unearned premiums on reinsurance ceded computed, except for one block of business, on a 50-percent factor basis.

Supplementary contracts without life contingencies, $489,948

The above captioned represents the balance of amounts on deposit at interest and the present value of future payments due beneficiaries receiving death benefits and matured endowments under the following settlement options:

(*a*) Installments of fixed amounts. Proceeds may be left with the company at interest as determined by the company at or in excess of specified minimum to accumulate on said proceeds, provided payments of a fixed amount, to be made periodically until such proceeds and accumulated interest are exhausted, are agreed upon.

(*b*) Installments for a period certain. Proceeds to be paid in equal monthly installments for a specified number of years.

(*c*) Interest income. Proceeds may be left with the company with withdrawal rights, if any, as may be agreed upon, and with interest as determined by the company, but not less than specified minimum.

A hand posted card is maintained for each contract showing total payments of interest and principal for the year and calculation of the current reserve. The accounting is maintained on mechanical equipment and a yearend tabulation was prepared showing total disbursements for the year, amounts received under contracts, interest paid and yearend reserves.

Various test checks were made as to the accuracy of interest and reserve calculations with no material differences noted. A representative number of contracts were examined which appear to have been made in accordance with option provisions.

The contracts in force at December 31, 1962, are summarized by current interest rate and type of payment as follows:

Number of cases	Interest rate (percent)	Type of payments		Total
		Interest only	Periodic payments	
103	4	$277,234	$123,266	$400,500
14	3½	.....	32,326	32,326
9	3	.....	13,035	13,035
5	2½	.....	44,087	44,087
131	.....	277,234	212,714	489,948

Policy and contract claims—Life, $420,071

The net liability for life policy and contract claims outstanding as of December 31, 1962, is summarized as follows:

	In course of settlement		Incurred but unreported	Total
	Resisted	Other		
Ordinary:				
Life	$73,750	$107,471	$59,737	$240,958
Disability	.....	177	0	177
Life conservation benefits	.....	200	150	350
Protector death claims	.....	455	712	1,167
Total ordinary	73,750	108,303	60,599	242,652
Group: Life	.....	78,701	155,742	234,443
Grand total	73,750	187,004	216,341	477,095
Reinsurance	47,500	4,524	5,000	57,024
Net liability	26,250	182,480	211,341	420,071

The aggregate reserve for life claims reflected in the foregoing exhibit is $10,992 in excess of the amount reported by the company in its 1962 filed annual statement. This amount is attributed to the increase in the incurred but unreported death claims on the ordinary business.

The reserve established for group life claims was $40,762 in excess of the amount reported by the company. This amount represents an offset against the liability, group insurance contingency reserve commented on elsewhere in this report; therefore, no increase was made in the reserve for group life claims.

The death claims were determined from a review of the claim register and claim files with the benefit of 9 months' retrospection. All outstanding claims, as of December 31, 1962, that remained open, were reviewed and the reserves were established according to the information contained in the claim files. On claims closed by payment during the retrospection period the amounts paid were substituted for the estimated liability established by the company. The reserve for incurred but unreported claims was established in the same manner as for the reported claims with an additional loading for claims yet unreported. The company follows the practice of leaving up the policy reserve on all death claims until a settlement has been made; therefore, the claim liability on the ordinary business is net to policy reserves on the in course of settlement as well as the incurred but unreported claims.

An additional liability for death claims in the amount of $98,579.60 which represents the company's participation in the Federal employees group insurance has been included in the foregoing reserve. This amount has been offset by an admitted asset which has been included under the caption "Life Insurance Premiums and Annuity Considerations Deferred and Uncollected." The necessity of this was due to the net asset taken by the company on its participation that has been reflected and commented on under the caption "Federal Employees Group Conversion Pool Fund."

The disability claim reserve was determined from a complete listing of approved disability claims outstanding which were checked with the claim cards maintained by the actuarial department. The reserve for disability on disabled lives has been based upon the 1926 class (3) disability table at 2½ percent. In accordance with annual statement provisions the accrued payments have been included in the foregoing exhibit, while the unaccrued payments have been reflected under the caption "Aggregate Reserve for Life Policy and Contracts."

Claims resisted, compromised, or closed without payment during the 3-year period covered by this examination were reviewed in detail. In all cases the company's position appeared to be tenable. The review of paid claims indicated that the company settles just claims for death and other benefits promptly upon receipt of necessary proofs and in accordance with policy and contract provisions. The older claims still outstanding were due to the lack of followup by the company. This was brought to the company's attention, and remedial steps have been taken to alleviate this situation.

Policy and contract claims—Accident and health, $333,820

The net liability for accident and health policy and contract claims outstanding as of December 31, 1962, is summarized as follows:

	Group	Individual	Total
Due and unpaid	$28,895	0	$28,895
In course of settlement	101,329	$60,512	161,841
Incurred but unreported	128,668	48,448	177,116
Total	258,892	108,960	367,852
Less reinsurance	26,111	7,921	34,032
Net liability	232,781	101,039	333,820

The aggregate reserve for accident and health claims established as of December 31, 1962, is $89,168 in excess of the amount reported by the company in its 1962 filed annual statement. The deferred portion of the claim reserve reflected under the liability entitled "Aggregate Reserve for Accident and Health Policies" is $9,445 less than the amount reported by the company.

The company's allocation was made on a percentage basis whereas the reserve was established on an actual basis where possible for the purpose of this report. The excess of the deferred portion was transferred to the accrued portion of the claim liability. Therefore, the net liability reflected in the foregoing exhibit, which represents the accrued portion of the claim liability, is $98,613 in excess of the amount reported by the company.

The company maintains manually posted claim registers on individual accident and health claims, however, the registers do not reflect the incurred date. Payment cards were punched during the year on the direct business written.

The liability for claims in course of settlement at December 31, 1962, was established with the benefit of 9 months' retrospection. Payment listings were furnished by the company and the amounts paid were substituted for the company's estimated liability. Claims that indicated continuing payments were reserved on a case basis.

The reserve for incurred but unreported claims was established in the same manner as for the reported claims with an additional loading for claims yet unreported. Due to the lack of the incurred date, it did not seem feasible to search the files for 1962 incurred claims, therefore, an additional loading has been included to provide for claims that remained open where no payment has been made.

The company does not maintain claim registers on its group accident and health claims. Payment cards were punched during the year on the direct business written, with the exception of approximately 20 percent of the business written under the "Special risk" category. These payments were manually posted to claim work tickets.

Group accident and health claims in course of settlement at December 31, 1962, were reserved with the benefit of 9 months' retrospection. Payments listings furnished by the company were substituted for the company's estimated liability. An additional loading has been included to provide for claims that remained open where no payment has been made and for continuing claims.

The reserve for group incurred but unreported claims was established in the same manner as for the reported claims with an additional loading for claims yet unreported.

Claims resisted, compromised, or closed without payment during the 3-year period were reviewed to the extent deemed essential. The company's position appeared to be tenable. A review of paid claims indicates that the company settles just claims promptly upon receipt of necessary proofs and in accordance with policy and contract provisions.

From a general review, it appears that the claim departments are not receiving the full benefit of the company's electronic equipment. It is recommended that the company review its entire claim recording and processing procedure and make the necessary changes where it is deemed essential.

Policyholders' dividend accumulations, $2,175,829

This liability represents dividends left with the company to accumulate at interest. It includes dividends and interest, credited to the policyholder's account to the date of the last policy anniversary and accrued interest thereon to December 31, 1962.

Earlier policies carried a guaranteed interest rate of 2½ percent, while later policies provided for a rate based on the interest earned by the company. Interest at the rate of 4 percent has been allowed on all policies on 1962 anniversary dates. Prior thereto interest was at the rate of 3¾ percent.

Electronic data processing equipment is used in maintaining the necessary accounting records. Changes in the policyholders' accounts are recorded in daily transaction journals and are reflected in a master premium record card. The daily transactions are summarized monthly and correlated with the master premium record cards. An annual audit of all policyholders' accounts is made by summarizing the detailed transactions and reconciling the transactions with the master premium record cards. A test check of selected policyholders' accounts, and a test of the interest computation, was made to substantiate the company's development of the yearend liability.

The increase in policyholders' dividend accumulations, during the period covered by this examination, amounted to $142,518.47.

Policyholders' dividends due and unpaid, $28,488.77

Included under the above caption are bonuses and dividends for which the liability was incurred but unpaid as of December 31, 1962.

Certain dividends, for various reasons, due prior to the yearend are not credited to the policyholders' accounts until the subsequent year. Dividends in this category amounted to $8,476.66 at December 31, 1962. Certain participating policies provide for payment of a bonus at such time as the full annual premium is paid. At December 31, 1962, those policyholders paying premiums on a basis other than annual had paid portions of the annual premium. Accordingly, the company accrued a liability of $20,012.11 to cover that portion of the next annual bonus which attaches to the premium paid in 1962.

Electronic data processing equipment is used in developing this liability. The company's accounting procedure and methods of control, relative to this liability, were reviewed and appear to be adequate. Tests of the detailed transactions were made to substantiate the accuracy of the computation of the liability.

Provision for policyholders' dividends payable, $235,671.28

The above liability represents the total dividends to become payable during 1963 on all dividend paying policies in force December 31, 1962. A resolution adopted December 5, 1962, provided, "that the dividend formulas and schedules, heretofore employed for policies of insurance, be approved, and that such formulas and schedules for the year 1963 with interest at the rate of 4 percent per annum, be and hereby are approved."

Electronic data processing equipment is used in establishing the amount of the dividend payable at the next policy anniversary date. Adjustments are made for possible lapses and discount. The amounts of the adjustments were $3,639.21 and $4,779.50 respectively for lapses and discount. These amounts appear to be nominal and have been accepted for purposes of this report.

Test checks of the company's detailed records supporting the reserve were made to the extent deemed necessary. The company's accounting procedure and methods of control relative to this liability were reviewed and appears to insure the accurate development of the liability.

Premiums and annuity considerations received in advance, $110,140

The premiums and annuity considerations received in advance less $6,931.64 discount, including $6,616 accident and health premiums as of December 31, 1963, amounted to $110,140 and is classified as follows:

Nonparticipating	$56,009
Participating	42,597
Annuities	4,918
Accident and health	6,616
Total	110,140

The above liability was determined in conjunction with the test check of the due and deferred premiums. From a machine listing, tests were made and reference was made to policy files to ascertain the adequacy of this liability. The discount deduction for policyholders and annuitants on premiums paid in advance totalled $6,931.64. The interest rate allowed by the company in discounting premiums currently is 3¾ percent per annum on policies issued prior to 1962 and 4 percent thereafter. If the premiums are paid in advance, and a death claim should arise, the discounted value of any premiums paid beyond the policy year in which death occurs will be refunded.

Liability for premium deposit funds, $775,374

The above liability represents deposits made by policyholders, under policy provisions, to pay future premiums. The liability includes accrued interest to December 31, 1962. In 1962, interest was at the rate of 4 percent. Prior thereto it was at the rate of 3¾ percent.

Deposits which have not been applied to pay premiums may be withdrawn in cash at any time without penalty or reduction of the rate of interest allowed.

It is the general practice of the company to limit the accumulated deposits to an amount not in excess of 10 annual premiums of the number of premiums to valuation change year.

Accounting records are processed and audited in the same manner as policyholders' dividends as a part of the same accounting program. The system is described more fully in the section of this report captioned, "Policyholder Dividend Accumulations."

Tests of selected policyholders' accounts, and a test of the interest computations, were made to substantiate the company's development of the yearend liability.

Surrender values on canceled policies, $95.82

The above captioned represents the amount due at December 31, 1962, under a surrendered policy.

Provision for experience rating refunds, group and reinsurance, $476,260.80

This liability consists of the following:

Experience rating refunds, group life	$154,997.69
Reinsurance dividends payable	321,263.11
Total	476,260.80

Group life business is written on a retained percentage basis. A majority of the group contracts are on a fiscal year basis, but experience rating refunds are computed according to their status as of December 31, 1962, for annual statement purposes. During the course of the examination, test checks were made of selected group files noting annual settlements, and it was determined that the company's liability therefor is substantially correct and remains unchanged.

The liability for reinsurance dividends is increased $1,966.77 over the amount reported in the company's annual statement on the basis of actual payments made in 1963 on business for the year of 1962.

Cosmopolitan health benefit reserves, $3,084

A group of accident and health policies reinsured by the company provide a maximum of 50-percent return of premiums for a 10-year period in the event all premiums have been paid, without any claim having been paid thereunder during such 10-year period.

A review of policies in force at yearend is made to determine which have not had claims or refunds for the 10-year period. The premiums on these policies are totaled to which a 50-percent factor is applied to establish the liability. Policy and claims files were test checked and to the extent tested were found to be correct.

Life conservation benefit reserve, $2,167

The company's "life conservation rider" issued in connection with some of its life policies provides limited benefits for permanent loss of member or sight and major surgical operations.

The reserve shown above is calculated on the basis of 50 percent of the net premium income for the year 1962 using a loading factor of 15-percent to convert from gross to net.

Annuity savings certificates, $20¼

Annuity savings certificates were at one time issued by the company which may be converted to a straight life annuity at any time the cash value equals or exceeds $1,000. The certificates also provide for additional accidental death benefits equal to the regular death benefit, but not in excess of $2,500.

There were only two such certificates remaining in force at December 31, 1962. The cash value or reserve consists of the face amount with interest accumulated at the rate of 2¼ percent per annum compounded quarterly.

Commissions to agents due or accrued, $17,820.20

This liability consists of bonuses and prizes due or accrued to agents and payable contingent upon performance and production. The liability as established for the purpose of this examination is $15,764.44 less than reported in the company's annual statement. This decrease is the result of an increase of $530.33 in the liability for prizes and bonuses based on payments made during 1963 and a decrease of $16,294.77 in the company's liability for commissions on due and unpaid group premiums. The group premiums were shown net as to commissions and this amount was duplicated as a liability in the company's annual statement.

General expenses due or accrued, $81,138.77

Copies of checks in payment of expenses incurred as of December 31, 1962, and paid during 1963 were examined. The liability for general expenses due or accrued as of December 31, 1962, as developed by this examination, is $36,195.84 in excess of the $44,942.93 reported by the company in its 1962 annual statement.

Taxes, licenses, and fees due or accrued, $39,897.88

The following schedule compares the liability for taxes, licenses, and fees due or accrued, which was reported by the company in its annual statement, with the liability as developed by the examination.

	Liability per company	Liability per examiners	Increase (decrease)
Real estate taxes	$35,503.00	$35,451.57	($51.43)
State taxes on premiums	241,061.34	225,838.97	(15,222.37)
Other State taxes	7,080.81	7,080.81	0
U.S. Federal income tax	145,737.28	117,914.47	(27,822.81)
Other U.S. Federal taxes	2,483.89	499.24	(1,984.65)
All other taxes	11,112.82	11,112.82	0
Total	442,979.14	397,897.88	(45,081.26)

The above liability was determined through a review of tax returns, related documents and 1963 disbursements.

Premium taxes paid in 1963 which were applicable to 1962 premiums amounted to $242,698.39. This liability, as developed by the examination, was reduced by $16,859.42. This amount represents premium taxes retained by the company from reinsurance premiums paid and is included in the liability for "Amounts Withheld or Retained by the Company as Agent or Trustee."

Cost of collection on premiums deferred and uncollected in excess of total loading thereon, $18,026

The above captioned represents the amount of commissions payable to agents upon collection of due and unpaid accident and health premiums, including individual and group.

Unearned investment income, $98,939.69

Unearned investment income at December 31, 1962, consisted of interest received in advance on the following asset items:

Mortgage loans	$5,353.00
Real estate	292.00
Policy loans	93,294.69
Total	98,939.69

Amounts withheld or retained by company as agent or trustee, $173,485.34

The following schedule reflects the above liability as reserved for by the company as of December 31, 1962.

Mortgage loan escrow funds	$118,852.58
Mortgage loan employee pension	6,847.11
National Farmers Union, escrow	2,054.16
Insurance and taxes, real estate sold escrow	3,103.45
Premium tax escrow	16,859.42
Unclaimed equities	109.25
Employees donation fund	54.80
Colorado withholding tax	7,244.41
FICA tax withheld	1,984.65
Blue Cross premiums	6.65
U.S. savings bonds	96.25
Federal withholding tax	16,186.16
Withheld unemploment fund	86.45
Total	173,485.34

The first three items are commented on in the "Mortgage Loans—Escrow Funds" section of this report. The liability for premium tax escrow is commented on in the "Taxes, Licenses, and Fees Due or Accrued" section of this report. The remainder of the items included in the above liability appear to be self-explanatory.

This liability was verified through examination of 1963 disbursements or by review of related documents and company records. Minor differences were noted during the review, but for purposes of this report, no adjustment has been made.

Amounts held for agents' account, $2,133.12

This liability represents gross credit balances as established from a trial balance of agents' accounts as of December 31, 1962.

Remittances and items not allocated, $44,832.20

The following schedule reflects the liability for remittances and items not allocated as developed by the examination:

General suspense	$22,541.56
Premium clearance	20,984.24
Mortgage clearance	431.25
Employees merchandise purchases	725.15
Parking lot collections	150.00
Total	44,832.20

The above liability has been increased by $1,098 over the amount reported by the company in its 1962 annual statement. The $1,098 represented an advance commission payment which should have been included in agents' balances.

It is recommended that the company keep a detail listing of the items included in the above accounts for substantiation purposes at year end.

This liability was verified by review of the appropriate company records.

Mandatory securities valuation reserve, $306,397.70

The mandatory securities valuation reserve was calculated in accordance with the resolution adopted by the National Association of Insurance Commissioners on June 21, 1962, and amended December 6, 1962.

The examiners reserve was less than the amount reported by the company due to the adjustment in the admitted value and the inclusions of savings and loan association shares in the market value of stocks. Due to the infinitesimal amount involved, the company's reserve has been accepted for the purpose of this report.

Missouri group mass hazard reserve, $215,344.81

This reserve is established in compliance with the State of Missouri mass hazard reserve requirements. The annual contributions to the reserve are based on 2 percent of direct premiums received on group business other than creditor group. This reserve was included in the company's annual statement under the caption "Group Insurance Contingency Reserves."

Claim fluctuation reserves, $547,359.04

In accordance with agreements between the company and certain group assureds, experience rating refunds are held as reserves for possible future adverse loss experience. In most cases, interest is allowed on these reserves. In the event of termination of the group contract, these reserves are returnable to the assureds. This reserve was included in the company's annual statement under the caption "Group Insurance Contingency Reserves."

Field force retirement plan, $20,000

This liability arises from the adoption of a retirement plan for agents and general agents as previously discussed in this report. Under the plan, the agent contributes a percentage of commissions earned which is to be matched by the company. As of December 31, 1962, the liability as provided in the company's annual statement was comprised as indicated in the following summary which is approximately correct and has been accepted for the purpose of this report:

Agents' contributions collected	$9,722.68
Approximate amount required to match agents' contributions for the year 1962 to be paid by the company	10,277.32
Total	20,000.00

Contingency reserve, $2 million

Special surplus funds represented by a contingency reserve was shown in the company's annual statement in the above-captioned amount and is so shown in the balance sheet of this report.

Capital paid up, $1,500,000

Capital paid up at December 31, 1962, consisted of 337,500 shares series A common stock and 37,500 shares series B common stock, each with a par value of $4 per share.

Unassigned surplus, $3,084,424.72

The unassigned surplus of the company at December 31, 1962, as determined by this examination amounted to $3,084,424.72 which is $26,321.09 less than reported in the company's annual statement. The net decrease was effected by changes in asset and liability items as follows:

	Company	Examiners	Surplus, increase or (decrease)
Assets:			
Stocks	$938,171.00	$970,769.10	$32,598.10
Cash and bank deposits	1,780,742.23	1,747,078.13	(33,664.10)
Interest and other investment income due and accrued	313,727.69	318,766.70	5,039.01
Liens upon policy reserves	2,250.00	5,576.01	3,326.01
Liabilities:			
Aggregate reserve for accident and health policies	1,510,375.00	1,455,946.00	54,429.00
Policy and contract claims: Life, accident, and health	409,148.79	420,071.00	(10,922.21)
	235,207.00	333,820.00	(98,613.00)
Provision for experience rating refunds: Group and reinsurance	474,294.09	476,260.80	(1,966.71)
Commissions to agents due or accrued	33,584.64	17,820.20	15,764.44
General expenses due or accrued	44,942.93	81,138.77	(36,195.84)
Taxes, licenses, and fees due or accrued	442,979.14	397,897.88	45,081.26
Unearned investment income	98,840.64	98,939.69	(99.05)
Remittances and items not allocated	43,734.20	44,832.20	(1,098.00)
Net change in unassigned surplus			(26,321.09)

SUMMARY

The results of the examination disclose that at December 31, 1962, the admitted assets were $58,875,269.14, total liabilities $52,290,844.42, capital stock outstanding $1,500,000 with special surplus funds of $2 million and unassigned surplus of $3,084,424.72.

Recommendations and matters of special importance which were brought to the attention of management during the course of the examination are summarized for convenient reference as follows:

REFERENCE

Recommendation that holdings of Treasury stock be reported through exhibits 13 and 14	6
Follow up on older claims by the company	24
Investments in savings and loan associations reflected as cash and bank deposits	43
Company does not carry errors and omission policy	53
Recommendation that the company review its entire claim processing and recording procedure	92
Recommendation that the company keep a detail listing of items included in remittances and items not allocated	103

CONCLUSION

Acknowledgment is made of the courtesy and cooperation of the officers and employees of the company during the examination.

In addition to the undersigned, Messrs. Robert D. Balzano, Joe G. Newman, and Robert W. Williams participated in the examination. The actuarial phases of the examination were conducted by Mr. Henry F. Ries, actuary for the Colorado Insurance Department.

Respectfully submitted.

LLOYD J. ENGSTROM,
Examiner, Colorado Insurance Department.
G. R. MORGAN,
Examiner, Commonwealth of Kentucky, Representing Zone 3, NAIC.
ROSS M. EDDINGTON,
Examiner, State of Wyoming, Representing Zone 5, NAIC.
BEN R. MCBROOM,
Examiner, State of Utah, Representing Zone 6, NAIC.

Mr. HARRIS. Do you wish the exhibit referred to—even though it is rather lengthy, it does give an example of a complete report of your company—included in the record?

Mr. DEERING. The exhibit 1 in the record; yes, sir.

Mr. HARRIS. Let it be included in the record.

Mr. Ford, does that conclude the presentation of your panel?

Mr. FORD. Yes, sir.

Mr. HARRIS. Mr. Long, any questions?

Mr. LONG. Mr. Deering, assuming the Securities and Exchange Commission merely requested that you file a copy with them of the statement that you now file with the State insurance commissioners in the various States in which you operate, would you still object to this bill?

Mr. DEERING. Yes, sir; I would. I believe that if the insurance industry is to be specially treated, it should be specially treated in a statute. I don't think we should be required to rely on an SEC regulation or an SEC representation as to the type of reporting that they will require.

Mr. LONG. This question of what type of reporting they will require is pretty much up in the air, isn't it?

Mr. ROBERTS. No, sir. In a letter to Mr. Combs, the commissioner from Arkansas, which I just referred to in response to a remark by Mr. Harris, the details are set out, and I hope I made it clear in my testimony that not only did we subject the costs under the bill as written, but we subjected the costs of the proposed more moderate regulations in estimating the cost to the companies. It would require dual bookkeeping in effect. It is true that all of the information is obtainable from the material upon which the annual statement is based, but it is not existent in the form that the SEC proposes to require, if the SEC is not proposing to accept an amendment to the bill that would exempt life insurance companies, except that they should file a copy of their annual statement with them, which would be an entirely different thing from their asking that we develop a completely parallel mass of information for their use based on entirely different accounting theories.

Mr. LONG. Mr. Deering, how did you come up with the figure of $15,000 to $20,000 as your annual cost of preparing your reports that are required?

Mr. DEERING. Our actuaries estimated that this would be the amount that it would cost the average company in the Colorado life convention to comply. I can't tell you what tests they went through and exactly how they arrived at the figure, but it was through our actuarial department attempting to compute what would be required in man-hours, and outlay of time, and money in order to comply with what we feel that the SEC is going to require us to do.

Mr. LONG. Mr. Roberts, Chairman Cary in his statement before this committee said, and I quote:

> The only difference between the reporting that will be required by the proposed commission article and that currently required by the States is that the former will include substantially less detailed information pertaining to insurance matters than that included in the NAIC statement. The only other change is that the proposed article would require certain brief explanatory notes, including a historical analysis of surplus, for the benefit of the investors not conversant with the insurance accounting practices and terminology.

This suggests to me that they are not going to require you to change your entire system of accounting, but merely require explanatory footnotes showing the difference in the types of accounting.

Mr. ROBERTS. Mr. Long, I am relying upon the letter of Mr. Cary to Commissioner Combs setting out in detail the small additional information that he proposed and the costs that we estimated were based first upon the bill and then, second, upon Mr. Cary's letter.

Actually there is no essential difference between them. As I say, all of the information, it is true, may be obtained from the material upon which the annual statement is based, but it is organized in such a fashion that it would cost just as much almost to go through with the preparation of his projected report as it would be to follow the letter of the bill.

He is making what appears to be a concession, but in actuality, it is no concession at all. The letter, as I recall, and I have it somewhere in this rather voluminous file, was dated in early September of last year following a conference between Mr. Combs and certain other commissioners and Mr. Cary, and it sets out in very great detail the forms that he proposes. I have gotten my file slightly disorganized so I cannot cite the date of this letter, but I think I can find it if you would be——

Mr. LONG. If it is not already part of the record I would like to have it made so in order that I may look at it.

Mr. ROBERTS. I do not think that it is a part of the record.

Mr. FORD. I think it should be.

Mr. ROBERTS. It is a most complicated proposed form and most expensive to develop.

Mr. LONG. If you would make it available to the committee, subject to the approval of the chairman and the rest of the committee, and send me a copy of it, Mr. Roberts, I would like to look at the letter.

Mr. ROBERTS. Very well. I will endeavor to find it now.

Mr. HARRIS. It seems to me that it is in the record.

Mr. ROBERTS. I have it here.

Mr. HARRIS. I think I questioned someone meticulously on it, but, anyway, if it is not in the record it will be included.

(The letter referred to follows:)

SEPTEMBER 18, 1963.

Hon. HARVEY G. COMBS,
Commissioner, Insurance Department, State of Arkansas,
Little Rock, Ark.

DEAR MR. COMBS: This will confirm our discussion at the conference held in my office on September 12, 1963. I want to make it absolutely clear that financial reports required to be filed by life insurance companies under H.R. 6789 (S. 1642) would involve a minimum additional effort and nominal additional cost.

I enclose a copy of a draft of a proposed article 7A of our accounting regulation S–X which would prescribe the form and content of financial statements required to be filed by life insurance companies in annual reports under the Securities Exchange Act of 1934, and under H.R. 6789. Drafts of this article have been under consideration since 1960, and have been thoroughly discussed with official representatives of the National Association of Insurance Commissioners (NAIC) as well as with representatives of the life insurance industry. As a result of these discussions substantially all differences have been resolved and we are prepared to accept the views of the NAIC as to the one or two remaining points with respect to reporting gains or losses on investments which are still open. If any commissioners, including any one of you, still have any reservations, I hope you will advise us.

In connection with this matter the following points should be borne in mind:

1. The draft contemplates that the financial statements required to be filed by life insurance companies will conform to the requirements of the State insurance commissions for an annual report as specified in the NAIC convention blank, together with certain additional explanatory notes provided for in rule 7A-05 on page 5 of the enclosed. These notes are designed to explain certain insurance accounting terms and practices for the benefit of investors not familiar with insurance accounting. We also would not require the filing of certain schedules which are now included in the convention blank but which we believe are of primary interest to insurance regulatory authorities rather than to investors.

2. The financial reports filed by life insurance companies under the Securities Exchange Act of 1934 are not required to be reviewed, certified, or audited by independent public accountants. Company officials may, in effect, file with us the financial statements which they file with the State insurance commissioners, together with the additional explanatory notes. We will rely upon the company itself and the review made by the State insurance commissioners.

I believe there is an erroneous impression which has currency in the industry that an independent audit would be required. The facts are that the financial work of the company's own employees exclusively will be accepted under H.R. 6789. This has been the practice of the Commission for 30 years in handling the financial reports of life insurance companies filed under the Exchange Act. During the Senate hearings on the pending legislation we committed ourselves to continue this practice and the Senate committee report indicates it expects us to do so.

Confusion may have arisen by reason of the fact that life insurance companies have been subject to the registration requirements of the Securities Act of 1933 whenever they sell a new issue of securities to the public. Under this act as contrasted with the 1934 act, financial data of life insurance companies included in registration statements for such new issues are required to be certified by an independent public accountant and fairly complete information concerning all material aspects of the business is required to be included in the registration statement. Compliance with these requirements for the registration of a new issue involves some expense. For the reasons explained above, compliance with the reporting requirements to be established by H.R. 6789 for life insurance companies should by much less expensive, indeed minimal.

3. To coordinate our efforts even further, I suggest it would be possible—if the NAIC so desired—to modify the convention blank by adding an additional page of notes after the principal financial statements containing the explanatory material which we need. If this were to be done, a life insurance company could simply file with us a copy of its filing with the State insurance commissioner as full compliance with the financial portion of its annual report.

4. As you will note from the enclosed proposed article, life insurance companies would be required to follow the rules and instructions governing the definition and computation of items in their annual statements to State authorities. Thus they could include in their balance sheets only admitted assets at admitted assets values, and nonadmitted assets can be stated only in a note to the financial statements.

I believe the discussion above demonstrates fully that the financial material required under H.R. 6789 represents a minimum effort and expense. Moreover, according to our best estimate, roughly a third of the life insurance companies subject to H.R. 6789 are already filing these reports with this Commission.

In addition to the financial items, the annual report of life insurance companies on form 10-K would contain certain narrative material. We would reply on the proxy material filed by the life insurance company to provide most of this, so that the only remaining items would be a list of parents and subsidiaries, a statement of the number of stockholders of record and a brief statement of material changes in the business not previously reported. To the extent these items are included in the company's annual report to shareholders, they could even be incorporated by reference. Thus the annual reporting requirement would involve little more than filing the State convention blank plus the foregoing three items. This should not prove burdensome and the cost should be nominal.

A life insurance company subject to the disclosure provisions of H.R. 6789 would also have to file proxy statements once a year, send to its stockholders an annual report containing financial statements not inconsistent with those

required by the State insurance commissioner, and report currently on form 8-K in case certain specified material developments in its business, such as an acquisition, occurred. In addition to reporting by the company itself, H.R. 6789 would require insiders, i.e., officers, directors and 10-percent stockholders, to file brief reports of their holdings of the company's equity securities and any changes therein.

We appreciated meeting with you and thought it most useful to secure your views on this important subject. I am confident that it will be possible, by cooperation between the State insurance commissioners and the Commission, to establish procedures for compliance by life insurance companies with the disclosure requirements of H.R. 6789 in a manner which will be of material assistance to investors and netiher burdersome nor expensive for life insurance companies. We believe that these additional protections for investors in life insurance companies will result in better markets for their securities and will in no way conflict with, or duplicate, the invaluable work of the State insurance commissioners.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

Mr. LONG. That is fine, Mr. Roberts. I don't mean to take up the committee's time on that at this stage. If it is not I would like to see a copy of it.

Mr. ROBERTS. I have it here.

Mr. LONG. Mr. Yost, I gathered from your statement that you felt that the approval of the Securities and Exchange Commission would be required before any merger could be consummated. Do you interpret the proposed legislation to that effect?

Mr. YOST. Yes, I do. I think the proxy requirement would require SEC approval of the proxy material that was sent to stockholders and I think that the delay in securing that approval might handicap us in consummating a merger.

Mr. LONG. But not per se an approval of any merger?

Mr. YOST. I do not know whether the SEC would wish to approve the merger or not, but certainly they would want to approve all material sent to stockholders, which would have the same effect.

Mr. LONG. I don't know whether the submission to them constitutes an approval on their part, but I did want your view. Thank you, Mr. Chairman.

Mr. HARRIS. Mr. Glenn?

Mr. GLENN. No questions, Mr. Chairman.

Mr. HARRIS. Mr. Keith?

Mr. KEITH. Thank you, Mr. Chairman. When you say—I believe it was Mr. Roberts who said it—that the life insurance industry is the only financial group which would be made subject to this bill, could it not also be said that what you are seeking is that the life insurance industry be the only group exempted from the bill?

Mr. ROBERTS. I don't think so, sir. You have exempted building and loans and various other classes.

Mr. KEITH. Excuse me. Are building and loan associations, generally speaking, stock corporations?

Mr. ROBERTS. Many of them are.

Mr. KEITH. And are they specifically exempted if they otherwise qualify?

Mr. ROBERTS. I think so; yes, sir. In addition the Senate has effectively exempted banks.

Mr. KEITH. I would like to pursue this just a bit further. Perhaps the committee counsel could clarify for me whether savings and loan associations are specifically excluded.

It has been my understanding that savings and loan associations, at least in Massachusetts, don't issue stock. I wasn't aware of the fact that they issued stock, generally speaking, anywhere in the Nation.

Mr. ROBERTS. A great many do, sir.

Mr. KEITH. Are they limited stockholder operations?

Mr. ROBERTS. Pardon?

Mr. KEITH. Are they a combination of a mutual——

Mr. ROBERTS. No, sir. They are stock building and loan companies, although I think in some States they probably utilize the name "association." There are many stock ones, notably in California. There are some in Arizona. We have a few in Georgia.

As a matter of fact, they are widespread in the country.

Mr. KEITH. The stockholdings are widespread?

Mr. ROBERTS. No. I cannot say how widespread the stockholdings are, but the companies are widespread.

Mr. KEITH. Would you say that investors dealing with that kind of corporation were risking their money as much as in the life insurance industry?

Mr. ROBERTS. I would say that the stockholder in a building and loan or savings and loan company would probably have slightly more risk involved than in an insurance company because the system of annual reports and the system of biennial examinations is somewhat less meticulous, I think—that is my impression—with them than with life insurance companies, and I don't think that any States have provisions for, in the instance of new companies, requirements of experience and the like on the part of the executives, so I would say offhand that a stockholder in a savings and loan would have a greater element of risk than in a life insurance company.

Mr. KEITH. You mentioned the enforced mutualization at the time of the Hughes investigation. I wasn't aware of the fact that the giants of the mutual insurance industry had been forced to mutualize.

Mr. ROBERTS. Prudential was forcibly mutualized, the second largest one. I think that Equitable, which is the third largest, was forcibly mutualized.

Mr. KEITH. Having read the company's history years ago, I apparently overlooked the fact that it had been forcibly mutualized.

Mr. ROBERTS. This Hyde can really be called, sir, the father of insurance in this country, and let me observe that even though policy he sold might have been a little bit quaint, he was the first person really to provide mass protection and I am not sure that the damage he did was not far exceeded by the good he did.

Mr. HARRIS. Will the gentleman yield?

Mr. KEITH. Yes, sir.

Mr. HARRIS. I think, going back to this jurisdiction, it might be advisable to clear up for the record a little bit more definitely, if we could, the exemptions that are included in S. 1642, which are on pages 7 and 8, subparagraph (2) (C).

The provisions of this subsection shall not apply with respect of—

(C) any security, other than permanent stock, permanent reserve stock, or any similar certificate evidencing nonwithdrawable capital, issued by a savings and loan association, building and loan association, cooperative bank homestead association, or similar institutions, which is supervised and examined by State or Federal authority having supervision over any such institution.

I think that pretty clearly describes what is exempted in that field, that is, the filed of savings and loans, and building and loan associations, and so forth.

Mr. KEITH. Thank you, Mr. Chairman. The key may be in the last phrase; "State or Federal." I wonder if there could be a very substantial savings and loan outfit with a lot of widely held stock which is not now under the supervision of some Federal agency. I would be surprised if there were.

Mr. HARRIS. Well, you will also observe that it does not include such institutions without "permanent stock, guarantee stock, permanent reserve stock, or any similar certificate," whatever that means.

Mr. KEITH. Thank you very much.

Mr. FORD. On your building and loans, I think your principal supervision is if they had Federal insurance.

Mr. KEITH. Is the stockholder protected as well as the shareholder or the account?

Mr. FORD. I don't think so.

Mr. KEITH. The stockholder doesn't have any protection.

Mr. FORD. I don't believe so.

Mr. ROBERTS. I would say it varies substantially from State to State.

Mr. FORD. Federal insurance.

Mr. ROBERTS. Yes.

Mr. KEITH. The Federal Government protects——

Mr. ROBERTS. Only protects the equivalent of the depositor. It does not protect the stockholder.

Mr. KEITH. No further questions, at this time, Mr. Chairman.

Mr. HARRIS. Mr. Curtin?

Mr. CURTIN. No questions, Mr. Chairman.

Mr. HARRIS. Gentlemen, on behalf of the commitee I want to thank you for your presentation here this morning. Did you have the privilege of being here yesterday when Mr. Grady testified on behalf of the National Association of Insurance Commissioners?

Mr. FORD. I was here, but these gentlemen were not. I attempted to brief them as well as I could.

Mr. HARRIS. Are you gentlemen familiar with what Mr. Grady explained as to what happened in Phoenix, at their recent meeting?

Mr. HUNDAHL. Just 2 weeks ago I received a letter from our Texas commissioner setting out the additional material that they were requiring, so that is already in the hands of our people who are preparing our statement right now.

Mr. HARRIS. The commissioners through their association have recommended the imposition of a three-point program to be included in addition to what has been included in the disclosures in the past. Does anyone in the industry that you know of take exception to the proposal of the State insurance commissioners?

Mr. ROBERTS. Oh, no; we have never objected to that. As a matter of fact, sir, the question of insider trading had never been brought to anyone's attention. It is perhaps an excellent thing that this bill came around when it did because it is a potential thing, although we have had no trouble with it.

Insider trading in life insurance companies usually means the picking up of stray shares of stock by officers of the company when they are offered. There isn't any extensive insider trading. There could be, however, and I think that the commissioners requirement about reports on that is very highly necessary and very desirable.

Mr. ROSENBERG. Sir, I would like to make the point that the industry as a whole has always been for complete disclosure and should there be anything else, I think, that is necessary to be disclosed within the framework that we are operating we would be more than willing to put this into the statement.

Mr. HARRIS. Gentlemen, I appreciate your position and your willingness for disclosures and all of that. We are trying to develop something here, and it has been developed, in which the State insurance commissioners themselves say that there has been a void in the past and they have not included it and they propose to include it. I am not asking you to argue whether or not they have or they haven't or any excuses about it.

They say that this is what they will undertake, so what I am trying to find out, as we developed yesterday, is there any objection on the part of anybody in the industry?

Mr. ROBERTS. No one in the industry has made any protest and it is my understanding that the Blanks Committee has already taken action, Mr. Chairman.

Mr. HARRIS. That was mentioned yesterday; I am not sure for the record, but it was to me afterward, if not included in the record.

Mr. KEITH. Mr. Chairman.

Mr. HARRIS. Mr. Keith?

Mr. KEITH. On that point, and I am not quite certain I understand all the ramifications of insider trading activities, I notice in this statement furnished by the Chesapeake Life Insurance Co. that the president and treasurer are both named Rosenberg. There is no listing as to who is the counsel for the corporation that I can see. Are you by chance counsel?

Mr. ROSENBERG. No, sir. The vice president, Mr. Charnas, is the counsel for the corporation; Mr. Charnas and Mr. Spector, two counsel.

Mr. KEITH. Joint counsel?

Mr. ROSENBERG. Yes, sir.

Mr. KEITH. How much remuneration did they receive in connection with the formation of this company?

Mr. ROSENBERG. Nothing.

Mr. KEITH. Have they received anything since as counsel?

Mr. ROSENBERG. I think they have been paid maybe a total of about $5,000 or $10,000 in legal fees over the past 8 years, between $5,000 and $10,000 over the past 8 years.

Mr. ROBERTS. That would show in the annual statements, sir. All payments to attorneys and all salaries to officers of the company are shown in exhibits, in their annual statement each year.

Mr. KEITH. I would like to ask, if I may, one more question of Mr. Deering. I am quite impressed by the growth of small insurance companies in Colorado. Is it your main argument that in certain areas throughout the country there is a need and a market for venturesome life underwriting by small companies which are familiar with the area; that at the same time the area has a need for capital that can be acquired through the formation of these companies, and that when these small companies are getting started, the kind of reporting that is required here would work to their detriment and, incidentally, to the benefit of the already existing larger companies?

Is that the essence of your argument?

Mr. DEERING. That is the essence of part of my argument, yes.

Mr. KEITH. Thank you, Mr. Chairman.

Mr. HARRIS. Back to the testimony yesterday of Mr. Stafford R. Grady, commissioner of insurance, State of California, on behalf of the Association of Insurance Commissioners on page 6 of his statement he explained the action of the association in its meeting at Phoenix and he referred to the adoption or the inclusion of so-called stockholder information supplement.

He explained that—

> In adopting the stockholder information supplement, the NAIC was cognizant of the facts which were disclosed by the SEC study and report. We commissioners thoroughly agree that, in the best interests and for the protection of those who invest in insurance company stocks, additional information should be required to be disclosed to stockholders in respect to the following matters:
>
> (1) Annual reports—

and so forth.

> (2) All proxy statements—

and so forth.

> (3) So-called insider transactions—

and so forth.

Do you or any of you disagree with the comments of Mr. Grady?

Mr. ROBERTS. No. As a matter of fact, I cannot imagine why, except that no one felt that there was a need for it, the insider transaction report was not put in, say, 8 or 10 years ago with the general growth of companies, because it really is a most necessary thing.

Mr. HARRIS. Do you agree with the record, which has not been disputed yet, that the traditional procedures of State commissioners have been toward the protection of the policyholders and not the investors?

Mr. ROBERTS. You mean the investing public, sir?

Mr. HARRIS. Yes.

Mr. ROBERTS. No, sir; I do not agree with that thesis, because the investment regulations, the expenditure regulations, that exist, it is true they are primarily for the benefit of the policyholder, but if they maintain the company's solvency, if they compel it by statute to operate within a limited expenditure, how could it other than protect the shareholder in the company.

I don't see why the interest of the policyholder and the interest of the shareholder are in conflict in any sense.

Mr. HARRIS. I do not know that anyone has suggested that there is any conflict, but this record is rather repleat, and as I say, until now has not been disputed, that the procedures have been toward the

protection of policyholders and not emphasized as far as protection of the investing public.

You think differently. If that is the situation and the companies think as you have just indicated, and the representatives of the insurance commissioners state otherwise, it seems to me that there should be a meeting of the minds somewhere between those of you who are supposed to be regulated on those who are supposed to be regulating.

Mr. FORD. I think what Mr. Roberts said was that if you properly regulate the policyholders, in the very nature of things it benefits the stockholders.

Mr. HARRIS. I doubt very seriously if that is true and, as little as I know about it, I can't see that.

Mr. HUNDAHL. I have a copy here of Mr. Price's statement to you—I believe he made it yesterday—and in that statement he says that their opposition to the bill in the present form was based on the following:

> That the State of Texas is effectively regulating and supervising the business of insurance, and that adequate protection is being provided not only to the policyholders, but to the stockholders of the insurance companies under our jurisdiction.

That was out of his statement, sir.

Mr. HARRIS. Maybe so, but the general trend of things here is that there should be a tightening up on the other end of those for investors.

Mr. HUNDAHL. I offered that so there wouldn't be any question about us arguing with the gentlemen who was here yesterday.

Mr. WILLIAM E. LONG. I would like to volunteer that most of us handle stockholder relationship without any insistence on the part of the insurance commissioners to put in and ask for additional information.

Some of us send all the information we can because the price of our stock, the public acceptance of our stock, is determined entirely, especially if it is widely held—maybe not if these companies are closely held—and our stock is held by many people and in about 48 States and therefore we have to provide them with adequate information or otherwise they would be selling it and as a substantial stockholder in the company I would lose my shirt, so it is to my own interest, if I didn't have any care for the public, which I do have, but I think most of the companies—there are exceptions always—are trying to operate in the public interest, to the stockholders of good will, because the stockholder helps you to get policyholders and that is the way most of us operate, from the stockholder to the policyholder.

Mr. HARRIS. Now, Mr. Long, we are primarily talking about insurance, but you do not contend that the over-the-counter transactions are as safe as those that are on the exchange?

Mr. WILLIAM E. LONG. Well, I don't know that that is true. However, in the past, looking at mutual funds which deal in life insurance company stocks, and there are a great many of them over-the-counter stocks, they have done pretty well with them.

Mr. HARRIS. Yes; they have.

Mr. WILLIAM E. LONG. They haven't found them suffering.

Mr. HARRIS. Most of them are insured by the Federal Government, too, up to a certain point.

Mr. WILLIAM E. LONG. One of the things that I think I can say in favor of our industry, Mr. Harris, is that at least our policyholders have never had to be insured by the Federal Government, which is not true of the depositors in banks and savings and loans, and so the regulation at least has kept us so that we have been able to meet our obligation to the public and therefore if we can meet it to the public we have to meet it to our stockholders.

Mr. HARRIS. Perhaps the State insurance commissioners are to be highly complimented in their administration of the program to make it abundantly clear and to give assurance without any doubt that that protection will be given.

There has been some suggestion in these hearings that a certified copy of the annual report filed with the State insurance commissioner be filed with the SEC for its information. Is there any objection to that procedure?

Mr. WILLIAM E. LONG. If it were certified in the bill that this was to be the requirement I have no objection. If it is left to the decision of a body which could be guided to make a decision this year and next year to change it to suit their own taste, then I object.

Mr. HARRIS. To what?

Mr. WILLIAM E. LONG. If it is left to the SEC this year to accept and then next year to change their mind and then go on to where we have to have a CPA report, then I object. If it is spelled out in the bill that we are to file a certified copy of our present convention statement with the SEC, I have no objection.

Mr. HARRIS. You mean that if it is there at all you want it to be mandatory?

Mr. WILLIAM E. LONG. I want it spelled out that that is the kind of report we are to file and that it won't be at the discretion of the SEC to change its mind as to what type of form it wants.

Mr. HARRIS. I am not talking about that. I am talking about a certified copy without any further authority that goes with it, as I understand the suggestion that has been made.

Mr. ROBERTS. You mean put it in the bill that the companies shall be exempt, except that they shall file a certified copy of the annual statement?

Mr. HARRIS. Yes, whenever decided.

Mr. ROBERTS. I don't see why we should object to that, a certified copy of the annual statement with anybody at all, Mr. Chairman. This company, for example, printed 1,500 miniatures of the annual report. They are identical with the annual report in every particular except that they are smaller in size. I think that Mr. Yost's company—I used his company because he was the only one that had enough miniatures to go around to the subcommittee—printed 750. Those are to send to anybody that wants a copy of them. Any stockholder, any investment broker, or anybody with a reasonable interest in them, beacuse they cost a good bit of money, can get a copy of them, so we are very happy to have SEC have a copy of the annual statements.

Mr. WILLIAM E. LONG. We send out several hundred ourselves.

Mr. FORD. The simple answer is that there would be no objection to it if it was contained in the statute that we file the certified copy of the report. My concern as an attorney has been that the SEC sug-

gested that it be through regulations rather than legislation, and through an exchange of letters from the Chairman of the SEC to the chairman of the committee, thus making nice legislative history, but in a statute might carry penal sanctions. I would rather have it written in the statute than have to rely upon legislative history.

Mr. HARRIS. Frankly, I don't see why it would be necessary for every company in the country to file a certified copy with the SEC. I don't know what they would do with all of them if they had them, but, on the other hand, I think, if there is any problem that comes up where there is any question with reference to their responsibility, that if they need the information, it should be available to them. Whether it would be on request or mandatory is something else.

Mr. FORD. Either way, sir.

Mr. WILLIAM E. LONG. We would be happy to do it.

Mr. HARRIS. Gentlemen. Thank you very much on behalf of the committee for your appearance here today.

Mr. FORD. Thank you.

Mr. HARRIS. This will conclude this series of hearings for this week. So far as the Chair knows this is all of the witnesses that have been scheduled and who desire to testify at this session.

The record will be held open for a reasonable period of time for anyone who desires to file their comments on the proposed legislation.

The committee will adjourn the hearings until Tuesday, February 4, at which time Mr. Funston, the president of the New York Stock Exchange, will reappear to testify on some matters that were brought up and others since. The committee will expect him to present to the committee a full and detailed report on the Ira Haupt & Co. transaction of which there has been so much comment in recent weeks.

On February 5, the following day, we will have Mr. Cary, the chairman of the Securities and Exchange Commission, back, and should we not be able to conclude with him on Wednesday, the 5th, it will be continued until we do conclude with him during the week, following which it is the intention to close the hearings in order that the committee may proceed with its considerations.

The committee will adjourn.

(Whereupon, at 12:38 p.m., the committee was adjourned until Tuesday, February 4, 1964.)

INVESTOR PROTECTION

TUESDAY, FEBRUARY 4, 1964

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE
OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to recess, in room 1334, Longworth Building, Hon. Harley O. Staggers presiding.

Mr. STAGGERS. The committee will come to order.

We are glad to have you with us, Mr. President, President Funston of the stock exchange.

I feel at this time on behalf of the subcommittee that I should make a few opening comments before we start with these hearings.

Following Mr. Funston's last appearance before this subcommittee, two things occurred in quick succession, each involving a fundamental aspect of the New York Stock Exchange.

Mr. Funston testified here on the afternoon of Wednesday, November 20.

On the same day, his stock exchange announced the suspension of two of its members for failure to meet the exchange's capital rule. At the time he was testifying, the subcommittee did not know that this had occurred.

On Friday, November 22, following the President's assassination, the stock exchange suspended all trading more than an hour before its normal close.

The suspension of these members, one of whom was so insolvent that the exchange made arrangements to cover his obligations to his securities customers, sharply again poses the question of just what is the adequacy of the protection that a customer may have who leaves any cash or securities with a broker-dealer.

The fluctuation of the stock exchange market prices in the trading between 1:41 and 2:07 on the afternoon of November 22 after the President's assassination and the trading when the exchange reopened on November 26, sharply again poses the question of just what is the role of the specialist in auction markets, and what is the adequacy of the protection than an investor has when he participates in that market.

Neither question is a new one. These questions concerning the protection of customers' credit balances and securities and concerning the role of the specialist and segregation of the broker-dealer functions have been around since the passage of the act 30 years ago. They were subjects of study from 1935 to the recent special study of the Commission that was made at the direction of the Congress. Both the Commission and the New York Stock Exchange indicated last Novem-

ber 20 in testimony here that they wished to make these the subject of further study.

Whatever might have been the attitude of this subcommittee on November 20 concerning this further putting off of the coming to grips with these two very basic features of the stock exchange system, it would seem to me that the stock exchange actions of November 20 and of November 22 can do nothing less than lead to a most insistent demand that something definite be done in this field to insure investor protection, and that this something be done right soon.

This is the reason, Mr. Funston, that we requested you to return to discuss these and other matters.

Indeed, it may be appropriate at this point to include in the record an editorial in the New York Times of January 29 calling upon Mr. Funston to give some definite answers concerning the specialist, and an editorial in the Washington Post of January 2 calling for something to be done for the protection of customers' balances with brokers.

If there is no objection, I will at the appropriate time insert these two editorials in the record.

(The editorials follow:)

[From the Washington Post, Jan. 2, 1964]

PROTECTING CUSTOMERS

One aspect of the great vegetable oil swindle that has been accorded scant attention is the inadequacy of the laws and regulations drawn to protect the cash balances and securities which brokerage houses hold in custody for their customers.

When Ira Haupt & Co. failed after it became hopelessly enmeshed in the futures speculations of Anthony De Angelis, many of the firm's customers were unable to withdraw their cash balances or take possession of paid up securities that were held in "street" name (registered in the name of Haupt). The members of New York Stock Exchange worked out a plan under which $12 million were made available in order to free the assets of Haupt's customers, and to date it has paid out more than $6.7 million. But in spite of this prompt action, many of Haupt's customers have suffered losses for which they will not be reimbursed. The dividends on securities held in street name was immobilized for periods of a week and upward, and many investors were unable to trade during a period in which there were opportunities to make considerable profits.

Haupt's bankruptcy underscores two weaknesses in the provisions of the Securities and Exchange Act. As a consequence of the custodial functions which the Nation's brokerage houses perform, they currently hold about $1.2 billion in "net free credit balances"—the funds from the sales of securities, dividends, and interest which are in excess of debts due from customers. These free balances are an important source of working capital, and there is little doubt that brokerage fees would be much higher in their absence.

But the law makes no provision for protection of free balances in the event of bankruptcy. Consequently the "Report of the Special Study of Securities Markets" recommended that brokerage houses be required to maintain cash reserves of 15 percent against customers' free balances, a principle which has worked well in the commercial banking industry. And the study also urges that customers be fully informed that their balances are being used by the firms holding them and that they are vulnerable in the event of insolvency.

There is also a danger because the law is not clear as to whether a broker may hypothecate—pledge against a loan—a fully paid security without the consent of his customer. And where a blanket consent is obtained, hypothecations can be made without informing the customer.

Although the organized exchanges have done a creditable job in protecting the public when their members have been bankrupted, the Security and Exchange Commission Act should nonetheless be amended to provide adequate reserve against customers' free balances and tighten rules governing the hypothecation of securities by brokers.

[From the New York Times, Jan. 29, 1964]

DISORDER IN THE MARKET

Specialists of the New York Stock Exchange, who are charged with maintaining orderly markets, turned in a mixed performance on November 22, 1963—the day that President Kennedy was assassinated.

An investigation of their activities by the Securities and Exchange Commission shows that some specialists contributed to the extremely disorderly conditions that took place in the 30 minutes that the exchange remained open following the news of the shooting in Dallas. Its findings reveal that specialists dumped shares on the market ahead of the public, which led to a nosedive in prices and was hardly consistent with the claim by the New York Stock Exchange that specialists play a vital role in maintaining stability.

Keith Funston, the exchange president, acknowledged that "not all specialists acted alike," observing that "some people do not perform as well as others in a crisis." But he neglected to mention that the ability of specialists to provide stability depends to a large extent on their financial resources, which in many cases are inadequate. In Mr. Funston's view, specialists did a good job simply because they ended up buying more shares than they had sold.

Specialist purchases do not constitute a true measure of their performance, for it is quite possible to play a destabilizing role and still increase commitments. Mr. Funston also clouds the issue by suggesting that the responsibility of specialists can be set aside in a crisis, which is precisely the time when their stabilizing function is most needed.

Even then there is no expectation that specialists can prevent panic or halt a decline. Specialists could be wiped out if they tried to stem a selling wave. But they are supposed to provide a temporary cushion when there is a large gap between supply and demand. And they have a responsibility to avoid adding to any selling or buying pressure.

This limited responsibility demands that specialists have adequate financial resources. It also requires the exchange to strengthen its own supervision, with tougher disciplinary penalities against specialists who contribute to disorder. The problem cannot be explained away simply by saying that there will never be another crisis like November 22. There are bound to be new crises that will test the nerves and purses of the specialists.

Mr. STAGGERS. I trust I may be indulged in making the parenthetical remark that in view of the expressions both editorial and reportorial hitherto made by the Times and the Post concerning this subcommittee's zealousness in seeking to protect investors, I find their newly expressed position of considerable interest.

As I wrote you, we wish to know just what is involved in this Haupt cause, the steps which you have taken to remedy the situation, and the steps you have taken, or propose to take, or suggestions for legislative action which will enable you to provide adequate protection in the future.

I also wrote you requesting that you discuss the Commission's report on the activities of the specialists on your exchange following the assassination of the President and that you give us a clearer picture than you presented last time of just what action the exchange intends to take and what action the exchange and the Commission together may take as a result of the deliberations in this field which have been going forward now for some time.

In addition, I expressed the desire that you be able to comment briefly on the position of the exchange with respect to the question of Commission authority to issue the proposed rule 17a–8 to require every national securities exchange to file with the Commission any proposed notices in the exchange's constitution, bylaws, or rules 3 weeks in advance of their being adopted by the exchange.

We are pleased to have you here today, and I know that you welcome the opportunity to speak not only on the specialist subject, but also

on the subject of the Haupt Co. insolvency and what you are doing to protect the securities customers even though it appears that in this instance much of the trouble stems from transactions in the commodities markets.

In this connection, I cannot but be reminded of your comments on June 29, 1961, when you appeared before this subcommittee to testify on House Joint Resolution 438, which directed the Securities and Exchange Commission to make the study we now are considering. I believe this description of the duties and responsibilities of the New York Stock Exchange in the carrying out of these self-regulatory functions under the Exchange Act is so clearly germane that it here should be repeated.

Mr. MACK. What is the extent of your jurisdiction in the matter of disciplining your members?

Mr. FUNSTON. It is very broad. When the exchange was first——

Mr. MACK. I would like to further ask if it goes beyond the actual operation of the exchange?

Mr. FUNSTON. Under the original constitution of the exchange, when it was set up in 1792, the purpose of the exchange was to promote just and equitable principles of trade, and I think the other phase was to provide for high standards of business conduct.

When a man comes and signs the constitution of the exchange, a member, he agrees to abide by these rules, and the exchange can, by invoking any one of these things exercise whatever discipline is necessary to bring about compliance with these stands. So our power is very broad. It is generally recognized. The members sign the constitution agreeing to it when they buy a seat on the exchange, and the same rules apply to all of the allied members of a member of the exchange.

Mr. Mack then asked of you:

Then it would include other activity—

and you replied—

Yes, sir. Any member of the New York Stock Exchange is responsible to the exchange for the performance of just and equitable principles of trade in any line of business in which he is engaged.

This wide scope of exchange powers and duties under its constitution and rules, is precisely the reason, as you know, that House Joint Resolution 438 was couched as it was, for this scope encompasses much more than the field covered by the act, itself.

Mr. Funston, before you proceed, I believe that I shall here insert in the record my letter to you of January 27. That shall be inserted in the record.

(The letter follows:)

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., January 27, 1964.

Mr. KEITH FUNSTON,
President, New York Stock Exchange,
New York, N.Y.

DEAR MR. FUNSTON: It is my understanding that the date of February 4 has been confirmed with you for your return to present additional testimony to the subcommittee which is considering the special study made by the Securities and Exchange Commission into the adequacy of the rules of the securities exchanges and the recommendations of that study and of the Commission as contained in H.R. 6789 and H.R. 6793 for legislative action.

As you know, on the date of your previous appearance here in November, you released but did not discuss with us at that time the notice of suspension of two members of the exchange for overextension in the commodities market. Indeed, in view of the ramifications that subsequently developed concerning

the activities of one of these firms, it probably would have been premature at that time to have engaged in any extensive discussion of the problem. I am sure by this time, however, you are much more conversant with the problem of protection of customers' securities and credit balances as well as of exchange examination of members' financial position, and now can give us as requested of you by Chairman Harris in December, a more detailed presentation of just what is here involved, the steps which you have taken to remedy the situation, and the steps you have taken, or propose to take, or suggestions for legislative action which will enable you to take, to provide adequate protection in the future.

In addition, as we all are too regretfully aware, following your previous testimony there occurred the tremendous fluctuation in stock market prices following the assassination of the President. What the activities were of the specialists on your exchange in this fluctuation has now been suggested to us by the Securities and Exchange Commission on the basis of a report on the specialists in 25 securities. I understand that a copy of this report and the Commission's memorandum on the subject was made available to you by the Commission last week.

It is my wish that on your return next Tuesday you also might discuss this subject and give to us a clearer picture than you presented last time of just what action the exchange intends to take and what action the exchange and the Commission together may take as a result of the deliberations in this field which have been going forward now for some time.

In addition, I trust that you also may be enabled to comment briefly on the position of the exchange with respect to the question of Commission authority to issue the proposed rule 17a–8 to require every national securities exchange to file with the Commission any proposed notices in the exchange's constitution, bylaws or rules 3 weeks in advance of their being adopted by the exchange. This is a subject which I understand you discussed with Chairman Harris last December and is also the subject of a letter of inquiry I made of the Commission several weeks ago following the press announcements of the Commission's proposal, and is commented upon by reply dated January 22 which I received from Chairman Cary of the Commission. It is my purpose to include this comment by the Commission in the record when we reconvene next week but in anticipation of that, I am enclosing a copy so that you may the better present your comments in this regard.

Sincerely yours,

HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance.

Mr. STAGGERS. So that we might have a full discussion this week of the specialists activity on November 22, I have inserted previously in the record my December 2 request of the Commission for a study of what happened on the day the President was assassinated and the Commission's reply to me of January 21.

Also for purposes of a full discussion this week, I here shall insert in the record my query of the Commission of January 17 concerning the source of its authority to require the exchanges to file rules with it in advance of their adoption in view of the special study position that the Exchange Act did not so provide, and the Commission's reply of January 22.

(The letters follow:)

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., January 17, 1964.

Hon. WILLIAM L. CARY,
Chairman, Securities and Exchange Commission,
Washington, D.C.

DEAR MR. CHAIRMAN: The Wall Street Journal for January 10 carries an article to the effect that the Commission is about ready to adopt a regulation which will require the New York Stock Exchange and all other securities exchanges to notify the Commission of proposed changes in their constitutions, rules, and bylaws 3 weeks before the exchange themselves act on them. In this connection, I note on

both pages 199 and 200 of part 5 of the report of Special Study of Securities Markets presented by your Commission to the Congress on September 17 that there is reference to the Commission's power under the act to promulgate this regulation. On page 200 there is the statement, "The Exchange Act does not require exchanges to file rule changes prior to adoption."

Although I recognize over the years that the exchanges have voluntarily given the Commission some advance notice of the promulgation of rules by them, I am still puzzled, in view of this flat statement in the Commission's report, as to the authority on which the Commission relies for promulgating the requirement that the exchanges notify the Commission of proposed changes in rule, if the press report is correct.

I am sure that you appreciate that I am not raising any question concerning the desirability or undesirability of the Commission's having authority in this field, but simply the question of where the Commission finds the power to do something which the Commission has informed the Congress it did not have the power to do.

Sincerely yours,

HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance.

SECURITIES AND EXCHANGE COMMISSION,
Washington D.C., January 22, 1964.

HON. HARLEY O. STAGGERS
Chairman, Subcommittee on Commerce and Finance,
Longworth House Office Building, Washington, D.C.

DEAR MR. STAGGERS: This is in reply to your letter of January 17 which refers to press reports to the effect that the Commission proposes to adopt a rule requiring stock exchanges to give the Commission advance notice of changes in their rules, and in which you also refer to certain statements on pages 199 and 200 of part 5 of the "Report of the Special Study of Securities Markets" with respect to exchange rules.

The Commission has circulated for comment a proposed rule 17a–8 which would require the exchanges to file reports of proposed changes in their rules. I enclose a copy of Securities Exchange Act Release No. 7218 setting forth this proposal. As you will not from the release, the proposed rule does not require advance approval by the Commission of exchange rules or restrict the right of exchanges to adopt such rules as they may desire. It merely requires a report of rule proposals to the Commission. The proposed rule would be adopted pursuant to section 17(a) of the Securities Exchange Act of 1934 which requires the exchanges to make such reports as the Commission by its rules and regulations may prescribe. The proposed rule would also be adopted under section 23(a) of the Securities Exchange Act which authorizes the Commission to adopt such rules and regulations as may be necessary for the effectuation of the functions vested in it.

While we considered the question of our power to adopt this proposed rule before circulating the proposal for comment, we recently requested our General Counsel to furnish a more detailed memorandum with respect to our power to adopt the rule, and I enclose a copy of such memorandum. By coincidence, it is dated the same date as your letter.

Without repeating the detailed considerations referred to in that memorandum, we believe that the proposed rule is necessary and appropriate in order to permit the Commission to discharge its responsibility of maintaining oversight and surveillance of exchange rulemaking, as recommended by the special study. This becomes more pertinent in view of the recent decision of the U.S. Supreme Court in *Silver* v. *New York Stock Exchange*, in which decision the Court recognized the existence of the Commission's authority and duty to exercise such surveillance.

We believe that the discussion by the special study to which you refer was not intended to imply that the Commission had no authority to require a report of proposed exchange rulemaking, but that the study primarily was contrasting the provisions of section 15A(j) of the Securities Exchange Act, which expressly specifies that changes in the rules of a registered securities association cannot take effect until after they have been filed with the Commission and then only if the Commission does not disapprove the proposed rule, with the absence of any

such express provision in respect of rules of the exchange. In other words, I think that in the statements to which you refer the Study was concerning itself with the power of the Commission to require that proposed rules be filed in advance in order that the Commission may determine whether to approve or disapprove them, rather than with the power to require a report of proposed rule-making action but without any substantive control in the reporting rule over the content or effectiveness of the exchange rule changes.

Sincerely,

WILLIAM L. CARY, *Chairman.*

[Securities Exchange Act of 1934, Release No. 7218]

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C.

NOTICE OF PROPOSED RULE 17a–8 UNDER THE SECURITIES EXCHANGE ACT OF 1934 TO REQUIRE EXCHANGES TO FILE REPORTS OF PROPOSED RULE CHANGES

Notice is hereby given that the Securities and Exchange Commission has under consideration a proposal to adopt rule 17a–8 under the Securities Exchange Act of 1934 to require every national securities exchange to file with the Commission a report of any proposed change in its constitution, bylaws, or rules not less than 3 weeks before they are submitted for any action by the membership or by the board of governors of the exchange. Under the proposed rule, if any substantive change is made in the exchange's proposal after the report is filed with the Commission, a new 3-week period would begin to run, unless the change is made to conform it to a suggestion made by the Commission. The Commission's rule would also provide that if emergencies arise in which a report cannot be filed as provided above, the exchange shall give the Commission as much notice as the circumstances permit, together with a written statement of the reasons why the filing of a report as required was impracticable.

Under the act the Commission has the responsibility to oversee the self-regulatory functions of national securities exchanges. Moreover, under sections 11, 19(b), and other sections of the act, the Commission has broad powers and responsibilities with respect to the rules of such exchanges and matters covered by such rules. Chapter XII of the special study report concluded that the Commission's existing procedures for the review of exchange rules did not seem to be sufficient to assure the needed oversight by the Commission and it recommended that the Commission review exchange rules prior to the time when they become effective. The Commission's proposed rule would afford an opportunity for orderly Commission review of exchange rules before they become effective and assist the Commission in the execution of its functions and responsibilities.

Section 17(a) of the act provides that every national securities exchange shall make such reports as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors. Section 23(a) of the act provides that the Commission shall have the power to make such rules and regulations as may be necessary for the execution of its functions. The Commission's proposed rule would be adopted under the act, and particularly sections 17(a) and 23(a) thereof.

TEXT OF PROPOSED RULE 17a–8

"Each national securities exchange shall file with the Commission three copies of a report of any proposed amendment or repeal of, or any addition to, its rules not less than 3 weeks (or such shorter period as the Commission may authorize) before any action is taken on such amendment, repeal, or addition by the members of such exchange or by any governing body thereof: *Provided, however,* That under emergency circumstances such report need not be filed as hereinabove provided, but in such case the exchange shall file three copies of a report giving the Commission as much notice as the circumstances permit, together with a written statement of the reasons why the filing of a report as above provided was impracticable.

"If any change is made in a proposed amendment, repeal or addition after the report is filed with the Commission, the 3-week period (or such shorter period as the Commission may authorize) will commence to run from the time the Commission is notified of such change unless the change does not alter the

substance of the proposed amendment, repeal or addition, or the change is made in conformity to a suggestion by the Commission.

"For the purpose of this rule the term 'rules of an exchange' shall mean its constitution, articles of incorporation, bylaws, or rules or instruments corresponding thereto whatever the name, and its stated policies.

"The failure on the part of an exchange to file a report as hereinabove provided shall not affect the validity, force, or effect of any rule of the exchange or of any exchange action or omission to act thereunder."

All interested persons are invited to submit their views and comments in writing to the Securities and Exchange Commission, Washington, D.C., 20549, on or before January 31, 1964. Except where it is requested that such communications not be disclosed, they will be considered available for public inspection.

By the Commission:

ORVAL L. DUBOIS, *Secretary.*

JANUARY 17, 1964.

Memorandum

To: The Commission.

From: Office of the General Counsel.

Re: The power of the Commission to require reports of changes in exchange rules.

The Commission has given notice of a proposal to adopt a rule 17a–8 which would require every national securities exchange to file with the Commission a report of any proposed change in its constitution, bylaws or rules. Such reports would have to be filed 3 weeks before action to adopt the proposed exchange rule is taken, except that under emergency circumstances, the exchange need only give the Commission such notice as the circumstances permit. The proposed rule expressly provides:

"The failure on the part of an exchange to file a report as hereinabove provided shall not affect the validity, force or effect of any rule of the exchange or of any exchange action or omission to act thereunder."

Some question has arisen as to the power of the Commission to adopt this rule.

Section 17(a) of the Securities Exchange Act gives the Commission broad authority to require reports from the exhcanges. That section provides in pertinent part that every national securities exchange shall "make such reports as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors." Section 17(a) also requires exchanges to make and keep such records as the Commission may prescribe and provides also that such records are subject to examination by representatives of the Commission.

Section 23(a) of the Securities Exchange Act further empowers the Commission and the Federal Reserve Board to "make such rules and regulations as may be necessary for the execution of the functions vested in them." Given these broad powers to require reports and to require the making of records and to examine such records as well as to adopt other necessary rules, there would seem little question as to the power of the Commission to require exchanges to report proposed rule changes, except for possible negative implications which might be drawn from the provisions of sections 6(c) and 6(a)(4) of the act. Section 6(c) provides that nothing in the act shall be construed to prevent any exchange from adopting and enforcing any rule not inconsistent with the act itself or applicable State law. Section 6(a) requires exchanges, as a condition to registration, to agree to furnish to the Commission copies of any amendments to their rules "forthwith upon their adoption." In order to appraise any objection to proposed rule 17a–8 under these provisions, it seems first necessary to examine the total statutory scheme in order to see how the proposed rule and the sections of the statute referred to fit into that scheme.

The proposed rule is the outgrowth of a recommendation of the special study of the securities markets which concluded that the Commission had a responsibility to exercise oversight over the self-regulatory process including exchange rulemaking and that "the Commission's present arrangements and procedures for review do not seem sufficient to assure the needed continuous oversight on the Commission's part. The most obviously needed change is to provide for filing all proposed rules with an adequate interval between effectiveness as is now required in the case of NASD rules."

The Commission's responsibilities with respect to exchange rules spring from various provisions of the act. Section 6 requires a finding by the Commission that "the rules of the exchange are just and adequate to insure fair dealing and to protect investors" as a condition to granting registration in

the first place. Section 19(b) authorizes the Commission to require changes in the rules of an exchange dealing with 12 important areas of exchange operation together with "similar matters." In *Silver* v. *New York Stock Exchange*, 373 U.S. 341, the Supreme Court stated that this provision not only gave the Commission authority to require changes in exchange rules but also "impliedly, therefore, to disapprove any rules adopted by an exchange." Other sections of the act give the Commission direct rulemaking authority over various phases of exchange operation which are ordinarily governed by exchange rules. This includes the provisions of sections 9, 10(a), and 11(a) with respect to puts, calls, options, short sales, stop loss orders, floor trading, and other trading by members of the exchange. Section 11(b) significantly provides that the rules of an exchange may contain provisions for the functioning of odd-lot dealers and for the vital specialist system only when these provisions are "not in contravention of such rules and regulations as the Commission may prescribe." The Court in the *Silver* case referred to the function of the exchange to formulate rules governing the conduct of its members as a "statutorily imposed duty of self-regulation" and characterized the entire statutory scheme as creating a "federally mandated duty of self-policing by exchanges."

Mr. Justice Stewart, in his dissenting opinion in the same case, concluded that these provisions of the statute "delegate governmental power to working institutions"; i.e., the exchanges. It seems reasonably clear, as the special study said, that any such scheme of federally mandated self-regulation or of delegation of governmental powers necessarily implies an obligation on the part of the Commission, as the responsible agency of government to maintain surveillance and oversight over the exercise of these delegated or federally mandated powers. As this committee put it "although a wide measure of initiative and responsibility is left with the exchanges, reserved control is in the Commission if the exchanges do not meet their responsibility" (H. Rept. 1383, 73d Cong., 2d sess., p. 15 (1934)).

In view of the fact that, as the Supreme Court concluded in the *Silver* case, the statutory scheme necessarily contemplates Commission oversight over exchange rules and impliedly the power to disapprove exchange rules in many important areas, it would necessarily seem to follow that the Commission has both the power and the duty to keep itself informed in a regular and orderly way as to the actions of the exchanges in respect to rulemaking. Indeed, the exchanges do not seem to question this basic proposition since, as pointed out by the special study, the major exchanges have for years voluntarily given the Commission advance notice of any material changes in their rules. Consequently rules intended to accomplish this purpose are in the words of section 23(a) of the act "necessary for the execution of the functions vested" in the Commission and are the proper subject of a reporting requirement.

The proposed rule requiring the reporting of changes in exchange rules does not conflict with either section 6(c) or section 6(a)(4). With respect to section 6(c) which permits the exchanges to adopt rules not inconsistent with the statute, the proposed reporting rule expressly provides that the reporting requirement or any failure to comply with it shall not affect the validity, force or effect of any exchange rule or of any action by the exchange thereunder. The exchanges can continue to adopt such rules as they please insofar as this proposed Commission rule is concerned. With respect to section 6(a)(4) requiring an agreement by the exchange to furnish the Commission with copies of amendments to rules forthwith upon their adoption, the advance reporting of proposals in no way conflicts with this obligation, but merely supplements it. These provisions can be construed as limiting the power of the Commission to adopt the proposal only if one reads into them a negative implication that the Commission's clear authority under sections 17(a) and 23 to maintain surveillance over exchange operations is somehow superseded or eliminated in the area of exchange rulemaking. In view of the entire statutory scheme referred to above, such an implication seems to be wholly unwarranted. Further, we suppose that no one would question the fact that, under its broad authority to require the making of records and to inspect records, the Commission could require the exchange to keep a record of proposed rules, which incidentally the exchange would do in any event, and the Commission could inspect such records at any time. In the light of this, a contention that the Commission cannot require this information to be reported to it but must instead obtain the information by visiting the exchange, implies that Congress drew an inconsistent distinction.

Mr. STAGGERS. Mr. Funston, before we started, I wanted to give this background of what was proceeding and the reason for your presence before the subcommittee. If you will now, proceed with your statement.

STATEMENT OF KEITH FUNSTON, PRESIDENT, NEW YORK STOCK EXCHANGE

Mr. FUNSTON. Thank you, Mr. Chairman.

My name is Keith Funston. I am president of the New York Stock Exchange. Accompanying me today is Walter N. Frank, vice chairman of our board of governors; Mr. E. C. Gray, executive vice president of the exchange; Mr. S. L. Rosenberry, our counsel, of the firm of Milburn, Tweed, Hadley & McCloy; Mr. William O'Reilly who is director of the floor procedure department; Mr. Frank Coyle who is the vice president in charge of the member firm department; and Mr. A. B. Chapman who is a vice president of the exchange..

As you have just said, I am appearing at the request of the committees, first, to discuss what is involved in the *Haupt* case, the steps which the exchange has taken to remedy the situation, and the steps it proposes to take or suggest for legislative action in order to provide adequate protection for customers' securities and credit balances;

And, second, to comment on the SEC report on the performance of specialists on November 22, and to indicate what action the exchange intends to take—either with or without the Commission—with respect to the specialists' activities on the exchange.

These matters concern very complicated problems which are currently the subject of crash programs of investigation and consideration by the exchange. A final program to solve the inherent problems has not been found and probably will not be found for some time. Hence, it is not possible for me to make any definitive statement concerning them at this time. However, I will do my best to outline the scope of the problems and the progress that is being made to solve them.

First let me point out that both of these situations are unprecedented. There has never been an assassination of a President of the United States since widespread shareownership became part of the American economic scene. The flash panic it engendered on November 22 was greater than that ever known before, according to many professionals who have been in the business for 50 years. The Allied Crude Vegetable Oil Refining Corp.'s failure ranks as one of the great manipulations of all time—one which has involved industrial oil refineries, warehouse firms, commercial banks, commodity dealers all over the world, as well as Ira Haupt & Co., whose financial losses, while a small part of the total apparently lost, nevertheless were large enough to cause its failure.

That two such events should occur at almost precisely the same time also is unprecedented. The situation is unusual also because it is only the second time in 25 years that a member firm of the New York Stock Exchange found itself facing financial failure, and probably the first time that such embarrassment came as a result of difficulties in the commodities business. Let me emphasize, therefore, that we are dealing today with two very unusual situations

which should be studied so that we may learn from them, but should not be regarded as a new pattern of normal events to which new policies must be geared.

To turn first to the exchange's actions and program relating to the recent failure and current liquidation of one of its member firms, Ira Haupt & Co., it is axiomatic that failure in business—as in any walk of life—is a very unfortunate event. Yet, in a profit-and-loss economy, failure of an individual or a business unit is difficult to prevent in isolated instances. When it does occur, it sometimes brings forth responses from a community that can be a source of deep pride and satisfaction. I think the record will show that in the Haupt case the response of the exchange community and the participating banks was one of which the financial community may be justly proud and one in which the investing public has already demonstrated its approval.

It is fitting and proper, and an indication of its alertness and concern for investors, that the Interstate and Foreign Commerce Committee should inquire as to the actions of the exchange in the Haupt case. The firm was a member of the New York Stock Exchange and the securities customers of the firm are directly affected. The record should be clear, however, that the New York Stock Exchange is not a principal in the underlying salad oil failure—and that Ira Haupt & Co., was only one of the many parties which has suffered serious loss. It should be emphasized that the difficulties of Ira Haupt & Co., arose as a result of the failure of a large customer to meet margin calls and commitments in commodity dealings—an area not under the jurisdiction of the exchange. Federal and State investigative and law-enforcement agencies, the Securities and Exchange Commission, the Commodity Exchange Authority of the U.S. Department of Commerce, and the various commodities exchanges are also looking into the situation.

The difficulties of Ira Haupt & Co., are but one small part of a large and complex bankruptcy of a vegetable oil refinery. The bankruptcy was brought about by a classic manipulation of inventory and forgery of warehouse receipts. The exchange is one of the many organizations and individuals who, through no doing of their own, became involved when the vegetable oil refiner failed.

The exchange received information on the morning of November 19, 1963, that the inability of Allied Crude Vegetable Oil Refining Co., to meet margin calls on commodities contracts had imposed serious financial difficulties on Ira Haupt & Co., and on one other firm then a member, J. R. Williston & Beane, Inc. The exchange immediately launched an investigation and, shortly after the start of trading on November 20, the board of governors suspended both member firms.

The Williston & Beane problem was resolved and the firm was reinstated on November 22.

However, also on November 22, Ira Haupt & Co., indicated that it had no prospect of being able to satisfy the exchange's minimum capital requirements or even to continue as a securities firm. Later the same day, President Kennedy was assassinated.

The exchange worked almost continuously on the problem presented by the suspension of Ira Haupt & Co., from the time of the

suspension until agreement on a liquidation plan was reached in the midnight hours of Monday, November 25. Throughout the deliberations, the objective of the board of governors was to assist the Haupt securities customers who, through no fault of their own, found their funds and accounts immobilized because of the firm's difficulties, and who in the event of bankruptcy probably might suffer financial loss.

The assassination of President Kennedy, the shooting of the presumed assassin, and the day of national mourning when business firms, including the securities markets, were closed, were the somber background to the board's emergency sessions.

We have recounted the deliberations and negotiations at the exchange in some detail in communications to our own members and to the Haupt clients, making them public at the time. To review them briefly, it became apparent during the hectic afternoon of Friday, November 22, that, if, during the long weekend, no plan were devised looking toward liquidation of the firm, then bankruptcy proceedings might be unavoidable, probably when the courts reopened on Tuesday, and the firm's securities customers would be subjected to the expense, additional delay, and losses of such proceedings.

In midafternoon, the heads of a number of representative firms who were readily available in the New York area were invited to the exchange. These industry representatives agreed with the board of governors that every effort should be made to find a method of helping the Haupt securities customers. A special board meeting was then held to empower negotiations with creditor banks, to be conducted for the exchange by a team consisting of the chairman, the vice chairman, and the president.

Late that same afternoon, spokesmen for a group of banks that were important creditors of Ira Haupt & Co., met with the exchange representatives and agreed to work with the exchange in seeking a course of action which might avoid bankruptcy proceedings.

Throughout the negotiations during the next 3 days, the board stood by, at the call of the chairman, and met frequently to pass on matters of policy. The negotiations were extremely complex, requiring as they did the agreement of a group of domestic banks, both in New York and out of town, a number of foreign banks, and partners of Ira Haupt & Co. In all, 28 signatures were required on the agreement. A public announcement was released shortly after midnight so that the information would be generally available in time for the opening of the market that same Tuesday morning.

Under the terms of the agreement—assuming that no bankruptcy proceeding, et cetera, was instituted—the exchange agreed with the banks and the firm that the firm should be liquidated. The exchange offered to make available $7,500,000 initially, and up to an overall maximum of $12 million, if necessary, that could be drawn on by the liquidator. This represented the only new money going into the tangled situation.

The participating banks, for their part, subject to the same assumption, agreed to defer collection of two dollars in loans to Ira Haupt & Co. for every dollar in cash provided by the exchange—up to $15 million in deferments initially, and an overall maximum, if

necessary, of $24 million. The deferred bank claims will have priority over the exchange on assets recovered from the firm in liquidation.

It is essential to recognize that the exchange assumed a leadership role in the *Haupt* case because of the wholly unique circumstances surrounding that specific situation. It cannot be too strongly emphasized that the exchange had no obligation to act, and that customers of exchange member firms cannot regard the unusual action taken in this case as setting any kind of precedent for the exchange to assume liability for customers' losses stemming from financial problems encountered by member firms in any of their activities.

The liquidation began on the morning of November 26 and is still continuing under the direction of James P. Mahony, chief examiner of the exchange. I am glad to be able to report that the bulk of the work of aiding Haupt's customers has been done. As of the close of business last week, some 4,500 customers have received their fully paid securities; margin accounts with debit balances of $69 million had been delivered to other broker-dealers; and exchange funds of $7,300,000 have been paid to Haupt customers.

Two limited partners recently commenced a proceeding in supreme court of the State of New York to have the firm placed in receivership. However, on January 24 the court postponed any consideration of this matter until March 9. On January 30, the same partners commenced another action which must be answered by February 20. Meanwhile, the liquidation is proceeding on schedule, in the best interests, we believe, of everyone. The exchange is proud of the many expressions of confidence and good will addressed to us by Haupt clients.

The liquidation, however, is by no means completed. To carry it on is taxing to exhaustion the sizable number of exchange personnel assigned to the task. Many unforeseen problems have arisen and been solved. Undoubtedly others will arise. We are blazing a new trail and there is no well-traveled path to follow.

The board of governors has unanimously approved, and the members have now overwhelmingly ratified, a plan for recovering the exchange's expenses in the Haupt liquidation through a series of special charges to members and member organizations. The plan, which does not involve any charges to the public, should enable the exchange to recover the bulk of expended funds within about a 3-year period.

Three standard exchange procedures for checking on the financial stability of member firms were carried out at Ira Haupt & Co., during the summer and fall of 1963. Yet the timing of the commodities transactions of Allied Crude Vegetable Oil Refining Co. was such that these procedures did not—and could not have been expected to—expose earlier the situation that led to Haupt's failure.

Rules of the exchange require a surprise audit of all member firms by an independent auditor at least once a year, and also require members to answer detailed financial questionnaires at other times during the year. The answers to at least one of those questionnaires are then checked during an unannounced visit to the firm by an exchange examiner.

The books of Ira Haupt & Co. were audited as of May 29, 1963, by an independent auditor and a questionnaire answer on this audit

was filed with the exchange. On October 21, Haupt filed with the exchange another routine questionnaire answer covering its financial position as of September 26, 1963. Neither one of these reports on the firm contained any information that gave cause for concern on its commodities accounts.

Allied transactions as a customer of Ira Haupt & Co. in soybean and cottonseed oil spot and futures contracts mushroomed in 5 weeks during October and November. This was after the September 26 date on which the questionnaire from the exchange was based, and after the head of the Haupt Commodities Department went to the hospital for an operation. The exchange received the answer to the questionnaire on October 21 and on November 12 an exchange examiner arrived at Ira Haupt & Co.. for a surprise but routine visit which was to start with a check on the answer.

The drop in the price of vegetable oil which led to the problem occurred late in the same week that the examiner began his visit. Normally, it takes about 4 weeks to complete the examination of a firm of this size. The examiner started, as is customary, with the part of the member firm's business which comes directly under exchange jurisdiction—that is, its securities accounts—and he had not yet reached the commodities accounts when Haupt reported to the exchange its financial difficulties.

The exchange first learned of Haupt's situation when its managing partner came to the exchange in person on the morning of November 19 to report that a large commodities customer had failed to meet margin calls for substantial amounts.

By hindsight, one can contend that had the examiner begun his surprise visit a week or so earlier, or had he gone straight to the commodities accounts, the situation would have been uncovered earlier. Probably that is so. While there is no present exchange rule on the maximum size of positions that firm may carry for any one customer, examiners are expected to report any positions that seem so large as to raise a question whether the firm is adhering to sound business practices.

The examiner was, however, following prescribed exchange procedures in making his visit shortly after the analysis of the financial questionnaire had been completed at the exchange and in starting his examination with the securities accounts. No examining procedure can guaranteee rule compliance or fiscal soundness. In this case, it did not. The point I wish to make, however, is that the exchange has an effective surveillance procedure which, except in a most unusual case, undoubtedly would have disclosed the extended position of the firm with one customer.

The exchange, of course, was not the only agency, self-regulatory or Government, which was concerned with the proper operation of Ira Haupt & Co. The several commodity exchanges of which the firm was a member, and the Commodity Exchange Authority also had a direct interest in the commodities operations of the firm. We do not know what facts were in the possession of these agencies covering the conduct of Haupt's commodities operations or the extent of its commitments with a single large customer.

Because the exchange is prominently in the public eye, some people might conclude that it exercises blanket control over all phases of its

member organizations' business. This is not the case. A precise definition of the area of self-regulation encompassed by the exchange is not easy to develop. Many exchange members and member firms whose New York Stock Exchange securities transactions come under exchange regulations also belong to other self-regulatory bodies, such as the Regional Stock Exchanges, the Commodity Exchanges, the National Association of Securities Dealers, et cetera. Each of these organizations exercises in certain specific areas self-regulatory authority in the conduct of the business of its member organizations.

For the exchange to regulate all phases of its member organizations' business would be an impossible administrative task. In addition, it might lead to claims that the exchange was encroaching upon the primary jurisdiction of other self-regulatory bodies and putting its member organizations in jeopardy of multiple penalties for single infractions.

When I appeared before this committee in June 1961, I was asked what is the jurisdiction of the exchange in disciplining its members. Mr. Chairman, in your introductory remark, you recounted that in some detail.

My reply was that it is very broad, based as it is on the constitution of the exchange, which since 1792 has provided for the promotion of "just and equitable principles of trade" and "high standards of business conduct."

The exchange prescribes overall capital requirements in an effort to keep its member organizations in a position to meet their financial obligations to customers and other creditors. But while our authority in these areas can be called broad, their focus has clear limits.

The point I would like to stress today is that in administering its rules in these broad areas, the exchange's actions, in specific cases, may from time to time affect a member organization's business in an area which is primarily regulated by another self-regulatory organization. Thus, the exchange's interest in Haupt's commodity trading is limited only to its effect upon the firm's capital integrity and to seeing that their dealings be just and equitable.

The basic purpose of the exchange's self-regulatory activities is to see that its member organizations conduct their business in New York Stock Exchange listed securities properly. In any other area, the exchange tries to exercise its authority over its member organizations sparingly and only to the extent that such regulation contributes to fair business dealings and financial soundness. We believe it is the primary responsibility of other self-regulatory and governmental bodies to see that proper rules in the area of their specialities are written and enforced.

Consistent with this policy, steps have been taken during the past year to turn over to other exchanges and to the NASD certain matters involving possible infractions of their regulations by New York Stock Exchange members which formerly the exchange had handled. Similar efforts will be continued in the future.

The exchange is making a careful investigation in connection with possible violations of exchange rules by Haupt personnel. It may be some time before all the facts are developed. If any violations are found to have occurred by persons still within the jurisdiction of the exchange, proper disciplinary action will be taken.

Within the limitations I have attempted to define, the exchange is taking measures to deal with policy problems presented by the failure of Ira Haupt & Co.

Two top-level committees of the exchange community have been named for this purpose. The committee on member firm commodity business has been studying the rules and regulations of the exchange to see whether any changes should be made to give greater protection to the securities customers of those member firms which also carry commodity accounts.

This committee is due to report to the board of governors at its February 19 meeting. While I am unable to anticipate its recommendations or future decisions of the board, I can mention some of the proposals for changes in our rules that have been under study. The philosophy of the committee has been that our member firms should not be denied the right to offer commodity services to customers, if they wish, but the rules governing such services should be tightened considerably. To this end, the committee has been evaluating a number of suggestions including the following: (1) drastic limits on loans against warehouse receipts, including complete prohibition of commodities in unleased warehouses; (2) much more restrictive limits, by means of the net capital rule, on the size of positions in commodities that may be carried for any one customer, and on total size of a firm's commodities positions; and (3) requiring examinations on their qualifications for either partners or employees handling commodities accounts, similar to the examinations now required for persons handling securities accounts.

The second committee, the expense recovery committee, developed the plan for special member charges which has recently been approved by the membership. The committee is now at work on the second phase of its assignment, namely, to study the feasibility of devising a plan to deal with this type of situation should it ever occur again—including a suggestion for establishing a reserve fund.

It is anticipated that the exchange will be able to implement the recommendations of these two committees within its existing authority and without the need of any new legislation. In the event this should not prove to be the case, we would seek the assistance of Congress.

Many other organizations and agencies are making studies evaluating the problem posed by the failure of Allied Crude Oil. Representatives of several commodity exchanges have been in contact with the exchange's committee on commodities business. The commodity exchanges, Commodity Exchange Authority, auditing firms and the banks all are reviewing policies and procedures. Our member firms will, of course, be affected by whatever changes are made by any of these organizations.

As I stated at the outset, the failure of a member firm was indeed regrettable, but the exchange community has reason to be proud of its response to the situation and of the support that the public has demonstrated for the measures we have taken. Of course, it would have been far better had the difficulties of Ira Haupt & Co. never developed at all. Yet, when they did arise, stemming as I have mentioned from transactions in markets not under the jurisdiction of the New York Stock Exchange, the exchange stepped in swiftly to suspend the firm from membership and to help the firm's securities customers. And now

the exchange is hard at work studying possible improvements in its constitution and rules in the light of these events.

Let us now turn to the second topic which the committee has asked me to discuss, namely, the unusual conditions that prevailed in the stock market on November 22 and November 26 of last year, with particular reference to the performance of specialists.

There have been days in the history of the New York Stock Exchange that have witnessed sharper drops in prices than occurred last November 22. But never before in the history of the exchange has there been a selloff that approached it in intensity. In the short span of 27 minutes between the moment the tragedy first became known at 1:40 p.m. and 2:07 p.m. when the market closed, an estimated total of 2,603,000 shares changed hands, and the Dow-Jones industrial average dropped 24.24 points. The whole decline and nearly 40 percent of the day's total volume occurred in that 27-minute period. Had it not been for the prompt action of the board of governors in halting trading 83 minutes before the normal closing time of the market, the decline might have been the biggest in history.

The Securities and Exchange Commission asked the exchange to supply information on the activity of specialists and floor traders in 25 selected stocks on November 22 and 26, and, of course, we complied. Week before last, the Commission reported its analysis of this information to your committee and released it publicly. Using similar information, plus additional data which was not requested by the Commission, we at the exchange have been trying to put together a more comprehensive picture of trading activity in those stocks on those 2 days. While our statistics parallel those of the SEC with respect to specialists and floor traders, since they are derived from much the same sources, we believe we have compiled a more complete account of the trading which places the performance of the specialists and floor traders in perspective.

A copy of our report, entitled "President Kennedy's Assassination and the Stock Market," has been filed with the committee and is attached to my statement. Some of the major findings of our analysis may be summarized here. We found:

1. Selling pressure after 1:40 p.m. November 22 was primarily the result of market orders by active individual customers (the so-called volume accounts).

2. Stop orders placed by the public before the assassination also contributed significantly to the selling wave after 1:40.

3. Odd-lot investors were also swept up in the selling panic, even though they were moderate buyers on balance. Virtually all their purchases after 1:40 were the result of limit orders entered on the books before President Kennedy was shot. Most market orders placed by odd-lotters after 1:40 p.m. were sell orders.

4. Buying support came mainly from specialists and floor traders and limit orders placed by individual investors before 1:40 p.m. Buy orders at the market by public customers were negligible after 1:40. Specialists increased their net holdings in the 25 stocks by 99,800 shares, representing an additional commitment of $5,161,700 in the final 27 minutes in these 25 stocks.

5. Institutional customers and off-floor members and allied members were buyers on balance. But they accounted for a relatively small share of the volume after 1:40.

6. The strong recovery of the market Tuesday, November 26, was a tribute to the orderly transfer of the reins of Government and public confidence in its fundamental stability. A contributing factor certainly was the plan for liquidation of Ira Haupt & Co. announced during the night before trading reopened.

As regards the performance of individual specialists under these unusual conditions, our study shows that in all but 4 of the 25 issues, the specialists closed the day on November 22 with more shares than they had had at 1:40 p.m. Using continuity as a yardstick, 86.5 percent of the transactions in these 25 issues after 1:40 p.m. were at the same price as the previous sales, or varied by not more than one-fourth of a point. This continuity ratio is as high as that achieved by all specialists for all of 1961 and 1962, and equals the standards achieved at the time of the market break of May 1962, and the ensuing recovery.

There were some few stocks in which specialist performance was not up to the standard achieved in most of the issues selected for study. The Commission pointed this out in its analysis and, of course, the exchange also is aware of it. With respect to these specialists, the exchange has been conducting an investigation to determine all the facts. If any disciplinary action is warranted, it will be taken.

The bare statistics of buying and selling by specialists in the minutes following news of the shooting of President Kennedy cannot begin to tell the whole story. As our study indicates, there was an avalanche of sell orders from the public, in a crisis atmosphere. During the minutes the market remained open, no one at the exchange knew the full facts of the situation.

In making any overall judgment on performance of individual specialists, the conditions under which they were operating must be borne in mind. For example, until the bell was rung at 2:07 p.m. closing the market for the day, specialists on the floor did not have foreknowledge that it would be closed, and hence specialists had to act on the assumption that trading would continue until the normal closing time of 3:30 p.m.

Furthermore, to analyze the performance of a specialist in just one of his stocks, ignores the fact that each specialist is responsible for making a market in a number of stocks, about 15 on the average. The specialist's responsibility is to exert his efforts to maintain a fair and orderly market in each of his stocks, and this requires that he keep a position of liquidity at all times.

The exchange has, of course, also been studying the recommendations concerning specialists contained in the Specal Study of the Securities and Exchange Commission. Since mid-October, a top-level exchange committee has been evaluating these recommendations.

Our committee has had the services of outside consultants retained to advise the exchange on statistical methods of evaluating the performance of exchange specialists, in the belief the consultants may provide helpful outside viewpoints. The exchange staff, of course, has been making its own extensive review. The report of the outside consultants is due this week, and the committee is planning to make its final report to the board of governors at its March 19 meeting. On the basis of that report, the board will draw up a specific plan which will be discussed in detail with the SEC at a meeting scheduled for early April. I am not in a position at this time to anticipate what those policies and recommendations will be.

Mr. Chairman, we are discussing here highly technical matters that concern the mechanics of the marketplace. The exchange has the day-to-day responsibility for running this marketplace and, as you will readily agree, it is to the direct interest of the exchange to make our marketplace mechanically as efficient and as responsive to public needs as possible. Over the years, we have frequently amended our procedures so that we could continue providing the best possible service to the investing public. I can assure you, to the extent that our studies of specialists indicate a need for improvements in present methods, the necessary steps will be taken.

I ask that this summary be inserted in the record.

Mr. STAGGERS. That may be done.

(The summary follows:)

SUMMARY

On November 22, 1963, the world was horrified and saddened by the assassination of the President of the United States. The public's shock and confusion were manifested in the stock market almost immediately—in a selling wave of panic proportions.

In statistical terms, the drop in prices on the New York Stock Exchange on November 22 was not as severe as in other major market breaks of recent years. But the intensity of the 27-minute selloff that afternoon has never been matched. By closing the market 83 minutes early, the board of governors of the exchange averted what could have become the worst 1-day decline in history.

Since it would be an insuperable task to compile detailed information on all listed issues, the exchange has concentrated its study on 25 stocks selected by the Securities and Exchange Commission. The exchange's studies have yielded sufficient evidence to indicate market conditions after 1:40 p.m., when the tragedy first became known. Some of the major findings are—

Selling pressure after 1:40 was primarily the result of market orders by active individual customers (the so-called "volume accounts").

Stop orders placed by the public before the assassination also contributed singnificantly to the selling wave after 1:40.

Odd-lot investors were also swept up in the selling panic, even though they were moderate buyers on balance. Virtually all their purchases after 1:40 were the result of limit orders entered on the books before President Kennedy was shot. Most market orders placed by odd-lotters after 1:40 p.m. were sell orders.

Buying support came mainly from specialists, floor traders, and limit orders placed by individual investors before 1:40. Buy orders at the market by public customers were negligible after 1:40.

Institutional customers and off-floor members and allied members were buyers on balance. But they counted for a relatively small share of the volume after 1:40.

The market recovered on Tuesday, November 26. Brokers were swamped with buy orders (many at limits close to Friday's closing prices), as investors sought bargains. By midweek the market effects of the assassination were generally dissipated.

FRIDAY, NOVEMBER 22, 1963

At 10 a.m. on Friday, November 22, the clang of the opening bell signaled the start of another day of trading on the New York Stock Exchange. Roughly 2,500 men—members and employees of member firms and the exchange—went about their assigned tasks as usual.

The market opened on strength, with the Dow-Jones Industrial Average at 733.35, up slightly from Thursday's close. But, the next 2 hours were uneventful, with moderate volume and generally steady prices. At 12:26 p.m. the tape carried the announcement that J. R. Williston & Beane, Inc., has been reinstated 2 days before, for failing to maintain minimum capital requirements.) The favorable news seemed to strengthen the market. By 1 o'clock, the Dow-Jones Industrial Average had risen to 735.87, a gain of more than 3 points from Thursday's close.

The immediate reaction to the reinstatement of Williston & Beane seemed to be typical of the sensitivity and uncertainty that had characterized the market for some weeks. This erratic behavior had been clearly evident during the 4 preced-

ing days. On Monday, November 18, the closing Dow-Jones industrial average was off 5 points for the day at 734.85—roughly 25 points below the alltime high of 760.50 recorded on October 29, 1963. However, the market was up slightly on Tuesday. On Wednesday, November 20, the fact that A.T. & T. announced a 2-for-1 split, a dividend increase and a new rights offering helped to add 5 points to the Dow-Jones industrial average for the day. On Thursday the market declined 9 points on substantial volume, apparently as a result of the Wednesday suspensions of the two member firms. On Friday, November 22, 1963, optimism once again prevailed—at least during the morning and early afternoon.

At 1:39 p.m. eastern standard time, United Press International reported that the President had been seriously wounded while riding in a motorcade in Dallas, Tex. Within minutes all major news media were flashing the tragic story to the Nation and the world. There were confused reports of the extent of the President's injury and the condition of the Vice President, who was also in the motorcade. Rarely, if ever, had the market experienced a shock wave of public reaction as intense and unexpected as the one which was about to engulf the floor of the New York Stock Exchange.

A minute-by-minute account of what happened on the exchange in the next 27 minutes would be next to impossible to assemble. But—allowing for gaps in the information available—it is possible to draw a broad outline.

Shortly after the news of the shooting of President Kennedy became known, a deluge of sell orders hit the market. Prices weakened in a panic. By 1:49 p.m. the tape was 1 minute late. Communication lines between customers and their brokers and between member firms and the floor were overwhelmed. By 1:55 p.m. the tape was 5 minutes behind.

Immediately after news of the tragedy was received, urgent calls went out to convene a quorum of the board of governors as quickly as possible. An exchange rule specifies that only the board can authorize closing the market prior to 3:30 p.m. At 2:07 p.m., by authority of the board, trading was officially terminated. The tape was then 13 minutes late.

At the close, the Dow-Jones industrial average was 711.49, 21.16 points below Thursday's close. In the 27 minutes from 1:40 to the close, an estimated 2,603,000 shares changed hands. Total reported volume for the day was 6,630,000 shares.

COMPARISON WITH MAY 28, 1962, AND SEPTEMBER 26, 1955

In terms of the scope and magnitude of the decline, the market break of November 22, 1963, was not as severe as those of May 28, 1962, and September 26, 1955 (the first trading day after President Eisenhower's heart attack).

On November 22, 1963, the Dow-Jones industrial average dropped 21.16 points (or 2.9 percent) from the previous day's close. But, on May 28, the Dow-Jones industrial average fell 34.95 points (5.7 percent), and on September 26, 1955, the decline was 31.89 (6.5 percent).

In addition on November 22, 6,630,000 shares were traded compared with 9,350,000 on May 28, 1962, and 7,720,000 on September 26, 1955. Also, as shown in table I, fewer issues declined and more issues rose in price on November 22.

TABLE I.—*Comparison of Nov. 22, 1963, with other recent market breaks*

	Nov. 22, 1963		May 28, 1962	Sept. 26, 1955 [2]
	Entire day	1:40 p.m. to close [1]		
Dow-Jones industrial average:				
Previous close	732.65	[3] 735.73	611.88	487.45
Close	711.49	711.49	576.93	455.56
Net change	−21.16	−24.24	−34.95	−31.89
Percent decline	−2.9	−3.3	−5.7	−6.5
Issues traded	1,312	1,049	1,375	1,247
Up	121	23	74	39
Down	993	920	1,212	1,154
Unchanged	198	106	89	54
Reported share volume	6,630,000	2,603,000	9,350,000	7,720,000

[1] Data on volume and price changes from 1:40 p.m. to the close on Nov. 22 were developed from information furnished to the New York Stock Exchange by Quotron Division of Scantlin Electronics, Inc.
[2] 1st trading day after President Eisenhower's heart attack.
[3] 1:40 p.m.

The market breaks of September 26, 1955, and May 28, 1962, involved full days of trading. On November 22, 1963, however, the whole decline and nearly 40 percent of the day's total volume occurred in a 27-minute period. Some indication of the tremendous acceleration in activity that followed the tragic news is contained in comparisons of volume before and after 1:40 p.m. From the opening to 1:40 p.m., the reported volume was approximately 4,027,000 shares—an average of approximately 18,000 shares a minute. In the final 27 minutes, an estimated 2,603,000 shares changed hands. This amounted to almost 100,000 shares a minute, or more than 5 times the rate earlier in the day.

The explosive suddenness of this selling panic was unparalleled. Had it not been for the prompt action of the board of governors in halting trading, the decline might have been the sharpest in history.

SOURCES OF VOLUME

Where did the surge of activity on November 22 come from? Who was selling? Who was buying?

To answer these and related questions for all NYSE-listed issues would require an enormous amount of detailed information and a great deal of time. Recognizing this fact, the SEC requested detailed information on 25 issues selected by the Commission's staff.

These issues (listed alphabetically in table II) showed price declines from 1:40 p.m. to the close ranging from 4 percent (General Motors) to 32 percent (High Voltage Engineering). The median decline was 15 percent.

In the final 27 minutes of trading on November 22, the 25 SEC issues accounted for approximately 22 percent of total reported volume on the NYSE.

TABLE II.—*Nov. 22, 1963: Price change and reported share volume after 1:40 p.m.—25 issues selected by SEC*

Common Stock	Change in price (percent) 1:40 p.m. to close	Reported share volume		
		After 1:40 [1]	For day	As percent of total
American Motors	−19	59,300	78,200	75.8
American Photocopy	−17	47,300	85,400	55.4
American Telephone & Telegraph	−6	118,800	186,700	63.6
Collins & Aikman	−12	7,000	10,200	68.6
Crown Cork & Seal	−18	8,700	13,900	62.6
Delta Air Lines	−16	7,000	15,400	45.5
General Motors	−4	28,900	69,500	41.6
General Refractories	−20	3,000	4,500	66.7
Great Northern Paper	−9	2,000	2,400	83.3
High Voltage Engineering	−32	23,200	44,600	52.0
International Telephone & Telegraph	−11	6,800	16,300	41.7
Korvette	−21	19,700	33,500	58.8
Mueller Brass	−11	3,300	4,400	75.0
National Airlines	−19	8,200	14,600	56.2
Perkin-Elmer	−15	3,900	6,100	63.9
Polaroid	−9	8,900	40,100	22.2
RCA	−7	38,300	119,300	32.1
Rockwell Standard	−11	3,800	5,000	76.0
Smith-Douglass	−22	4,200	7,200	58.3
Sperry-Rand	−13	89,200	191,900	46.5
Technical Materiel	−27	6,500	8,000	81.3
20th Century Fox	−26	5,900	17,000	34.7
United Air Lines	−14	4,400	11,500	38.3
United States Steel	−10	57,300	89,400	64.1
Wilcox Oil	−24	4,500	4,900	91.8
Total	[2] −15	570,100	1,080,000	52.8

[1] Data on volume and price changes from 1:40 p.m. to the close on Nov. 22 were developed from information furnished to the New York Stock Exchange by Quotron Division of Scantlin Electronics, Inc.
[2] Median.

SPECIALISTS

At about 1:40 p.m., specialists in the 25 selected issues had an aggregate position of 129,500 shares long, and 4,100 shares short (table III).

TABLE III.—*Nov. 22, 1963: Specialists' positions 1:40 p.m. and at close of market—25 selected issues*

	Shares		Market value	
	Long	Short	Long	Short
1:40 p.m.	129,500	4,100	$7,126,100	$316,000
Close of market	229,300	5,000	12,287,800	60,000
Net change	+99,800	+900	+5,161,700	−256,000

By the close of the market at 2:07 p.m., the specialists had increased their holdings by 99,800 shares to a total of 229,300 long and 5,000 shares short. This net increase represented an additional commitment by the specialists of more than $5,161,000 in 27 minutes. Naturally, the changes in specialists' positions varied from issue to issue depending on a number of factors, especially the supply and demand situations prevailing at the time. In 21 of the 25 issues, the specialists closed the day with more shares than they had at 1:40 p.m. In two issues, the specialists' positions showed no net change, and in two issues the specialists sold on balance.

Of the estimated 570,100 shares traded in these 25 issues from about 1:40 to 2:07 p.m. on November 22, specialists bought 144,200 shares, or approximately 25 percent of the total (table IV). They sold 39,500 shares, of which 4,300 were sold short. Thus, specialists in the 25 issues were net buyers of 104,700 shares in the final 27 minutes of trading.

TABLE IV.—*Nov. 22, 1963: Reported share volume after 1:40 p.m.—25 selected issues*

	Purchases	Long sales	Short sales	Net purchases or sales
Specialists	144,200	35,200	4,300	[1] +104,700
Floor traders	42,600	11,800	100	+30,700
Public and other [2]	383,300	518,700		−135,400
Total		570,100		

[1] Differs from the net purchase balance of 99,800 shares shown in table III because it omits "error trades." "Error trades" may result from errors in number of shares, in symbol designation, in indicating buy orders instead of sell orders, and a variety of other reasons. Because they represent stock actually bought or sold by the speacialist, "error trades" are included in his position. However, they are omitted from specialist purchases and sales for performance evaluation purposes.

[2] Includes round lot transactions of odd lot dealers, and off-floor members and allied members.

In evaluating the performance of these specialists in the face of the unparalleled selling "wave" on November 22, it must be kept in mind that every issue is different. Each is unique in terms of its set of buy-and-sell orders on the books, its recent market history, the pressure of new orders, and the specialist's current position in the stock.

The specialist's stabilizing function can only be evaluated by a transaction-by-transaction study of the extent to which he buys on declining prices and sells on rising prices. Nearly all of the 144,200 shares bought by specialists were in transactions which had the effect of cushioning the decline.

Another convenient statistical yardstick for judging the performance of specialists is "continuity," or the extent to which price changes were orderly and limited to one-fourth point or less. Examination of the price movements of the 25 selected issues on November 22 reveals that 86.5 percent of the transactions in these issues executed after 1:40 p.m. were at the same price as the previous sale, or varied by not more than one-fourth of a point. This is about equal to the continuity ratios for the years 1961 and 1962, and during the May 28–31, 1962, market break and recovery.

FLOOR TRADERS

Floor traders (NYSE members on the floor, buying and selling for their own account) were also heavy net buyers in the 25 selected issues after 1:40 p.m. on November 22. Although they had no transactions in 14 of the 25 stocks, floor traders bought a total of 42,600 shares and sold 11,900 shares—a purchase balance of 30,700. After 1:40 p.m., 91 percent of floor traders' purchases were in stabilizing transactions.

PUBLIC AND OTHER SOURCES OF ROUND LOT VOLUME

As the data in table IV indicate, specialists and floor traders, accounted for less than one-third of the round-lot purchases and less than 10 percent of the round-lot sales in the 25 selected issues after 1:40 p.m. The remaining volume came from the public and from off-floor members and allied members (including odd-lot dealers). A comprehensive breakdown of these sources would be difficult to develop quickly for all 25 issues. However, information was obtained from a small group of member firms on 11 of the most active of these stocks. Examination of purchases and sales totaling 97,300 shares indicates that off-floor members and allied members (including odd-lot dealers) were relatively inactive after 1:40 p.m. They accounted for 6 percent of these 97,300 shares. Ninety-four percent (91,400 shares) came from the public.

Further analysis of public volume in these 11 issues reveals the following:

Individual customers were sellers on balance. They were the source of 86 percent of the round-lot purchases and 96 percent of the round-lot sales after 1:40 p.m. (table V).

Institutions were net buyers. Fourteen percent of the round-lot purchases, but only 4 percent of the round-lot sales after 1:40 p.m. came from institutional sources (table V).

TABLE V.—*Nov. 22, 1963: Public round-lot purchases and sales after 1:40 p.m.—Partial volume in 11 active issues* [1]

	Purchases		Sales		Total	
	Shares	Percent	Shares	Percent	Shares	Percent
Individuals	36,600	86.3	47,200	96.3	83,800	91.7
Institutions	5,800	13.7	1,800	3.7	7,600	8.3
Total	42,400	100.0	49,000	100.0	91,400	100.0

[1] American Motors, American Photocopy, American Telephone & Telegraph, Delta Airlines, General Motors, High Voltage Engineering, International Telephone & Telegraph, Korvette, RCA, Sperry Rand, and United Air Lines.

Approximately two-thirds of the shares sold by the public after 1:40 p.m. represented market orders entered (mainly by individuals) after the news about President Kennedy became known (table VI).

Roughly 85 percent of the round-lot shares bought by public customers after 1:40 p.m. were accounted for by limit orders placed before 1:40 p.m. (table VI).

TABLE VI.—*Nov. 22, 1963: Public round-lot purchases and sales after 1:40 p.m.—Partial volume in 11 active issues*[1]

	Purchases		Sales		Total	
	Shares	Percent	Shares	Percent	Shares	Percent
Total market orders	6,200	100.0	33,600	100.0	39,800	100.0
Entered:						
Before 1:40	3,400	54.8	800	2.4	4,200	10.6
After 1:40	2,800	45.2	32,800	97.6	35,600	89.4
Total stop-loss orders	----------	----------	13,100	100.0	13,100	100.0
Entered:						
Before 1:40	----------	----------	12,800	97.7	12,800	97.7
After 1:40	----------	----------	300	2.3	300	2.3
Total limit orders	36,200	100.0	2,300	100.0	38,500	100.0
Entered:						
Before 1:40	35,700	98.6	1,600	69.6	37,300	96.9
After 1:40	500	1.4	700	30.4	1,200	3.1
Total	42,400	100.0	49,000	100.0	91,400	100.0
Entered:						
Before 1:40	39,100	92.2	15,200	31.0	54,300	59.4
After 1:40	3,300	7.8	33,800	69.0	37,100	40.6

[1] American Motors, American Photocopy, American Telephone & Telegraph, Delta Airlines, General Motors, High Voltage Engineering, International Telephone & Telegraph, Korvette, RCA, Sperry Rand, and United Airlines.

ODD-LOT ACTIVITY

On November 22, "odd-lotters" were buyers on balance for the day as a whole. This marked the third consecutive daily odd-lot purchase balance. Tabulation of odd-lot purchases and sales in the 25 SEC issues (table VII) indicates that "odd-lotters" were also buyers on balance after 1:40 p.m. However, if orders entered before 1:40 p.m. are excluded, the data reveal that odd-lot investors were also victims of the "sell" panic that gripped many larger investors immediately following the shooting of President Kennedy.

TABLE VII.—*Nov. 22, 1963: Share volume of odd-lot purchases and sales after 1:40 p.m.—25 selected issues*

	Purchases		Sales		Total	
	Shares	Percent	Shares	Percent	Shares	Percent
Total market orders	1,856	100.0	14,545	100.0	16,401	100.0
Entered:						
Before 1:40	375	20.2	1,032	7.1	1,407	8.6
After 1:40	1,481	79.8	13,513	92.9	14,994	91.4
Total stop-loss orders	45	100.0	18,015	100.0	18,060	100.0
Entered:						
Before 1:40	45	100.0	17,647	98.0	17,692	98.0
After 1:40	----------	----------	368	2.0	368	2.0
Total limit orders	36,646	100.0	934	100.0	37,580	100.0
Entered:						
Before 1:40	35,664	97.3	774	82.9	36,438	97.0
After 1:40	982	2.7	160	17.1	1,142	3.0
Total	38,547	100.0	33,494	100.0	72,041	100.0
Entered:						
Before 1:40	36,084	93.6	19,453	58.1	55,537	77.1
After 1:40	2,463	6.4	14,041	41.9	16,504	22.9

Analysis of the data in table VII also reveals other important findings:

Market orders in odd-lots executed after 1:40 p.m. showed a ratio of sales over purchases of nearly 10 to 1. Prior to 1:40 p.m. the ratio was less than 3 to 1 in favor of sales.

Ninety-three percent of the odd-lot shares bought after 1:40 p.m. resulted from limit orders entered before President Kennedy was shot.

Fifty-three percent of the odd-lot shares sold after 1:40 p.m. came from stop orders placed before that time.

This briefly was what happened in the stock market the day President Kennedy was assassinated.

TUESDAY, NOVEMBER 26

The impulse to sell which had seized some people when they learned of the tragedy, had disappeared by Tuesday morning. The quick, orderly transfer of the reins of government to President Johnson brought a renewal of confidence in the fundamental stability of our Government. And the announcement of the plan for the liquidation of Ira Haupt & Co., undoubtedly had its positive effect.

On the morning of November 26, regular customers, as well as bargain-hunters, contributed to an accumulation of orders which was reported by member firms to be from three to seven times normal. Orders were heavily on the buy side. Many were limit buy orders at prices close to or below Friday's closing prices. Brokers reported they were so swamped they could not assure customers that orders would reach the floor by the opening.

Specialists had a difficult time sorting and recording this large quantity of orders. However, it is essential that the specialist organize and review this information as a basis for determining the price at which a stock will open. Because the volume of orders was so great, the opening of many stocks was delayed to allow the specialists to complete the required paperwork. Some issues did not open until late in the afternoon. In the case of American Motors Corp., for example, only one transaction took place. That occurred at 3:30 p.m. and involved 250,000 shares.

The opening transactions in the 25 selected issues aggregated 1,043,800 shares. Of this amount, the specialists furnished 42 percent by selling 434,500 shares, including 261,100 shares sold short.

In general, the opening prices of the 25 issues were close to their levels just before the break on the previous Friday. The median increase from Friday's close to Tuesday's opening was about 16 percent (see table VIII). The median decline in these 25 issues from 1:40 p.m. to the close on November 22 was 15 percent.

TABLE VIII.—*Nov. 26, 1963: Price change—Opening Nov. 26 compared with Nov. 22 close—25 selected issues*

Percent increase:	*Number of issues*
Under 5	1
5 to 9	6
10 to 14	5
15 to 19	2
20 to 24	4
25 to 29	3
30 and over	4
	25
Total (median) (percent)	15.6

The soundness of the specialists' judgment in arriving at opening prices for 25 issues was confirmed by the pattern of prices during the remainder of the week. On Friday, November 29, 1963, 18 of these issues closed higher than their Tuesday openings. One issue was unchanged and six were below the Tuesday openings. In all six cases, however, the declines were less than 4 percent.

When the gong signaled the close of trading at 3:30 p.m. on Tuesday, November 26, 1963, the explosively irrational impact of President Kennedy's assassination was part of the history of the stock market. By midweek the market had recovered its balance and, within 2 weeks, it had advanced to a new alltime high—as measured by the Dow-Jones industrial average.

Major market declines daily

Date	Dow-Jones industrials	Date	Standard & Poor's composite
	Points		*Points*
Oct. 28, 1929	38.33	May 28, 1962	3.97
May 28, 1962	34.95	Oct. 28, 1929	3.20
Sept. 26, 1955	31.89	Sept. 26, 1955	3.02
Oct. 29, 1929	30.57	Oct. 29, 1929	2.31
Nov. 6, 1929	25.55	Nov. 6, 1929	2.27
Nov. 22, 1963	21.16	June 4, 1962	2.11
Oct. 23, 1929	20.66	Nov. 22, 1963	2.01
June 4, 1962	17.37	Oct. 23, 1929	1.67
Nov. 11, 1929	16.14	June 12, 1962	1.48
Sept. 19, 1960	15.42	Nov. 24, 1958 Apr. 24, 1961	1.37
	Percent		*Percent*
Oct. 28, 1929	12.8	Oct. 28, 1929	12.3
Oct. 29, 1929	11.7	Oct. 29, 1929	10.2
Nov. 6, 1929	9.9	Nov. 6, 1929	9.9
Aug. 12, 1932	8.4	Oct. 18, 1937	9.3
July 21, 1933	7.8	July 20, 1933	8.9
July 21, 1933	7.8	July 21, 1933	8.7
Oct. 18, 1937	7.8	Oct. 5, 1932	8.2
Oct. 5, 1932	7.2	Aug. 12, 1932	8.0
July 20, 1933	7.1	May 31, 1932	7.8
Nov. 11, 1929	6.8	July 26, 1934	7.8
Nov. 22, 1963	2.9	Nov. 22, 1963	2.8

Mr. STAGGERS. Mr. Funston, I want to compliment you on answering the questions we asked you to come here to answer and on giving us the benefit of your views. I think you have done an excellent job.

However, I am sure that the members of the subcommittee have a number of questions that they would like to ask, and I will also have a great number later.

We will start with Mr. Dingell.

Do you have any questions, Mr. Dingell?

Mr. DINGELL. Yes, Mr. Chairman.

Mr. Funston, I would like to refer to a few editorials that our chairman put in the record of hearings. Now, you indicated in your statement at the bottom of page 5:

> It cannot be too strongly emphasized that the exchange had no obligation to act, and that customers of exchange member firms cannot regard the unusual action taken in this case as setting any kind of precedent for the exchange to assume liability for customers' losses stemming from financial problems encountered by member firms in any of their activities.

Is that the position of yourself and the position of the exchange?

Mr. FUNSTON. Yes, sir.

Mr. DINGELL. That means that what was done in the case of the failure of the Haupt Co. was simply an act of grace on behalf of the exchange toward the various customers and clients who might have been injured in that failure. Am I correct in that?

Mr. FUNSTON. No, sir. I would not say it was an act of grace. I would say it was an act that the board made because of what we felt our responsibility was in the particular circumstances of this particular case.

Mr. DINGELL. But essentially it was an act of grace because the exchange had no responsibility in this matter and expressly disclaims that it would take the same action in a future case.

Mr. FUNSTON. No. I would not agree that it was an act of grace. As I say, I think there is a difference. I think that we reviewed this

particular case with the facts surrounding it as a responsibility which we should assume, and should in the future any other case come up with specific circumstances that we would feel it was our responsibility to assume, we would do likewise.

Mr. DINGELL. But there is actually no requirement in the constitution of the exchange or in the bylaws as they stand at this moment?

Mr. FUNSTON. No, sir. That is correct.

Mr. DINGELL. Which would so require?

Mr. FUNSTON. No, sir.

Mr. DINGELL. Were the exchange to so view the matter at some future time if there were similar failures, there would be nothing to compel the exchange to do other than to leave the various applicants of the customers, of the customer firms, very much at the mercy of the exchange?

Mr. FUNSTON. There is nothing in the law or in the constitution. However, there is the authority vested in the board of governors for looking after interests of the security customers that we serve.

Mr. DINGELL. But you expressly disclaim there is a responsibility on the part of the exchange to assume liability for customers' losses, and I am quoting now from your own statement here, "Stemming from financial problems encountered by member firms in any of their activities."

Mr. FUNSTON. Yes; that is correct.

Mr. DINGELL. Now, conceivably there could have been substantial losses to customers in the Haupt Co. under the set of circumstances—the exchange has come up with $7½ million, I think—referred to in this paper; is that correct?

Mr. FUNSTON. That is correct.

Mr. DINGELL. The Washington Post says that $6.7 million have been paid out to date.

Now, in the editorial in the Washington Post and in similar articles appearing in the press, the law, it goes to specifically state, is as follows: "The law makes no provision for protection of free balances in the event of bankruptcy," which means that a client of the member firm whose stocks were hypothecated or were sold indeed by a member firm would be treated just as a general creditor; am I correct?

Mr. FUNSTON. No, sir.

Mr. DINGELL. The firm in bankruptcy?

Mr. FUNSTON. No.

Mr. DINGELL. It would not be?

Mr. FUNSTON. In general, the fully paid securities which have been segregated, the customer would get those back.

Mr. DINGELL. He would?

Mr. FUNSTON. Yes.

Mr. DINGELL. Assuming they had been sold, how would he get them back?

Mr. FUNSTON. Assuming they had been sold?

Mr. DINGELL. Assuming they had been sold or assuming they had been pledged.

Mr. FUNSTON. Those kinds of securities could not be pledged.

Mr. DINGELL. They could not be?

Mr. FUNSTON. No. Not fully paid securities. Those that were in margin accounts could be pledged.

Mr. DINGELL. Margin accounts would mean there would be an equity of what, about 50 percent to 70 percent?

Mr. FUNSTON. Yes, but the equity would be greater than that. It is usually about a 3 to 1 ratio on an average overall.

Mr. DINGELL. But those could be pledged?

Mr. FUNSTON. Yes.

Mr. DINGELL. Very well.

Mr. STAGGERS. I wanted to ask you this question: What if a customer has fully paid for a stock and sells in the street name?

Mr. FUNSTON. There is some question about that but we believe that in those circumstances the customer would get the same securities back as though they were fully paid and in his own name.

Mr. STAGGERS. What about dividends that are being held by the broker?

Mr. FUNSTON. That would go the same way. The dividends would go the same way.

Mr. STAGGERS. Do you not think this is an area that must be cleared up?

Mr. FUNSTON. Yes, sir. If I may go on to say, what we think, of course, is that on this particular thing, as I said in my statement we have a committee working now to try to establish a plan whereby should this type of event ever occur in the future we would be able to have a reserve plan which would take care of it the same way that we did in the du Pont Homsey case. A few years ago something came up and the exchange again stepped in and took care of that situation and worked out an insurance program.

Mr. DINGELL. But you did both of these essentially by assessment from the membership, did you not, in each of these cases?

Mr. FUNSTON. The second one was by assessment, the first was paid out of the exchange which is the members' money.

Mr. DINGELL. Essentially?

Mr. FUNSTON. Yes, sir.

Mr. DINGELL. What was the amount in the Du Pont?

Mr. FUNSTON. I think that would net out to be about $6,000.

Mr. DINGELL. Relatively small amount compared to this.

Mr. FUNSTON. Small amount compared to this one.

Mr. STAGGERS. Excuse me. Did that involve fraud?

Mr. FUNSTON. That involved fraud.

Mr. STAGGERS. A completely different situation than what we are talking about.

Mr. FUNSTON. Yes; it was completely different.

Mr. DINGELL. Mr. Funston, is it not a fact, really, that the law is really not clear as to whether or not a broker may hypothecate a fully pledged security without consent of his customer? The law is ambiguous on this part.

Mr. FUNSTON. May I ask Mr. Rosenberry to answer that?

Mr. ROSENBERRY. There is no ambiguity in the New York law, it is a crime.

Mr. DINGELL. The same is very true with many States across the country, is this not so?

Mr. ROSENBERRY. Well, under the 1934 act the Commission is given power to write rules regarding the hypothecation of customers' securities.

Mr. DINGELL. But it has never done so.

Mr. ROSENBERRY. They have written an 8f rule, yes.

Mr. DINGELL. What do the rules do with regard to the modification?

Mr. ROSENBERRY. I don't have a copy of the rule here with me but basically they prohibit, as I recall, the lending of a customer's security without his consent. They prohibit the lending of a customer's security to secure an amount of money or indebtedness of the firm greater than the aggregate of the indebtedness of the customer's to the firm of the customers whose securities are pledged. They are quite detailed.

Mr. DINGELL. But I think you gentlemen will agree that if there is a defect in the SEC's regulation or in the Federal statute regarding this point of hypothecation that it would do more than that, should it not?

Mr. FUNSTON. I should think, yes, you should look into anything you feel is a defect in the law.

Mr. DINGELL. You gentlemen certainly support the legislation about tightening it up if the committee feels in its wisdom that kind of thing is necessary?

Mr. FUNSTON. We would have to see the specific legislation. On this point you just made, we believe that this is very clear cut and it is clear cut in the New York law under which we operate and under which our transactions are carried out, so in that area we would not see the need for new legislation.

Mr. DINGELL. With regard to Federal statutes in fact the whole country may be a little different and it might be desirable for us in the exercise of our Federal responsibilities to take some action in this if we find it is a defect.

Mr. FUNSTON. Sir, before I could comment on that we would like to know what the problem is, much more clearly defined than now, and see what the proposal is.

Mr. DINGELL. I certainly want to be fair to you, Mr. Funston. I am not trying to make a faulty implication.

Mr. FUNSTON. I know.

Mr. DINGELL. Now there is another point here and that is where a blanket consent was obtained by a member firm, then no consent is required by the customer for a specific hypothecation, am I correct?

Mr. FUNSTON. I don't follow your question, sir.

Mr. DINGELL. Where a blanket consent by a member firm is obtained for hypothecation and for management account.

Mr. FUNSTON. Well, the customers in any and all cases have to give approval.

Mr. DINGELL. Even after they have given what constitutes a blanket consent?

Mr. FUNSTON. Well, if a customer says, "I will allow you to have discretionary control of the securities and borrow against them or treat with them as my agent," then I suppose that the blanket consent would cover the individual transactions that occur thereafter.

Mr. DINGELL. This is not an uncommon practice though, is it, in the industry?

Mr. FUNSTON. I would say that I don't know whether it is uncommon. It certainly is infrequent, anyway.

Mr. DINGELL. But it is practiced?

Mr. FUNSTON. It is done, yes.

Well, Mr. Gray, would you say it was common or not?

Mr. GRAY. Well, if you are talking about margin customers, the consent is blanket.

Mr. DINGELL. That is what I mean.

Mr. GRAY. But where the securities are fully paid for, exchange rules require that the securities be specifically mentioned by name, those are infrequent.

Mr. DINGELL. Those are infrequent. But in the case of the Haupt Co. there were substantial amounts of customers' securities help on margin.

Mr. FUNSTON. Margin accounts; yes, sir; and this is very common.

Mr. DINGELL. Which were hypothecated?

Mr. FUNSTON. That is right.

Mr. DINGELL. And this is the reason, of course, for the exchange taking the action it did?

Mr. FUNSTON. Yes, sir.

Mr. DINGELL. As a matter of fact, a large number of these people were not really made completely whole because a number of them suffered losses of flexibility in trading, they lost the benefit of dividends, et cetera, during this time.

Mr. FUNSTON. No. Assuming the liquidation is completed successfully, nobody lost any dividends or any interest or anything like that. They did lose the ability to switch securities. In other words, there are some customers whose securities have not been delivered out to them that have been in the firm that they have not been able to get since November.

Mr. DINGELL. The people did, though, lose their money during that period, did they not?

Mr. FUNSTON. No.

Mr. DINGELL. Customers did not lose their money?

Mr. FUNSTON. No, they will get their dividends and so on.

Mr. DINGELL. They did lose effectively the control of their property?

Mr. FUNSTON. They lost the right, the opportunity, let's say, to sell one and buy another; yes, sir.

Mr. DINGELL. Which conceivably could have been a substantial loss.

Mr. FUNSTON. Well, it depends.

Mr. DINGELL. The point I am coming to, Mr. Funston, is that I am very much concerned about this and I think that the committee is going to have to be very careful in consideration and recommendations to the Securities and Exchange Commission and perhaps have to make some independent judgments on this point.

I notice here in the communication received in response to a letter by myself to the SEC the following language, and I am quoting from the letter now:

> At the same time broker-dealers holding free credit balances may use them to obtain positions in securities and otherwise in their general operations without notifying the customers or obtaining their specific consent.

Mr. FUNSTON. That is correct.

Mr. DINGELL. This is true?

Mr. FUNSTON. Yes, sir.

Mr. DINGELL. And conceivably this is something which in the event of a failure or major insolvency by a large firm could result in substantial injury to the investors.

Mr. FUNSTON. Yes, sir; but may I just say on that in 25 years and maybe even longer, I know it is for 25 years, there have been no losses of free credit balances by any member firm of the stock exchange. It is our aim, our concern—we are concerned too; your interests and ours are the same—we are concerned also and this Haupt case has opened our eyes to a new threat that we did not realize was there before.

As I said in my statement, we have a committee working very hard going at it on a two-pronged basis. One is to make sure that we have done everything possible to prevent this sort of thing happening in the future; and second, to come up with a reserve plan which would give us the ability to say that these free credit balances, net balances and everything else, will be protected in the future more than they are at present.

Mr. DINGELL. Now, Mr. Funston, what authority does the exchange have to take these steps?

Mr. FUNSTON. Well, most of these things would have to be approved by the member firms of the exchange and we go to them and get a vote, a change in the constitution, as we did with the Haupt reimbursement.

Mr. DINGELL. Are you aware of the case of Harold J. Silver doing business as *Municipal Securities Company, et al., Petitioners* v. *New York Stock Exchange?*

Mr. FUNSTON. I should say I am, sir.

Mr. DINGELL. On May 20, 1963.

Mr. FUNSTON. I am, indeed.

Mr. DINGELL. Does this not give you concern as to the power of the exchange over its members?

Mr. FUNSTON. It does in some areas. It does in the areas such as the commodity accounts or the other areas of business that do not come specifically under our jurisdiction. It is our present thought and intent, as I testified here 2 or 3 years ago, that we have the authority to insist on just and equitable principles of trade and make sure that our members are honest in whatever activity they are engaged in.

We also have the authority to establish net capital rules. We hope that by changing our net capital rules that we will be able in conjunction with steps taken by the commodity exchanges, and so on, to do this. Within the scope of our authority and without running afoul of antitrust difficulties, we believe we can solve the situation.

Mr. DINGELL. Now you indicate that you construe this to deal only with this case, which means that the Supreme Court feels that your power over your member firms is limited to activities that are properly within the purposes of the stock exchange and do not go, for example, to the provisions for sale of information. Is that your construction?

Mr. FUNSTON. Sir, I would not want to make any judgments as to the *Silver* case as a very limited, narrow case on a particular area. I would not want to make any assessment of how far that goes or to pin myself down to anything. This is something that only our attorneys could do after study.

I will say this, though, that we do not believe that the *Silver* case represents any bar to our being able to work out an effective plan, a reserve plan, for the future.

Mr. DINGELL. But with regard to commodities exchanges, the participation by your member firms, commodities exchanges' participa-

tion in commodity changes and so forth, this *Silver* case you indicated does make the power of the New York Stock Exchange somewhat questionable; am I correct?

Mr. FUNSTON. Well, no; I would not say that, sir.

Mr. DINGELL. It raises questions of the exchange to regulate its member firms in those areas that do not deal with the exchange in stocks and bonds.

Mr. FUNSTON. I would not say so, sir. It depends on how the regulation is extended. If it is extended through the net capital requirements, I believe that there is a great deal of latitude there. These, however, sir, are questions which are the type of thing that the committee on cost recovery is considering at this moment. All I can say is while I can't give you the pattern we do not believe that the *Silver* situation prevents any bar from our being able to work out such an adequate reserve plan.

Now if we are proved wrong, then we would have to change our views later on but this is our present opinion.

Mr. DINGELL. Now let me ask this question then. This has to do with a similar point. Would I be fair in inferring that the exchange views a situation created by the *Haupt* case with a fair measure of concern?

Mr. FUNSTON. Oh, deep concern.

Mr. DINGELL. $7½ million, as a matter of fact.

Mr. FUNSTON. That is right. You should hear, sir, what some of our members say when we are spending their money to reimburse another firm in the commodities business when the firm that is putting up the money is not in the commodity business.

Mr. DINGELL. Yes.

Mr. FUNSTON. Oh, you have, too?

Mr. DINGELL. The point I am coming around to, then, is that you do feel that something should be done in this area for protection of member firms and for protection of investments?

Mr. FUNSTON. Oh, my goodness; yes, sir. We do feel, and we are studying it, this has been a priority job that we have been concerned about and working on continuously since November 26. Two committees are working on it.

Mr. DINGELL. Do you have an idea as to when this information will flow back from the committee?

Mr. FUNSTON. Yes, sir. The first committee is due to report to the board on February 19 and then the second committee, the one that has to do with the expense recovery plan, we don't have as definite a timetable on that because we all recognize that a condition precedent to getting a plan approved by the membership on the recovery part or the reserve found would depend upon their satisfaction that a good job has been done by the first committee, if you follow me.

Mr. DINGELL. Mr. Funston, it is always a pleasure to have you before the committee. I have other questions but so do my colleagues, I am sure.

Mr. STAGGERS. Mr. Glenn?

Mr. GLENN. Mr. Funston, it is a little difficult for we laymen to understand the position of specialists on the exchange. I first want to ask you, could the exchange operate without specialists?

Mr. FUNSTON. No, sir.

Mr. GLENN. We have read in your statement and in the report of the SEC that they occupy an inside position, they make certain brokerage fees, they have certain obligations to act as dealers in maintaining an orderly market even though it may cost them money, and that in essence they act against the market trend and buy when the market goes down and sell when the market goes up.

Now this is sort of an unusual position for anyone who is earning a livelihood and trying to make money. Do they keep the profits which they make on the market when it goes up and do they sustain the losses likewise when it goes down?

Mr. FUNSTON. Yes, sir. The specialist income roughly depends on the specialist and it varies with different specialists but they get about half their income from commissions which they share in that are left with them to execute and about half of the profits overall are made as a dealer.

Now a dealer sometimes loses money, sometimes they make money. Of course, if they are going to stay in business over a period of time they have to make it more often than they lose it although sometimes a firm will lose money in a year on the dealer position and have enough on the commission position to offset their dealer losses.

Mr. GLENN. Then they are also authorized to act as dealers in the open market and they make commissions on their own operations in addition to profiting on the sales which they are making as a specialist; is that right?

Mr. FUNSTON. Sir, each specialist is assigned a certain number——

Mr. GLENN. Who assigns those?

Mr. FUNSTON. The board of governors of the exchange. They assign him the stocks, they impose a responsibility on him, they check up and make sure that he is carrying out his responsibility. In the stocks assigned to him, it averages about 15, he has the responsibility of standing at a certain spot from 10 in the morning until 3:30 in the afternoon, he and his associates, and making a market in a particular stock. Sometimes another broker on the floor will come and rather than wait and stand around all day there at that post, to wait for some member of the public to want to do the opposite of which he does, he will leave the order with the specialist to handle when there is a member of the public who wants to do the opposite. He gets a small percentage of the commission then.

Then if there is no member of the public willing to do the opposite of what another member of the public wants to do at a price very close to the last sale, it is the responsibility of the specialist to be willing to buy or sell but he can never compete with the public, he can only improve the position.

Mr. STAGGERS. Mr. Funston, you were talking about working against the specialist book. Now when he acts as dealer or broker and if on his book he has a certain amount, would you explain to this committee the workings of the book? I do not think many of them know.

Also, how long is he required to keep that book under your rules and what are the regulations and requirements? Is that not really the fundamental duty of the specialist?

Mr. FUNSTON. Yes, sir.

Mr. STAGGERS. Would you explain?

Mr. FUNSTON. May I start and ask my colleague, Mr. Frank, who is vice chairman of the board and who is a specialist, to correct me if I say anything wrong. I, being much more of a layman than he, maybe I can at least put it in more layman's language, at the start anyway.

The specialist has a so-called book. The book has buy orders on the one side and sell orders on the other side in which he records the transactions that are desired by another broker representing the public at different prices away from the last market price.

Just to give you an example: It may well be that in a particular stock there is a member of the public who through his broker is willing to buy a stock at $40 a share. There is someone who is willing to sell it at $45 a share. Say the last sale was about 42½ in between. Well, a member representing a customer comes in to that specialist and says, "I want to buy some stock, say, at the market." So the broker representing the public comes to the specialist and says, "How is the X–Y–Z stock?" The specialist seeing the 40 to 45 which is the public's spread there, that is much, much too wide, so he says, "42⅜ to 42⅝." The specialist does not know whether the person who is coming up to him is a buyer or a seller but he has to be willing to do the opposite of what that person wants to do.

So if the person wants to buy the stock, he would sell it to him at 42⅝; if he wants to sell it, he would buy it from him at 42⅜. In other words, the specialist has narrowed the market and as a dealer is quoting a quarter-point spread in this stock instead of the 5-point spread that would be there if the specialist was not on the floor and charged with the responsibility of making a close continuous and orderly market.

Mr. STAGGERS. May I interrupt you there. I would like to ask Mr. Frank if that specialist has the authority to say that it is 42⅜ and 42⅝ or should he quote his book as given to him what the bid is and asked?

Mr. FRANK. The specialist should quote the bid and the offer expressed by the public if he deems that it is a proper one and a wise one and one that would relate to the recent price activity and price history of the stock. If in his judgment he can better serve those who come to him by putting in his own bid as a dealer or his own offer to sell from his inventory and to improve that spread, then he must so do. He must combine both functions. He must combine his agency function and his dealer function in such a way as to give a continuity and a depth and a proper market in the relation that is called upon him by this price action of the stock.

Mr. STAGGERS. Perhaps I have been misinformed on this subject, because I thought by the rules of the exchange he had to do that and it seems to me it is the greatest chance for manipulation in this world when the dealer and the broker combines his two operations in one because he can manipulate the market and do as he pleases and control the market and make any kind of money he wants to make for himself.

Mr. FRANK. No, sir.

Mr. STAGGERS. You go ahead, Mr. Funston.

Mr. FUNSTON. I would disagree violently, sir, with that.

Mr. STAGGERS. You do not believe, then, they ought to be segregated?

Mr. FUNSTON. I certainly do not.

Mr. STAGGERS. This has been one of the big questions of the stock exchange rules in this committee starting way back in the manipulation in 1934 of the markets.

You go ahead with your statement.

Mr. FUNSTON. Sir, the reason why I——

Mr. GLENN. Will the chairman yield?

Mr. STAGGERS. Surely.

Mr. GLENN. This is a terrific responsibility on the part of these specialists; is it not, Mr. Frank?

Mr. FRANK. It is a responsibility placed upon him by our rules, which he understands, and is supervised by the stock exchange.

Mr. GLENN. He is in effect sitting under two hats and doing the work of two different entities; is that not so?

Mr. FRANK. No, sir. We are agents when called upon so to act. When there is a lack of balance between public supply and demand, then we are dealers to fill in that void.

Mr. GLENN. And only you make that decision?

Mr. FRANK. In line with the rules and regulations of the stock exchange and the requirements placed on me.

Mr. GLENN. Now there is no appeal from your decision when you make it, it is acted upon and that is the end of it; is that not so?

Mr. FRANK. No; the auction market is open for all to enter. I make my market and if it can be improved upon by others who enter the market it is done.

Mr. GLENN. When these dealers come to you do you have to buy if you do not feel like it?

Mr. FRANK. I must buy to furnish the continuity and the depth which is expected of me when I am registered as a specialist.

Mr. GLENN. But you decide that continuity and depth, do you not?

Mr. FRANK. The decision on the continuity and depth is always reviewed. It cannot be spelled out exactly and the decision is based on its price history and previous action and total market conditions.

Mr. GLENN. But you do all that?

Mr. FRANK. It is my responsibility to make sure that it is orderly.

Mr. FUNSTON. Mr. Chairman, may I break in here to say that the thing that keeps happening, what you say this conflict of interest, is not only the caliber and quality of the men who are honest men who do this but also the very tight and stringent rules that are imposed by the stock exchange to watch this operation.

Now we mentioned continuity. You remember in my statement I reported that even in this chaotic break from 1:40 to 2:07, 86 percent of all the trades were at no more than one-quarter of a point away from the last trade. This is continuity.

If the specialist group do not have proper continuity in the checks that are made, surprise audits that are made of them, we would catch that and subject them to some disciplinary action. It is fair to say that the SEC in their most intense study of the market did not conclude as you have, Mr. Chairman, that this was a place where people were not representing the public's interest but they made no recommendation at all about segregating the broker-dealer function.

Mr. STAGGERS. I know, and I know that there is a question that I will let Mr. Keith give to you in a minute, too, about one of the stocks, and there are several stocks dominant, that did actually take place.

We are not talking about the ones who did keep faith, we are talking about the ones who did not keep faith. There were those that did not and we know they did not according to the records and that is what we are after as protectors of the public welfare.

So we are trying to close the loopholes and that is why you are here today.

Mr. FUNSTON. Yes. I might say if anyone is not doing their job we are anxious to chastise them because our interests and yours are the same.

Mr. STAGGERS. We do not want only to chastise them, we want to do something about it.

If the gentleman would yield to me one moment.

Mr. GLENN. Yes.

Mr. STAGGERS. I do not believe we have it fully explained yet as to how it would protect the public; that he must give these orders as they come down the line from the brokers. The names he takes from the top and he may never get to the bottom or the rates there. When they buy and sell both and he comes here and as you say, he may step in on his own to say, "Well, I will make the market here."

Mr. FUNSTON. Yes, sir.

Mr. STAGGERS. But the public is here on the book.

Mr. FUNSTON. Yes.

Mr. STAGGERS. And this book represents the public; is that right?

Mr. FUNSTON. Well, it represents the orders that the public have seen fit to place on the specialist book away from the marketplace because in this illustration that I gave you of 40 to 45, the book, the public if they would come in and say, "I want to buy at the market," they would buy as I said at about 42⅝, whereas if the specialist was not acting as a dealer they would come in and buy at 45.

Mr. STAGGERS. I understand that. I wish you would go ahead with the responsibility of the specialist to this book, how he is bound by this book, the rules that make him adhere to the book itself, and its importance. I want you to explain that. I do not believe it is too well understood by the public.

Also, is it right that the specialist is the principal dealer in 1 stock but he may have 15?

Mr. FUNSTON. That is right.

Mr. STAGGERS. But in order to deal with this stock you are going to have to go to a specialist.

Mr. FUNSTON. That is correct.

Mr. STAGGERS. Then he controls to a great degree many of these things. Now you say that his job is to protect and keep the continuity of the market and we will agree to that. The theory is fine, but we are trying to get to the exceptions and why some of these events happened and why there is a responsibility to the book.

I wish you would go a little further into that.

Mr. FUNSTON. You are asking me what is the responsibility of the specialist to the book?

Mr. STAGGERS. I want you to explain just a little further the book itself and what part it plays in the activities of the stock market.

Mr. FUNSTON. The book itself is in essence only the vehicle in which the public's orders, which are away from the market, are recorded. In other words, most people when they go in to buy stock say, "Well, I want to buy stock at the market." In this illustration that I gave you it would be 42⅝. However, many people say, "Well, I don't want to pay 42⅝; if it ever falls to 40 I will buy it."

People on the other side say, "Well, I don't want to sell it at 42⅝, but if it ever gets to 45 I will sell it."

So they go to their broker and they say, "Put in a limit order to sell at 45." They give that to their broker and the broker takes that offer to the specialist and gives it to him and says, "Look, here is an order to sell at 45."

Where the specialist comes in, the specialist can never compete with the public. In other words, if the specialist can't buy at 45, if on his book a public customer wants to buy at 45—and I misspoke a minute ago when I said they had to come to the specialist, they don't. They have to come to the post where the specialist stands, but a commission broker representing a customer and another commission broker representing another customer can stand there in front of the post and trade by themselves and often do.

Mr. STAGGERS. What is the group that is at the post called in the ordinary parlance of the stock exchange?

Mr. FUNSTON. The crowd they call it.

Mr. STAGGERS. How many posts do you have?

Mr. FUNSTON. Eighteen.

Mr. STAGGERS. Eighteen posts plus one other.

Mr. FUNSTON. Yes, post 30 which is the one that has all of the inactive stocks.

Mr. STAGGERS. I am interfering with Mr. Glenn, but there are different capital requirements for the 30 post and also at your other 18 posts, I believe?

Mr. FUNSTON. Yes, that is correct.

Mr. STAGGERS. I wanted to get this thing in the book that the specialist is not supposed to compete with the public.

Mr. FUNSTON. Never.

Mr. STAGGERS. That is what we are trying to get at the bottom of, and I think we will before we get through.

Mr. FUNSTON. Yes.

Mr. STAGGERS. Mr. Glenn.

Mr. GLENN. Mr. Funston, how many specialists are there on the floor of the New York Stock Exchange?

Mr. FUNSTON. Well, there are 350 individuals collected together in about 110 specialist units.

Mr. GLENN. And you say they are appointed by the board of governors?

Mr. FUNSTON. Yes, sir.

Mr. GLENN. Are there any specific qualifications that they must meet?

Mr. FUNSTON. Yes, sir. They have to be a member of the exchange and as a member of the exchange have to be persons of integrity and have gone through all kinds of investigations. They have to be of adequate financial capacity and then they have to show evidence that they know by experience on the floor how to run a book, how to be a specialist.

Mr. GLENN. Now is this considered quite an honor or a profitable plum to be awarded the position of a specialist?

Mr. FUNSTON. Not necessarily. It is a very demanding, risky business that requires a certain kind of person. The only way that you can ever learn it is by the experience of being one and working in it which is the big advantage that the New York Stock Exchange has over all the other stock exchanges of the world, who, if they would try to establish a full-blown specialist system cannot find the people to do it.

Mr. GLENN. Is the risk greater than one would ordinarily encounter as traders on the floor?

Mr. FUNSTON. May I defer that to Mr. Frank? I think it is but I would like to hear what he says.

Mr. FRANK. To broadly describe risks would be delicate. The risks vary according to the particular experience that one has. I mean if we are called upon to make a bid of greater size than another, possibly a risk in one case would be more than another but they vary with each entrance into the market of a customer.

Mr. GLENN. Let me put it another way, then. Are the opportunities to make profit greater as a specialist than an ordinary trader on the floor?

Mr. FUNSTON. Are you using, sir, the word "trader" on the floor as a floor trader, a man who spends all his time on the floor buying and selling, or are you using "trading" in the sense of a commission broker representing the public?

Mr. GLENN. Well, an ordinary broker-dealer.

Mr. FUNSTON. I would say it would be hard to say. Undoubtedly there are, it varies. There are very successful specialists, there are those who are not successful. There are very successful floor brokers and those who are not so successful. So it is hard to say.

Mr. GLENN. What makes it attractive for someone to accept the position of specialist unless there is something of greater moment than the ordinary pursuit of the profession of a broker-dealer?

Mr. FRANK. Speaking from my own experience, my entrance into the business was based on the thought that I could possibly develop this type of business and be with it rather than to seek public commission business such as you mention other people have. Here I was willing to assume the risks of dealer activity under the rules of the exchanges and act as agent and broker as the demands were put on me. Exactly how they are divided cannot be spelled out.

In some instances my agency function in a particular stock is much greater than the dealer function; at other times the dealer function might be larger. It all depends on the type of security in which one specializes and the type of activity that is developed by the public interest.

Mr. HARRIS. Would the gentleman yield?

Mr. GLENN. Yes.

Mr. HARRIS. I am sorry to interrupt the gentleman.

Do I understand that these specialists are not employees of the exchange?

Mr. FUNSTON. Oh, no, sir; they are members. They are not employees at all. Everyone has to be a member of the exchange.

Mr. HARRIS. I know, and that is the reason I prompted these questions.

And yet being a member of the exchange they ordinarily are a member or employee of a broker-dealer firm?

Mr. FUNSTON. The specialists, yes, they are members and they associate themselves together in specialist firms because one man can't stand there from 10 in the morning——

Mr. HARRIS. I know but that does not answer my question.

Mr. FUNSTON. I am sorry.

Mr. HARRIS. What association or relationship do they have with a broker-dealer firm?

Mr. FUNSTON. Well, they are a broker-dealer firm.

Mr. HARRIS. That is what I asked.

Mr. FUNSTON. Yes. They are formed in a broker-dealer firm.

Mr. HARRIS. In other words, it is the broker-dealer that has its own employee who becomes a specialist?

Mr. FUNSTON. No, sir; a man cannot be an employee and be a specialist, he has to be a partner of a firm and a member of the exchange.

Mr. HARRIS. Well, all right, say he is partner then. That is where he gets his money, his income.

Mr. FUNSTON. He gets from specializing on the floor as a broker-dealer.

Mr. HARRIS. Well, he is paid, though, through a broker-dealer firm as a partner of that firm?

Mr. FUNSTON. Yes, sir.

Mr. HARRIS. And his income and his financial interest comes through his being a partner and associate of the firm.

Mr. FUNSTON. Yes, sir; that is right.

Mr. HARRIS. Well, that clears it up.

Mr. KEITH. Mr. Chairman?

Mr. HARRIS. I am sorry.

Mr. STAGGERS. Mr. Keith.

Mr. KEITH. I wonder if by chance Mr. Harris' questioning is not intended to reveal that the people to whom he is selling, for whom he has made the market, could be members of the same firm profiting perhaps through his activity.

May I elaborate just a little bit further? May I say do you not have two kinds of firms? This man who is a specialist belongs to a firm of specialists.

Mr. FUNSTON. Yes, sir.

Mr. KEITH. Dealing with other kinds of brokerage firms that do not have specialists among their partners.

Mr. FUNSTON. Yes.

Mr. KEITH. Is it possible to be a partner in a firm dealing with the usual kinds of broker activity and a specialist at the same time?

Mr. FUNSTON. A very few specialist firms do a public business. This is very limited. This is an area about which the SEC Special Study Group made some recommendations and this is an area that is being studied by our specialist committee.

Mr. KEITH. Is there not a very real danger of collusion or at least of insider trading?

Mr. FUNSTON. No, sir; we don't believe so. We don't believe so. This is an area that is policed and we do not believe it is an area of significant danger.

Mr. KEITH. Well, generally speaking, then, the specialist is separate and distinct from the broker-dealer with whom he is transacting?

Mr. FUNSTON. That is correct. One very good reason for it is because they don't want to compete with their customer.

Mr. KEITH. Thank you.

Thank you, Mr. Glenn.

Mr. GLENN. Mr. Funston, if I as an investor call my broker and say buy so many shares of XYZ stock, he then places the order and goes to a broker-dealer and there will be a commission earned on that purchase, will there not?

Mr. FUNSTON. Yes, sir.

Mr. GLENN. Now, that broker-dealer in turn goes to the floor of the exchange and he has to go to a specialist on the floor?

Mr. FUNSTON. Yes, sir.

Mr. GLENN. Now, that specialist will then take hold and he will get a commission, too, won't he?

Mr. FUNSTON. Not necessarily; it is the option of the man who is representing the public. The specialist will get a percentage of it if it is left in his book if it is one of these $40 to $45 orders that I am talking about. However, if the broker says, "Well, I don't want to share any of my commission with the specialist; I want to keep it all for myself," he just stands in the crowd there and waits for somebody else to come along with whom he can strike a bargain and then he does not give any part of the commission on that basis to the specialist at all.

Mr. GLENN. Well, I see where——

Mr. FUNSTON. The public does not pay more, sir. It is the same to the public no matter how it is whacked up by the different elements in the securities industry.

Mr. DINGELL. Would the gentleman yield for a brief question?

Mr. GLENN. Yes.

Mr. DINGELL. I don't understand the specialist functions. One point I am not quite clear on is, does the specialist have the responsibility of maintaining an inventory of the stock in which he happens to be a specialist?

Mr. FUNSTON. If it is necessary to maintain a close and orderly market; yes, sir, and that stock might be long or short.

Mr. DINGELL. Under circumstances where the market would be going through rather violent swings such as during the time of the President's assassination, would it not be fair to infer then that he would have to maintain some kind of inventory during those times?

Mr. FUNSTON. Yes, sir; if the presumption would be that if the market was going down rapidly, that he would be having to maintain an inventory, he would have to be buying stock.

Mr. DINGELL. Would it be fair to infer that he did not maintain the inventory, and presumably under those circumstances a growing inventory, that he was not maintaining an orderly market?

Mr. FUNSTON. Not necessarily. It would be something that would be looked into but it does not necessarily mean that he would be violating his trust.

Mr. DINGELL. I inferred no violation.

Mr. FUNSTON. Well, the SEC study report referred to, as I said in my statement—I think there were four people, four of the 25, who owned less at 2:07 than they did at 1:40 and these matters have been and are being looked into by the exchange to find out why.

Mr. DINGELL. Very good. I would like to hear from you at a later time what disciplinary action you propose to take.

Mr. FUNSTON. Yes, sir. I would be very happy to respond.

Mr. GLENN. Mr. Funston, I have oftentimes said that to be a member of this committee is an education in itself. We cover a realm of subjects. In fact, I believe we are more or less a catchall for the many subjects that don't fit into other committees; they then come to Interstate and Foreign Commerce. It is interesting work, but by the same token, we probably become a jack-of-all-trades but not a master of any. So you can excuse us for our shortcomings in our knowledge of the operation of the stock exchange.

Now, let's get over to the other subject and then I will close. You spoke of the study you are making in establishing a reserve that will reach a point so that your operation as the New York Stock Exchange would be similar to that of a banking institution where you would have reserves and surplus and even perhaps go so far as to have a national association. A voluntary arrangement or something that would compare to the Federal Deposit Insurance Corporation except in this instance it would be a Federal Exchange Insurance Corporation.

Mr. FUNSTON. The committee is looking into all sorts of possibilities, FDIC and so on.

Mr. HARRIS. What committee?

Mr. FUNSTON. Our committee on expense recovery which is the second of the two committees that is trying to figure out now that we have provided the funds to take care of the Haupt situation to set up a plan so that this sort of situation to set up a plan so that this sort of situation could be taken care of in the future. It is too soon to say yet exactly what pattern it would follow.

The endeavor of the committee at the present time is being directed to getting a program for the New York Stock Exchange. However, we would like, if possible, to get a core planned that would be able to be adapted to other exchanges and other people in the industry.

Mr. GLENN. You say we may expect the benefit of this study shortly?

Mr. FUNSTON. Well, not this particular one. The one committee is reporting on February 19. I would say some time this spring; yes, sir.

Mr. GLENN. One more question.

You mentioned that this was not the biggest decline in history.

Mr. FUNSTON. Yes, sir.

Mr. GLENN. What was the biggest decline in the history of the stock exchange?

Mr. FUNSTON. Well, in a 1-day period?

Mr. GLENN. Yes.

Mr. FUNSTON. I would guess the Eisenhower—no; May 20, 1962.

May 28, 1962, I think; I am not sure.

Mr. GLENN. Was that greater than any one particular day back in the 1928–29 period?

Mr. FUNSTON. I believe so. Of course, you are talking about different things. The decline was the greatest in points; whether it is the greater decline in percentage, I don't know because the declines most people talk about are in the Dow-Jones average or the Standard and Poor's and so on. These have increased so much that if you are interested in that, sir, I would rather not guess; I would rather get the facts and let you know.

Mr. GLENN. Could you get the facts and have them put in the record?

Mr. FUNSTON. Yes, sir.

Mr. GLENN. Comparison both in points and in percentages.

Mr. FUNSTON. Yes, sir.

Mr. STAGGERS. Was this not the sharpest decline for that period of time?

Mr. FUNSTON. Yes. This decline occurred within 27 minutes and it went down 24 points, which is without any doubt, as far as the memory of anyone we know, the sharpest decline that ever occurred.

Mr. GLENN. That is all, Mr. Funston. Thank you.

Thank you, Mr. Chairman.

Mr. STAGGERS. Mr. Van Deerlin.

Mr. VAN DEERLIN. Mr. Funston, I notice in skimming through your review of the events of November 22 that most of the responsibilities for this decline are placed upon the operations of the specialists, that action by public customers was negligible after 1:40.

I am wondering what it is that impelled this. I wonder what it was about the assassination of the President and the possibility of a more widespread assassination plot that would prompt a lack of confidence in the continuity of Government.

I am wondering two additional things which I would appreciate your comment on. What if the news had been of something more akin to disaster in the area of continuity, such as the report of a nuclear blast in Detroit, Mr. Dingell's home district—or what if a market decline occurred at a time it was impossible to muster a quorum of the board to ring the bell? I suppose that you don't let them all go to lunch at the same time, or any place else. Just as a amateur I am interested in knowing some of these technical facts.

Mr. FUNSTON. Well, sir, we made many studies in the past of the effect of any single event in moving the market, and in history there are very few single events that moved the market more than 2 percent, for example. Events that can be discounted and are known in advance, people get adjusted to them and they don't scare too easily. However, this thing here, the President being shot, well, I mean it put the whole Nation in a state of shock. Who would have thought anything like that would happen, and at the time the market made this great decline.

By the way, sir, it was the public that made the decline. I mean more people wanted to sell than wanted to buy so it was a mass panic. At the time the market was closed at 2:07, it was not known, for example, that the President was dead. The rumors were that he was badly injured; there were also rumors that Vice President Johnson had had a heart attack or was being attacked. The fear was that maybe there was a wide plot against the leaders of the Government. People just naturally panicked; they got scared to death.

Mr. VAN DEERLIN. The first impulse was, "My gosh, I have to sell."

Mr. FUNSTON. Yes. So they all rushed out to sell. Then, as I said in my statement, there were orders which had been put in, left on the books, these market orders away from the market that were executed. Anyway, what happened was then the market was closed and, as I say, the pros on the exchange say that in 50 years nothing has ever occurred like this before. There has never been a panic situation like this.

Then what happened, we convened the board promptly. Mr. Frank here was the one who rang the bell closing trading and he, well, I will let him tell the story himself, but in essence we closed the market very promptly. This was unprecedented. We had never done anything like this. Somebody threw a stinkbomb in the air-conditioning system back in the thirties and we had to close then. [Laughter.]

But nobody dreamed of this.

To answer your question about plans for closing the market quickly, we have that very much in mind, even more quickly, and under study. Perhaps the vice chairman here could tell you because he is the one who rang the bell.

Mr. FRANK. I don't have an exact recording of all the thoughts that went through my mind at the time, but I would try to tell you some of the things that occurred.

We first heard this dreadful news at about 1:30 or 1:40. Then in succeeding minutes we heard various conflicting reports that it was someone other than the President, and then we heard that something had happened to the Vice President who is now our President.

Our basic desire is to keep the marketplace open for the usual hours each day for the interchange of public investment, but as the minutes went past, and we could see the emotional reaction of investors we felt that we must be prepared if this avalanche continued to close trading for the day.

So, in conference with Mr. Gray, we called a meeting in a room upstairs at 1:56. The meeting, I think, convened at 2 o'clock, and by the time we got down to ring the bell it was 2:07. Our basic desire at all times is to keep the market open but we were faced with this tremendous avalanche of orders based on the emotional reaction of the public investors, and brokers alike, that in the best interest of all we decided to close.

Mr. VAN DEERLIN. How many persons had to be convened sir?

Mr. FRANK. Seven.

Mr. VAN DEERLIN. Is this the full membership of the board?

Mr. FRANK. No, sir. The full membership of the board is 33, but we needed 7 for a quorum.

Mr. VAN DEERLIN. What is the general situation regarding the availability of at least seven members? Are there always seven members?

Mr. FRANK. In general, there are 20 in the New York area, either on the floor or in the New York area. This is not a matter of record, but I don't know of any time when it was hard to assemble seven quickly. We had not been faced with that challenge so we don't have it recorded. We have 20 right in the New York City area.

Mr. VAN DEERLIN. You say they started upstairs at 1:56?

Mr. FRANK. We scheduled the meeting for 2 o'clock. Mr. Gray and I conferred at 1:53. He got the messages to whatever governors in the New York area to meet at 2 o'clock.

Mr. VAN DEERLIN. I am sure that Mr. Harris would be interested in knowing the techniques for producing a quorum on such instant notice. [Laughter.]

Is there presently provision or would it be possible, do you think, to make provision for future emergency by maybe having some quarterback would could act more quickly if necessary?

Mr. FRANK. I would bow to Mr. Harris first who could convene a meeting quickly.

Mr. FUNSTON. On this particular point, you don't want to make it too easy to close the exchange. In other words we set great store by being there in fair weather and foul, being there doing business between 10 in the morning and 3:30. That is something that we are talking about. As of right now, the chairman can suspend or the vice chairman or a senior governor on the floor can suspend trading in particular stocks. There is a proposal that the board has not even considered yet but which is being talked about anyway, that we might have under certain circumstances a special committee of three on the floor: The chairman, the vice chairman, and the senior governor or three senior governors present. They might be able to suspend trading subject to its confirmation of a closing by the exchange a board of governors by a quorum of seven.

As I say, this is one of the things that the committee I am talking about is discussing. They have come to no conclusion on it but it is something we are thinking about.

Mr. VAN DEERLIN. It would be your view, would it not, that since 1929 the activities of the stock exchange perhaps inordinately have been used as a gage of the well-being of the entire Nation, certainly the business community of the Nation.

Mr. FUNSTON. Sir, I might add you remind me of another part of your question that I didn't respond to. You said how could the American people have so little confidence in their Government?

Well, I think that what happened was that at the time that the market was closed and this great decline occurred nobody knew what happened. Then over the weekend, and our member firms played no small part in this, the people realized that President Johnson was all right and he was the President and he took masterful steps then to get the confidence of the people.

I think that the market performance and the complete reversal on the 26th in no small measure, as I say, was a vote of confidence on the part of the American people that there would be a good and solid transition. The people just had to have some time to think the thing over and come to their senses is what it amounted to.

Mr. VAN DEERLIN. The thing that spurred my curiosity was recalling what my thoughts were during the first 27 minutes after the assassination. Perhaps the fact that I didn't have this same response, "My gosh, I have to sell," stems from the fact that I had nothing to sell. [Laughter.]

Thank you, Mr. Chairman.

Mr. STAGGERS. I might make this statement to you, Mr. Funston, before we go ahead.

It looks like you will have to come back tomorrow at 10 o'clock because I know there are many questions that have not been asked and we would like to have answered. I suggest this possible remedy that

we might take in the situation. Until the bell rings for the quorum time, which I am sure will be within 5 minutes, I thought that perhaps Mr. Keith might be able to get in a question or two.

Mr. KEITH. Thank you, Mr. Chairman.

Mr. Funston, from the time that the market closed until it opened the following Tuesday, there was some rather extraordinary circumstance that took place. Some people might have been adversely affected by the selling that took place just prior to their departure implementing orders that were on the books just prior to closing. Was anybody caught short, not in the strong sense of the word, any customers very adversely affected? I recognize that generally speaking the overall reaction was beneficial, but were there any people who were very seriously hurt by the timing of these events?

Mr. FUNSTON. Well, I don't know of any particular individuals or situations. I suppose that the people who sold the stock when prices were down at the height of the panic and then they turned around and went back the next day where they were, those people didn't know nearly as well as if they had just not sold.

To my knowledge, nobody was particularly hurt or no member firms were hurt, no specialists were thrown into grave difficulty.

Mr. KEITH. I am not so much worried about the specialists as I am about some of the people who might have been adversely affected as a result of their actions, particularly those actions that were mentioned in Mr. Cary's response to a query by the chairman of this subcommittee, Mr. Staggers.

Quoting from page 4 of Mr. Cary's letter:

> At the other extreme were the specialists registered in Korvette, International Telephone, American Motors, and American Photocopy. In the first three of these securities the specialists sold substantial quantities of stock almost immediately after the news of the assassination. Thereafter, these specialists returned to the market and bought stock on balance only after prices had declined. Not only did their selling contribute to the disorderliness of the market, but the specialists were able to use their central market position to liquidate their positions ahead of the public.
>
> American Photocopy is unique. The specialists registered in this stock not only liquidated large positions in the minutes after the news and assumed short positions but they did not subsequently reenter the market as purchasers at all on November 22.

What has been done as a result of that?

Mr. FUNSTON. In addition to the stocks that were mentioned in the SEC report, we as a result of our stock-watching service, picked out a number of other specialists that should be looked into. These men have been interrogated and in most cases everything was found to be all right. Disciplinary action undoubtedly will be taken. Some action is going to be taken tomorrow on instituting disciplinary action in a very few cases.

Mr. DINGELL. Would the gentleman yield?

This took place the 22d of November 1963?

Mr. FUNSTON. Yes.

Mr. DINGELL. I note by the calendar on the wall it is now February 1964. Does this not appear to you to be a rather long period for action in view of the report of the SEC and in view of the high responsibility of the Exchange.

Mr. FUNSTON. Not at all, sir; no, sir. We have been interrogating some 83 cases, each one of which we are very careful, I assure you,

since the Silver case, to follow what is called due process. Each person interrogated has every opportunity to present his viewpoint. It is a very difficult, complicated matter to come to a judgment as to whether or not the responsibilities were being carried out properly in view of the surrounding circumstances or whether there is a cause for action.

No, sir; I would not say that 2 months is too long a period to have assessed 83 cases and have determined those which should be brought to the attention of the board of governors.

Mr. KEITH. I would think there might have been in this instance some obvious errors in judgment and action that were not in the public interest and that at least one or two cases could have been rather summarily treated.

Mr. FUNSTON. Well, sir, we wanted to wait. Rather than to make a summary treatment of one or two, we wanted to evaluate the whole picture which I believe is good judgment. It may be that one or two of the worst we could have done earlier but we wanted to assess the whole situation, which we may be wrong in our judgment as the way to proceed.

Mr. STAGGERS. The committee will stand adjourned until tomorrow at 10.

(Whereupon, at 12:05 p.m., the committee recessed until 10 a.m., Wednesday, February 5, 1964.)

INVESTOR PROTECTION

WEDNESDAY, FEBRUARY 5, 1964

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE OF THE
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10:10 a.m., pursuant to recess, in room 1334, Longworth Building, Hon. Harley O. Staggers (chairman of the subcommittee) presiding.

Mr. STAGGERS. The committee will come to order.

Yesterday, when the committee discontinued these hearings on the questioning of Mr. Funston, Mr. Keith was propounding some questions at that time to him. We shall continue in that manner.

Mr. Funston's appearance here is at the request of the committee to clarify his thinking and the thinking of this committee on the role of the specialist and also protection of securities holders in cases like the *Haupt* case when they occur, and other related matters.

Mr. Funston had given his prepared statement and questions had been asked by most of the committee.

Mr. Keith, you may proceed.

Mr. KEITH. Thank you, Mr. Chairman.

Shortly after the conclusion of yesterday's hearings, there were efforts on the part of the press to interpret your answer to my question concerning the possible exercise of your powers as president of the stock exchange with reference to the activities of the specialists. I referred particularly to the specialists who sold short at the close of the market.

You indicated that something was going to happen today with reference to the policing of this phase of their activities.

STATEMENT OF KEITH FUNSTON, PRESIDENT, NEW YORK STOCK EXCHANGE—Resumed

Mr. FUNSTON. Yes, sir. The way disciplinary matters are handled at the exchange is that the staff acting as it were as the prosecuting group counseled by knowledgeable people in the industry bring before the advisory committee or the board, and in most cases it goes to both groups together, questions as to whether or not certain acts have been in violation of exchange rules or procedures or policies.

What I was attempting to indicate yesterday in response to your question was that the inquiry into the acts of specialists in the November 22–25 price changes has been on a very broad basis, all specialists, some of them have been the subject of interrogation by the staff to see if there were any violations of exchange rules.

Today, the staff is going to bring before the advisory committee a problem or problems which have been presented in the light of that study. Of course, what the advisory committee decides to do, the Board of Governors of the New York Exchange has the ultimate power of discipline of members or allied members. The course that this will follow will be determined by the decision of the board.

Very likely, although it is not 100 percent sure, the action of the advisory committee might be, as the name indicates, just an advisory opinion in sending something to the board with a recommendation, because in certain types of disciplinary matters only the full board of governors has the right to exert discipline.

I think, sir, that the press, perhaps because I was not as clear as I could have been, interpreted my remarks as being that the board was going to take some action today, which is not the case.

Of course, in all of our disciplinary procedures, we are very careful to give hearings and due process of law to the people that are being charged with violation of exchange rules. This investigation by the advisory committee and the board is a part of that process.

Mr. LONG. Mr. Keith, will the gentleman yield?

Mr. KEITH. Yes.

Mr. LONG. Mr. Funston, you stated that they were going to make inquiry as to whether or not there had been a violation of the exchange rules. Would this inquiry include a determination as to whether or not the rules were adequate to cover such a situation? Will their study in any way cover that?

Mr. FUNSTON. Yes, sir. Not this particular disciplinary action, but these matters are being studied very intensively by another committee.

Mr. LONG. I realize that. It appeared to me this might be a particular situation which tested this as was discussed yesterday. Perhaps a determination could be made as to whether or not the rules are adequate to cover situations such as this. The exceptional situations are the ones that make the rules necessary and necessary that we look at them in great detail.

Mr. FUNSTON. Yes, sir. In this particular situation, of course, we are investigating whether a particular violation infringed existing rules and this whole general subject is being considered whether the rules need to be tightened or not.

Mr. LONG. I understood that. It was my thought that perhaps at this stage either your special committee looking at that situation or your general committee looking at the adequacy of the rules in this regard might give particular study to the series of events that happened between the 22d and 26th; whether or not they were adequate. This might shed some light upon not only the application of rules but the adequacy of the rules in view of the historical usage of them.

Mr. FUNSTON. Yes, sir. They very much have that in mind and that is being done.

Mr. LONG. Thank you.

Mr. KEITH. Thank you.

This committee is concerned with the amount of responsibility that can be delegated to the stock exchanges to organizations such as the National Association of Security Dealers and perhaps to a newly formed investment company group which would police that industry. We want to be certain that the self-regulation system is adequate to

protect the public as well as to protect the individuals who belong to the fraternity. This would concern discipline within the fraternity which, perhaps, would not be the subject of court or administrative action as would be the case if the Government, or an agency of the Government, had a direct responsibility in this area.

One segment of the securities business which we are hopeful may come under self-regulation to a larger degree than is now the case is the mutual fund industry. The SEC has recommended that we require them to belong to an association which would police that industry. What was the role of the investment company in stemming or furthering the decline on November 22? Did they buy or did they sell?

Mr. FUNSTON. In my prepared statement, sir, there was a reference to the effect that they were buyers that institutions would include——

Mr. KEITH. You mentioned institutions but you did not include——

Mr. FUNSTON. This included the mutual funds in that category.

Mr. KEITH. Ordinarily, I would have thought of it as including pension funds, insurance companies, and, perhaps, banks, but I should like to hear specifically with reference to the investment companies.

Mr. FUNSTON. The institutional customers and our floor members and allied members were buyers on balance; however, the institutional customers counted for a relatively small share of the volume after 1:40. The trouble was that it happened so quickly, institutional investors and people who invest more or less according to a plan just didn't have time to react quickly enough.

Now, I don't know whether any of my associates here have any specific figures on this for mutual funds or whether they could be goten, but I will inquire.

We don't have the breakout of the mutual funds from institutions but we probably could dig it out for you and send it down as a matter of record.

Mr. KEITH. Well, it might be interesting to get your records and compare them with those which have been furnished me. I believe they would indicate that on Friday, November 22, their percent of purchases was 3.5 and the percent of sales was 2.5.

On November 26, they purchased 4.4 and sold 5.5 percent.

On the 27th they purchased 4.7 and sold 5.4 percent.

On Friday, they purchased 3 percent and sold 6.5 percent.

I'm not certain of the full implications of these statistics therefore, I would welcome any comment you care to make.

Mr. FUNSTON. The only comment that I would make is that in general the figures sound about the right proportion. The mutual fund industry accounts for normally about 4 percent of the transactions. The figures there that we give that they were buyers on balance on the 22d would seem to be in accord with our general impression in terms of the analysis of the other things.

I could not make a comment unless I had studied them, although basically I think we feel that the mutual fund industry is a stabilizing influence in connection with the stock market because they are very intelligent, long-term investors.

Mr. KEITH. In your statement and in the supplemental comments you made, you did not exactly plead innocence but you indicated there was no obligation. I think if I had written the text of it I would

have said no "legal" obligation. I would say that you do have a moral obligation.

Mr. FUNSTON. I think, sir, the fact that we stepped in and did something about it would confirm your point.

Mr. KEITH. I think so, too.

Mr. FUNSTON. I think, based on this specific case and the specific facts in this case, we felt we had a moral obligation and that is why we acted even though we had no legal obligation.

Mr. KEITH. Had I written your press release, which incidentally sounds as if it had come from Madison Avenue rather than Wall Street, I would have stressed that. I think, too, that I would have stressed the need for some action in the field of specialist supervision. As I recall, the general tenor of your press release was that "we did a fine job, so there really was not too much need for the public to be concerned about the specialist end of the business." Perhaps the problem was being ignored.

Mr. FUNSTON. Sir, if our press release gave that impression, we did not intend that it should. I think that with respect to the performance of the specialist on that day that it was a day of a flash panic of great tremendous proportion. I think that all of us feel that based on hindsight, and, of course, it is different looking at something in hindsight, that the specialists undoubtedly could have done a better job as a group. That is different from saying that considering the circumstances looking forward at the time that they did a poor job. We think that they did a satisfactory job. We think that some did better jobs than others and, indeed, as I say, the board will consider certain cases where they did not do as well as they think they should have under the circumstances.

I didn't elaborate particularly about what was being done about it because we have an active committee that is getting a report—if it is on time it was supposed to come in yesterday from our consultants who are going to make recommendations on this very subject and make suggestions on how the exchange might better survey the activities and the performance of the specialists. We got this Joel Dean Associates to make a special study focusing on the SEC report. This report should have been in yesterday.

As I said in my statement by the March meeting of the board this specific thing will be considered and by April 1 we will be talking to the SEC about it.

Now, we have specific ideas in mind with respect to the improvements in this area but they have not been considered by the board yet so they are all informal and just thoughts at this point.

Mr. KEITH. You mentioned the responsibilities of the exchange in this matter. What collateral responsibility does the Commodity Exchange have?

Mr. FUNSTON. Of course, I am not an expert on the commodity exchanges. Ira Haupt is a member of any number of commodity exchanges and they are as much under the jurisdiction of those exchanges and under the governmental supervision of the commodity exchange administration in commodity matters as they are under our supervision and regulations with respect to security matters.

So, the commodity exchanges and the CEA I think have much the same powers over Ira Haupt in the area of their specialty as the New

York Stock Exchange and the SEC does over Ira Haupt in the area of securities; and it was in the commodity area that the trouble which we are all trying to alleviate now took place. It was not in the securities area; it was in the commodity area.

Mr. KEITH. What effort have you, as president of the New York Stock Exchange, made to protect your membership against paying for the losses incurred as the result of a commodity exchange deficiency?

Mr. FUNSTON. Well, from the very beginning, of course, as early as November 19, we were in touch with the heads of the commodity exchanges and finding out what their thoughts were and what their position was. Our committee on the commodity business have had discussions with the commodity exchanges. Frankly, we are hopeful that they on their own will take certain steps that are in the area of their jurisdiction, not in the area of ours, that will perhaps tighten things up and make this sort of thing more difficult to happen again in the future.

Mr. KEITH. Do they have any assets that could be tapped similar to those which the New York Stock Exchange has to protect it?

Mr. FUNSTON. Yes, sir.

Mr. KEITH. Have they made any efforts in that direction?

Mr. FUNSTON. Well; no, sir. In the very beginning, there were some conversations in getting up this pool as to whether they would be included in it. We emphasized that our pride of getting into this was not such that we would not be willing to talk to other people, sharing the costs, but for good and sufficient reason it was decided that we would go ahead on our own. We had to move very speedily and very quickly. We had only one weekend and you just could not consult too many people on one weekend. They have their own problems which differ from ours.

You are touching on some thing that I tried to point out very clearly in my testimony when I was down here 3 years ago because I made a statement which is absolutely true with respect to disciplinary matters, that we have very, very broad disciplinary authority over our members. We do not have that same authority or it is impossible to exercise it over all of our members in all of their activities.

Mr. KEITH. Do you have the authority under present regulations and laws to require your membership to segregate their assets on one hand to their own account and on the other to those of customers and brokers?

Mr. FUNSTON. I believe we would. This is a legal question but unless counsel here tells me I better not say so, I would say yes; we believe we do.

Mr. KEITH. Roughly, what would it cost a firm like Tucker Anthony, for example, to meet their assessment in reimbursing the accounts that suffered losses as a result of this Haupt situation?

Mr. FUNSTON. That is a hard question to answer because I don't know what the extent of the——

Mr. KEITH. What formula did you use?

Mr. FUNSTON. Well, Tucker Anthony, for example, pays the exchange 1 percent of their gross commission per year in their commission business, in their NYSE listed security business, and this assessment that has been made is an open-end assessment which would be,

however, only enough to reimburse the exchange for what we will have spent in the Haupt thing, and we figure it will be about 1½ percent. In other words, it will be the equivalent of about 1½ years' payment by our member firms to the exchange.

Mr. KEITH. Roughly, how much money?

Mr. FUNSTON. Well, it would depend, sir, on what they paid to us. I don't know what their commission business is. If they pay us $10,000 a year, which represents 1 percent on $1 million, if my arithmetic is correct, then they would pay us $15,000 for this. I would not be able to answer it until I knew exactly what their 1-percent charge was.

Mr. KEITH. Do you think, as an estimate, that $10,000 would be a fair amount?

Mr. FUNSTON. I don't know, sir. I could find out.

Mr. KEITH. No; I was interested in knowing how intimately you were associated with the member firms.

Mr. FUNSTON. Oh, I am not. See, we have 600 member firms so I don't know which ones.

Mr. KEITH. What firm is the largest of those?

Mr. FUNSTON. The largest one would be Merrill Lynch, and the cost for them of this program will be about $1½ million.

Mr. KEITH. Thank you.

Thank you, Mr. Chairman.

Mr. STAGGERS. Mr. Long, do you have any questions?

Mr. LONG. No questions.

Mr. STAGGERS. Mr. Dingell?

Mr. DINGELL. Yes.

Mr. Funston, it occurs to me that it is a great hardship on the members of your exchange to tell them, to ante up, to specially make whole people who have been injured through either lack of confidence or perhaps questionable practice on the part of others on the exchange.

I hope that you don't feel that that is the way in which the New York Stock Exchange or any of the other major exchanges should conduct their affairs, do you?

Mr. FUNSTON. Well, if it is necessary to, I certainly do. It is a hardship for them, but they voted 87½ percent in favor of doing this.

Mr. DINGELL. The point I am coming around to, though, is this is essentially a very poor way of handling this kind of thing, is it not?

Mr. FUNSTON. The best way to handle it is to prevent it from happening, and this is only the second time in 25 years that anything like this has happened. Our record has been good.

Mr. DINGELL. I think it has been marvelous but the fact of the matter is the second time was something which I think should be avoided in the future, should it not?

Mr. FUNSTON. I could not agree with you more; absolutely.

Mr. DINGELL. Necessarily, it should be done through tightening up of the examination procedure, should it not?

Mr. FUNSTON. Not necessarily. We don't think that examination procedures were at fault here.

Mr. DINGELL. Then the next question is the examination procedures in this case really did not go into other trading which was engaged in by the *Haupt* case?

Mr. FUNSTON. Yes, sir. Let me say I can speak only of examination procedures of the New York Stock Exchange. I am not aware of or qualified to speak as to whether the examination procedures of the commodity exchanges or the CEA were adequate. I just don't know.

Mr. DINGELL. But it becomes plain that something more in the way of protection for investors is required as a result of the *Haupt* case, does it not, in terms of requirements either of the exchange or of the SEC?

Mr. FUNSTON. I would say that it would be unless the exchange wants to be prepared to conduct bailout operations of this kind in the future, which we don't want to have to do.

Mr. DINGELL. Now, I noted here in the comments of the SEC with regard to the selloff that a specific recommendation was made that there be a substantial increase in specialist capital requirements. Now, that would go to the problem of selloff that occurred on the 22d, but I noted in the two editorials that our chairman referred to yesterday in reading over that in each instance these editorials recommended either explicity or implicity that there be changes in capital requirements by member firms with regard to liquidity and with regard to reserve requirements. Now, it appears to me that this is really the only way in which investors can be protected and in which the exchange can be really protected from having to engage in another bailout operation of the kind you are referring to in your testimony.

Mr. FUNSTON. Mr. Dingell, I wish it was as simple as that. I wish it were as simple as our saying that all we had to do was substantially increase the capital requirements and that would solve our problem. That would be easy to do but it is not the answer to the problem.

With respect to capital requirements, for example, our special committee undoubtedly will recommend a substantial, maybe from a couple of times, two and a half times more capital requirement on specialists than we have now but this is not the answer to the problem.

The problem is not one as simple as the editorials make out, that it is a capital requirement; the specialists do have access to capital. Much more important than capital is the willingness to venture and the knowledge to risk. This is the real problem; not the amount of capital.

Mr. DINGELL. I recognize the point. I recognize a good deal more is involved. What we are seeking is a device whereby this committee can be assured that the legislation is coming out as a result of our million dollars spent for the special study.

I think you do run a very fine and very responsible organization. I wish you to know these are my feelings. But to make sure that this expenditure and the legislation resulting is not less than the needs of the people require, this is my concern and I am sure it is the concern of my colleagues.

Mr. FUNSTON. Yes, sir. I think I can assure you that when the specialist committee makes its recommendations to the Board and when the Board makes its recommendations and discusses with the SEC what we think ought to be done that there will be a substantial increase proposed in the specialist capital requirements.

Mr. DINGELL. Thank you.

Thank you, Mr. Chairman.

Mr. STAGGERS. Mr. Curtin.

Mr. CURTIN. Thank you, Mr. Chairman.

Mr. Funston, I was much impressed yesterday with your statement and with your answers to questions that were propounded to you subsequently to your statement. I also regret that I was unavoidably detained for a time this morning so that I did not hear all of the questions that were asked and your answers to them.

The questions that I have in mind may have answered by you already, and, if so, please just so state, and then I can get your answers from the record.

I am much interested in this specialist angle which we were discussing yesterday. As I understand the situation, the function of the specialist is to maintain an orderly market.

Mr. FUNSTON. Yes.

Mr. CURTIN. To do that, he normally buys or sells against the trend; is that correct?

Mr. FUNSTON. Yes, sir.

Mr. CURTIN. I noticed in your statement yesterday that you said one of the things that caused this selling wave, immediately after the news of the tragic assassination of our former President was received, was the fact that so many of the orders had been placed with a specialist prior to 1:40 p.m.

Mr. FUNSTON. Yes, sir.

Mr. CURTIN. Now, if such specialist's function is to maintain an orderly market and to sell against the trend, what difference would it make what time he got those orders? Why were orders received before 1:40 so important in your testimony?

Mr. FUNSTON. Well, 1:40 was the time when the news hit and when the public began to be panic stricken and everybody rushed in and said to sell. The point that I was making there, I believe, was that prior to 1:40 members of the public had been in and they had said, I would like to sell stock at a price below the market. So, when the price fell a little bit because of the market transactions, this in turn triggered certain orders that were already on the books of the specialist from the public to sell at certain prices below the market.

The point I was trying to make was that these sales that were already on the books before 1:40 were triggered so it just added to the selling volume. I think that this was a small thing in comparison with the total flood of orders that came in, but it was a factor. In other words, what I said yesterday was stop orders placed by the public before the assassination also contributed significantly to the selling wave after 1:40.

Have I explained it, sir? Do you understand what I am saying? I may not have been clear.

Mr. CURTIN. I am not completely clear about certain features of your answer. The specialist is to sell against the market when the market is going up or buy against the market when the market is going down. Is that it?

Mr. FUNSTON. Yes.

Mr. CURTIN. If that is his function, to me it seems rather unimportant as to the exact minute he has an order placed with him. I would think that he would still be maintaining that function of trying to keep an even market, regardless of whether he had certain orders on his book for minutes or for hours.

Mr. FUNSTON. Oh, he is, sir. He is still responsible for buying. You see, these orders I am talking about were on the supply side by the customer; so when these orders were triggered because the price was falling, it was still up to him to buy them. These orders just added to the supply of stock which was his responsibility to take care of.

Mr. CURTIN. So far in your investigation of this, as I understand you to say you are undertaking at this time, do you have any evidence that any of your specialists were contributing to this selling wave by selling heavily at this point, even selling short?

Mr. FUNSTON. Yes, sir. Well, this is another question than stop orders, but, yes, our study did indicate that during this period some specialists were selling. Of course, this, in itself is not per se a bad thing. In other words, specialists always have to be able to liquidate in order to take positions which will enable them to continuously be able to maintain an orderly market.

Mr. CURTIN. Do I understand you to say, then, that it is an accepted thing for a specialist to sell short on a falling market?

Mr. FUNSTON. No; he is not allowed to.

Mr. CURTIN. That is what I asked you.

Mr. FUNSTON. No.

Mr. CURTIN. Isn't that what was happening on November 22 after 1:40 when the market was falling apart, were not some of your specialists selling short?

Mr. FUNSTON. No.

Wait a minute. Let me talk to my consultant or my friends here. We know of one short seller. May I ask Mr. Frank to answer that question because he is much more familiar with it than I.

Mr. FRANK. As the SEC letter stated, there was one specialist of the 25 who had sold short. There was one that sold short, but the other selling that Mr. Funston speaks of was not short-selling, the ordinary selling and buying in the course of the trading activity and the decline.

Mr. CURTIN. Now, in the opinion of you respective gentlemen, was that in accordance with the rules and regulations of your organization?

Mr. FRANK. Yes. The specialist at times must liquidate so that he can create a buying power in anticipation of certain events that he feels will cause him to use this buying power to good advantage in the public interest and in maintaining the orderly market. Sometimes, we liquidate so we can properly perform if what we anticipate will happen does occur.

Mr. CURTIN. Well, I am a layman on this sort of thing and I am not quite sure I understand what you mean by that. Do you mean by that, that under certain circumstances your specialist can sell short?

Mr. FRANK. No.

Mr. CURTIN. Is he ever permitted to sell short?

Mr. FRANK. No, sir. There are some times when a specialist inventory would be of such size that in his judgment he would be able to perform better in subsequent hours or days or minutes if he were to liquidate a portion of this inventory so that he could create buying power for the event that he thinks will happen shortly. This is entirely different from short selling, Mr. Curtin.

Mr. CURTIN. Is it permitted, according to the regulations of your exchange, for a specialist to sell short on a falling market?

Mr. FRANK. No, sir. He must only sell short on a price above the previous different price. So, if there is a short sale at any time, if it happens to be in a period of general decline, it must be at a price above the previous different price so it cannot contribute to the decline.

Mr. DINGELL. Would the gentleman yield for one question?

Mr. CURTIN. Yes.

Mr. DINGELL. You have been talking now, sir, if my memory is correct, about the justification for liquidation by specialists. Now, if a specialist is properly capitalized, he won't need, for the orderly course of events, to liquidate; isn't that a fact?

Mr. FRANK. If his capital is used fully at the particular moment when this need arises, then I would say that he must be free to liquidate so that he can free that necessary part of capital that he anticipates he will have to use.

Mr. DINGELL. You are not answering my question.

My question was: If he is adequately capitalized, he will have to less frequently liquidate than he would if he were not capitalized; isn't that a fact?

Mr. FRANK. I would say rather that if he did not always fully use his capital he might have less need for liquidating; but even if he were adequately capitalized and used it all, he might still be faced with the problem of having to liquidate.

Mr. DINGELL. That is right.

Now, let's understand one thing. Under a market which is going through very radical swings, it is a fact that liquidation by a specialist is not in the interest of the investors; isn't this a fact?

Mr. FRANK. No, sir.

Mr. DINGELL. Well, in each of the 25 instances cited by the SEC it appeared there was liquidation going on of one form or another.

Mr. FRANK. Liquidation might very well have been an asset——

Mr. DINGELL. And none of this liquidation contributed to the stability of the market in these 25 instances if it was going on; am I correct?

Mr. FRANK. No, sir.

Mr. DINGELL. Then do you make the statement that it was in the interest of the market?

Mr. FRANK. Yes, because by liquidating in many of the areas this created a buying power and created free capital for later entrance into the market in support of the market as this tremendous avalanche of orders developed.

Mr. DINGELL. I am afraid you disagree with the SEC on this.

Mr. FRANK. No, sir.

Mr. DINGELL. The SEC says it did not contribute to an orderly market. What I am coming around to is just this, and this is a very simple question: The higher the reserve and the liquidity requirements that are imposed on specialists and other member firms and member individuals of your exchange are, the less likely the liquidation and selling short in the kind of disorderly market that we saw during the 22d of November, the less often that that kind of liquidation and that kind of selling short would take place; is that right?

Mr. FRANK. I would say I would agree that certainly if more capital were at hand that it would have an effect on performance and it would be axiomatic that the greater capital available in any venture would lead to a stronger position; yes, sir.

Mr. FUNSTON. If I my say one thing, sir. I repeat what I said before, the amount of capital in hand is not necessarily the most important thing because the borrowing power of a specialist is adequate and what the problem is is to be able to get the specialists to be willing to venture and to utilize the full amount of capital that they have or the full amount of the capital which they can borrow.

Mr. DINGELL. I don't argue these points with you.

Mr. FUNSTON. That is the problem.

May I just say one other thing, sir, if I may interrupt here.

I don't think we ought to let this discussion about what happened in the 25 stocks go with any idea that the specialists were liquidating in these 25 stocks because, as is shown on page 8 of the report, these stocks, these 25 stocks—and again we are talking about from 1:40 to the close of the market, Mr. Curtin, because this is the difficult time. If we were taking the whole day, we would have a much more favorable picture than this, but during this critical 27-minute period they bought 99,800 shares and increased their position by $5,161,000.

The one point that you made of the case of the specialist that did seemingly sell short is a question that is going to be discussed in disciplinary discussions.

Mr. CURTIN. I would like to question you further on that.

Now, is it proper, or is it within the regulations of your exchange, to have such liquidation as you have been speaking of, even if the same will touch off sell orders below the market price by the public?

Mr. FRANK. No, sir. There is no time that liquidation by a specialist can touch off sell orders below the market. We have a rule which forbids us to make any transaction. We have a rule that forbids any transaction to trigger off the sell orders that are placed in that manner, so it is against our rules, it cannot be.

Mr. CURTIN. What is your rule on this particular problem?

Mr. FRANK. I don't know whether I can read it exactly as it is written but if I can offer the spirit or the broad interpretation of the rule.

Mr. CURTIN. All right.

Mr. FRANK. The specialist may not make a transaction in which he has a principal interest or he has a proprietary transaction which will put in effect any market order to buy or sell any stop loss order that has been put in his possession prior to this transaction. On occasion, he must in order to keep the fair and orderly market make this type of transaction; and if so, he must get the approval of a floor official or a floor governor before.

Mr. CURTIN. Has the exchange in mind any change in regulations which would lessen the possibility of what apparently occurred, to a larger or lesser extent, on November 22?

Mr. FRANK. I would just follow up on what Mr. Funston said earlier; that the committee studying the whole problem has in mind studying all phases of it and I would hope possibly come up with some suggestion and in coordination with the SEC come up with some plan that would possibly improve our performance, but it is still in the committee stages as Mr. Funston said.

Mr. FUNSTON. Yes. Mr. Curtin, I don't want to expand this discussion beyond what you want to go but the whole stop loss question is a question of debate and has been for years. The professionals, most of them, think that this puts a great deal of heavy responsibility on the specialist. On the other hand, the committee have always felt that the stop loss procedure was something that was very good for the public because a person could place an order and go away and forget about it, so it has been kept for that reason.

This is one of the things that is going to come up for discussion in the committee, and what they will decide, I don't know. I would guess that they would decide that stop loss orders were desirable.

Mr. CURTIN. To be sure I understand what you mean by stop loss, is that where a customer says that he wants to buy certain securities at a certain price?

Mr. FUNSTON. No, he wants to sell them; it is the reverse. The stock may be selling for 45. He says, "Look, if it gets to 35 I want to sell it." So he puts an order on the books and says, sell at 35.

Mr. CURTIN. I yield to Mr. Keith.

Mr. KEITH. Thank you.

Were the specialists pretty close to the end of their ability to handle this decline from a capital requirement point of view? Were they losing so much money that had the market not been closed and the downward trend had continued for another hour until the usual closing time, would they have been, in effect, liquidated?

Mr. FUNSTON. I think it is very difficult to answer that, sir, because that is such an "iffy" question that you don't know what might have happened in the last hour and a half.

Mr. KEITH. I said if the trend continued downward after the time it had gone down 58 points.

Mr. FUNSTON. At some point, they would have completely utilized all the capital they had, all the borrowing power they had, and would have had to more or less let the market seek its own level based on the public orders. We were checking very carefully during this period, checking specialists, making sure that none of them were in any trouble, and we found none. Of course, it is just the way that a specialist cannot peg the price of the market, no man or no individual has enough money to keep the stock from going down from seeking its level over a period of time and that is not the job of the specialist. How much longer it could have gone, on the basis of the way it was going, your guess is as good as mine.

Mr. KEITH. But there is no real further insurance for the maintenance of an orderly market once the capital of the specialist has been exhausted?

Mr. FUNSTON. Has been fully committed, that is right.

Mr. DINGELL. Would the gentleman yield? As a matter of fact, at that point you have a major market break, don't you, if the capital of all the specialists has been committed?

Mr. FUNSTON. Well, it depends, sir, what the public does. You see, if you go back to the Eisenhower heart attack day just using general figures, the specialists, when they came in that morning, had about $25 million worth of inventory. As of 1 o'clock that day, they had $100 million worth of inventory. So they had bought roughly $75 million in that 3-hour period.

Then the news came out that the President was recovering so then the public turned around and came in and bought heavily, so by the end of the day the specialist position was down from $100 million back down to $50, $75 million. So, if this happens in conjunction with a panic on the part of the public, then the drop could be very severe.

Mr. DINGELL. Then you would begin to go into a period, really of accelerating market decline if the public attitude was such as causing a continued wave of selling?

Mr. FUNSTON. Yes. All the specialist can do and his only responsibility is not to peg the price of the market but is to provide a close continuous short term orderly market to make up for a temporary disparity of supply and demand.

Mr. DINGELL. I understand.

Thank you.

Mr. CURTIN. Mr. Funston, in connection with that same thought, as I understand it, a specialist has certain stocks in which he is specializing.

Mr. FUNSTON. Yes, sir.

Mr. CURTIN. Supposing that particular stock has reached the point of very heavy selling and the specialist has become financially in a position where he can no longer accept sell orders. Is another specialist then able to go on from there, or what happens?

Mr. FUNSTON. No. What he does in such a circumstance, and this is one of the advantages of having a specialist have a number of stocks—15 is the average, because they are spread among industries—there will be an oil stock and railroad, and so on. It is seldom that the impact of any single event will hit all stocks simultaneously at the same time, so if he has a problem on his oil stock, then he can divert a large measure of his total resources to that one stock.

Mr. CURTIN. Let's assume a situation where there is a corporation—we will call it X corporation—that has many large Government contracts, practically all its business is Government work, and the news comes out some morning that the Government is going to cancel all its contracts with that company. That would mean, I presume, a very severe selling wave immediately on the stock of that company.

Mr. FUNSTON. In trouble on that stock, yes.

Mr. CURTIN. Now, is there more than one specialist prepared to handle this, or just one specialist?

Mr. FUNSTON. No, just that one specialist except he and his associates—in other words, each specialist has associated with him other people——

Mr. CURTIN. You mean the members of his particular firm?

Mr. FUNSTON. Yes. But what happens in those particular situations is that this is when floor trading comes in and is important. When it is known that there may be a situation as they call it in a stock, say, like this, then very often floor traders or other members acting as floor traders in this instance will step in and help out. This is a very usual situation.

Mr. CURTIN. Now, is that the result of a form of gentleman's agreement or do you have a regulation of your exchange to provide for that?

Mr. FUNSTON. No. Insofar as this is concerned, there is no regulation saying they have to do this. This is just. I would not even say it

is a gentleman's agreement, it is a custom and a way whereby these men, over a period of time, think that they can provide a service and also hopefully make some money in the long run.

Mr. GLENN. Will the gentleman yield?

Mr. CURTIN. Yes.

Mr. GLENN. Sir, I think somewhere in your statement you said that a specialist had no knowledge on the floor of the exchange that it would close at 2:07 p.m. on November 22.

Mr. FUNSTON. Yes.

Mr. GLENN. As a matter of fact, had not some of the issues been suspended by order of a floor governor before 2:07?

Mr. FUNSTON. Yes, sir. Many stocks were closed down with the approval of a floor official or floor governor because it got so chaotic and the orders could not get in there, you could not get to the post. You just had to suspend trading because there was nothing else to do.

The interesting thing is that in this whole thing, most specialists are trained with the idea and are very proud of the fact that we keep this market open from 10 to 3:30, fair weather and foul, so all of them were struggling to keep it open. However, some of them were just so swamped with the mechanics of getting orders in they could not. Those men who stayed open until 2:07 when the market was closed and had no alternative, the board of governors closed the exchange, these were the men that have been criticized the most because their stocks went down the most because they stayed open the longest. The next Tuesday when the public's psychology had changed completely and there was a tremendous demand, these were the stocks that opened up at about the level where they were selling at 1:40. The specialist then, in order to sell at that price, had to sell thousands and thousands of shares short. So it is rather ironic that the fellows who were standing there really taking it on the chin until 2:07 are the people who, based on the figures, are most apt to be criticized.

Mr. GLENN. Did I understand you to say some of the specialists had closed before 2:07?

Mr. FUNSTON. Yes, sir. I don't know how many there were but a number of them closed down before 2:07, they just could not handle the orders. What happened was, the trading was suspended in the stock, it was not closed. Trading was temporarily suspended in the stock and before it could be reopened, the market as a whole was closed.

Mr. GLENN. And this was because of the mechanical breakdown?

Mr. FUNSTON. Well, probably it was a mechanical breakdown. I don't know, maybe it was more than that in certain instances.

May I ask Mr. Frank?

Mr. FRANK. The physical handling of the tremendous volume of orders in some issues were such that they could not be assembled and have a fair price arranged. So, in the interest of all concerned, it was wisest that they suspend trading in those issues always with the hope that we could resume. A few minutes later, we closed the market so that trading did not resume in any of those issues.

Mr. FUNSTON. All orders are handled in accordance with a time schedule, I mean it is all worked out that the first there is the first one. It got so that you might be executing an order for someone whereas he really didn't have precedence in the market at all; so that if you kept on, you were being literally unfair to some other people whose orders had not been sorted out properly.

Mr. GLENN. Thank you very much.

Thank you, Mr. Curtin.

Mr. CURTIN. I yield to Mr. Keith.

Mr. KEITH. You made a statement that some people stepped in and helped out in the situation.

Mr. FUNSTON. Yes, sir.

Mr. KEITH. Are there not several kinds of personalities and characters involved in this kind of situation? We have the thoughtful investor who is buying an equity in a corporation which he thinks has value. They may be individuals, mutual funds, banks, or pension trust funds. Is there not another kind of individual that we have to be aware of, he being one who steps in to take advantage of broad swings in the market caused by this kind of tragedy? For example, one who might want to sell short and capitalize on a trend that he saw shaping up?

Mr. FUNSTON. That is right. They are traders, they are people who are trying to make money on variations in the stock market; yes, sir.

Mr. KEITH. To what extent would they influence this down swing?

Mr. FUNSTON. Well, I would suppose that it is hard to know exactly who the people were as individuals that were selling. I would suppose that the traders like that were ones who were early through the door after 1:40 to sell out their positions. I am talking now about the public; not the professionals—the public.

Mr. KEITH. Well, there are also some professionals who take advantage of a situation such as this, are there not?

Mr. FUNSTON. It depends what you call professionals. Are you talking about members of the exchange?

Mr. KEITH. Yes.

Mr. FUNSTON. The floor traders in these 25 stocks, for example, these are professionals. They purchased 42,600 shares. They sold 11,008. There were short sales of 100 shares and they ended up with 30,700 net purchases during this period. The specialists ended up with 104,700 net purchases and the public and other during this period sold 135,400 on balance.

So the public were the ones that were selling and the specialists and the floor traders were the ones who bought.

Mr. KEITH. On balance?

Mr. FUNSTON. Yes.

Mr. KEITH. Within the fraternity were there not some members who saw this as an opportunity to make very substantial profits?

Mr. FUNSTON. We are trying to seek them out and find them if there are. We don't know them.

Mr. KEITH. You do not know them?

Mr. FUNSTON. If there are we will seek them out and see what the circumstances were.

Mr. CURTIN. Would such actions be against the regulations of your exchange?

Mr. FUNSTON. No. Say a man who happens to be a member of the exchange, if he wanted to try to make some money, that would not per se be against any regulations I don't believe, would it?

Mr. GRAY. No.

Mr. KEITH. But you are definitely trying to determine how many or to what extent the "in and outers"—if that is what you would call them——

Mr. FUNSTON. No. When there were 2½ million shares sold during this critical period it is almost impossible to find out who they all were and why they all sold.

Mr. KEITH. I would think that at the luncheon table some would be bragging about how much money they made and others would be complaining about how much they lost.

Mr. FUNSTON. Don't worry, that is one of the most fertile sources of information that we get, that we look into. If there is anything that is improper or any member preying on the public or anything like that, I can assure you that will be looked into.

Mr. KEITH. Thank you.

Mr. CURTIN. Thank you, Mr. Funston.

That is all, Mr. Chairman.

Mr. STAGGERS. Thank you.

Mr. Funston, I do not want you to miss your meetings in New York today because I know they are important. But this committee meeting is important, too, as are the things we are looking into.

Mr. FUNSTON. Yes, sir.

Mr. STAGGERS. I understand that you are trying to be there with your group to take up what may be violations and to speak with them this afternoon?

Mr. FUNSTON. Yes, sir.

Mr. STAGGERS. We shall try to accommodate you but yet these things are serious to us.

Mr. FUNSTON. Right.

Mr. STAGGERS. I would like to ask you just a few questions as the time will permit and the rest of them will be transmitted to you in writing, if you would answer them.

Mr. FUNSTON. Very good.

Mr. STAGGERS. I have been amazed——

Mr. BENNETT. I would like to ask a few questions.

Mr. STAGGERS. Just a minute. These are ones I want to ask before we get through.

I have been amazed at some of the testimony that has been given in regard to the specialists. The Congress back in 1934 stipulated that the intention of this Congress was that the specialist, if he had any duty whatsoever, would be to keep an orderly market and did not specify exactly the fact his trading for himself but it was mentioned that it should be taken up. The possible evil in it was mentioned and the chance for many manipulations and has been so treated through all these times.

We come now to appraise where a specialist says he can do almost as he pleases, and I am only quoting the impression I got from Mr. Funston. I want to ask him a couple questions.

I would like for you, Mr. Frank, to tell us, and it has not been mentioned very much, this operation of the book and what its responsibility is to the specialist and how long he is required to keep it; and if it is to be opened up for the exchange, for them to see the manipulations of all of his activities and so forth.

Now I tried to get this yesterday. Would you as brief as possible say what his responsibility is to the stock exchange and to the public?

Mr. FRANK. Yes, sir; I will attempt to answer your question fully, sir.

Mr. STAGGERS. All right.

Mr. FRANK. The book is the record of orders left with the specialist by various brokers who choose to leave with the specialist those orders that are not readily executable, they are not at the market, and they avail themselves of the agency function of the specialist and leave with him the orders away from the market.

For instance, in a stock that is selling at 40, if a commission broker had an order to buy 100 at 38 it would not be worth his while to stay at the designated spot where that stock is traded and therefore he avails himself of the specialist performance and gives him the order to buy it at 38.

The specialists makes a record in his book of that order; he keeps all the orders for at least 3 years; he keeps a record of all the pages in his book within the range of the day's activity for 3 years. That is the records that he keeps.

Now as to his actual functioning, he acts as an agent for others and he also acts as a dealer. At all times his dealer activity is subordinate to his agency function. He must execute the orders that are given to him by others for others before his dealer activity can enter in at all.

Mr. STAGGERS. Just pause there. I want to reemphasize that you say his functions are as an agent or dealer and his must be served after the public.

Mr. FRANK. That is correct, sir.

Mr. STAGGERS. That is one thing I want to get in mind because that has not been emphasized, and actually I thought it was disclaimed here this morning and yesterday.

Mr. FRANK. I welcome the chance to emphasize it, Mr. Chairman.

Mr. STAGGERS. This is the thing we are trying to get at, his is not served during this day.

Mr. FRANK. His agency function is his first duty.

Mr. STAGGERS. Agency?

Mr. FRANK. His agency as an agent for other brokers who give him public orders.

Mr. STAGGERS. Dealing for the public.

Mr. FRANK. That is right. As he represents through other brokers he represents the public.

Mr. STAGGERS. That is right.

Mr. FRANK. That is his first duty. He must at moments in the day's activity where there is a void, a lack of public orders that would take care of the temporary imbalance between supply and demand. He must then supplement that agency function with a willingness to deal in response to the needs put on him by those who enter the market.

Mr. STAGGERS. Just a moment. You say what he can do is pick up any order that he wants and he does not have to pay 1 cent for it. He can deal with himself or someone else?

Mr. FRANK. No, sir; he must deal with another broker.

Mr. STAGGERS. He does not have to have permission?

Mr. FRANK. No; he is then a proprietor and buys for his own account from others who enter into the market in response to their requirements.

Mr. STAGGERS. Can he manipulate with another dealer to keep the market going?

Mr. FRANK. No, sir; his price activity depends only on his response to the needs put on him by people representing the public. If some-

one needs a bid he furnishes it. If someone needs an offer he in turn furnishes it.

Mr. STAGGERS. Just 1 minute. I asked you a question there; If in turn he buys from one broker if he cannot sell to another broker at exactly that same price?

Mr. FRANK. He may purchase from someone who wishes to sell and at any time reoffer or resell to someone else who then comes in with a demand, but at the time if both the offerer and the bidder are there, he does not enter it.

Mr. STAGGERS. It is short orders?

Mr. FRANK. He does or other brokers do.

Mr. STAGGERS. He orders at that time or he can cross an order between brokers or with his?

Mr. FRANK. That is correct. He may act for others or for himself.

Mr. STAGGERS. Go ahead and proceed now, if you will, please.

Mr. FRANK. As the burden put on him is to maintain the fair and orderly market that we read so much about——

Mr. STAGGERS. If you will just hold 1 second.

Mr. FRANK. Go ahead, sir.

Mr. STAGGERS. I want you to explain that because that is the crux of this whole thing, an orderly and continuous market.

Mr. FRANK. Let me try to give you a couple of examples that might bring out his thinking.

Mr. STAGGERS. I want the committee to hear these because on the face, these are good for students of this but in actuality and in performance, they are something different. You go ahead now, if you will.

Mr. FRANK. Thank you.

If the last sale of a stock is 50¾ and I have on my book an order to buy 100 at 50½ or 100 at 50¼ and 100 at 50, then the next bid might be 49. These are orders that I have indirectly from the public in which I will be an agent if that price is ever reached. A seller enters the crowd who wishes to dispose of 500 shares of stock at 50 or better. He possibly would sell me 100 at 50½ for my client, 100 at 50¼ for my client, 100 at 50 for my client. There I would have acted as an agent completely.

But to see his particular need in selling I would then probably use buying power from my own capital to purchase the other 200 shares at 50 that he wishes to sell. Then I act as a dealer.

Having bought that and satisfied his need I have taken care of my agency responsibility; they are first, they must buy theirs first. I cannot buy at 50. While I have an order to buy at 50, I must buy theirs first and then add my dealer activity to help him liquidate.

Once then having bought it we would say the next public bid is 49. Remember we came down from above, the next offer might be 51. If we rely on the public alone for a market, it would be 49 bid, it would be offered at 51.

Then I would say in my dealer function and my dealer activity I must enter into the market and possibly bid 49¾ for myself for my own account and reoffer the stock purchased at 50¼.

So anyone who enters the market would have the opportunity to trade at a price that seemed fair and orderly in relation to the last previous sale.

You see, my function is to take care of those who have entrusted me with orders but I also have an obligation to all who enter the market. It is in satisfying the obligation or the responsibilities placed on me by all that enter the market I must combine both functions.

I truly believe in our system, Mr. Chairman, and I hope I have made it clear to you. I would gladly enlarge on it at any time you wish to ask me. I am delighted with the chance to explain it and I hope I have been of some help, sir.

Mr. STAGGERS. Mr. Frank, I think you are entirely honest and frank about it. I just wonder if every member of this committee realizes just what you said, that you have a dual purpose on the exchange, that one is acting for the public and the other is acting for yourself and the great motive of the specialist is to protect the market and keep it continuous.

There is no man alive that is in business in this world that is not in there for self-interest, and one cannot kid me or anybody else that the specialist is not in the business to take care of his own profits.

It has been said by some that this last year there was $40 million that went to the specialists alone on their own accounts besides their customers. Back in 1934, it was stressed that they could not see the importance of this specialist in a dual capacity, that when the chips are down he is going to be acting in his own self-interest, he is not going to lose a million dollars or several million dollars.

As Mr. Funston said, one man had perhaps a million dollars more invested, I believe, at the decline.

But what about the specialist that you say you thought acted all right, too, in this one case of American Photocopy, that the specialist registered in this stock not only liquidated large portions in the minutes after the news of the President's death and assumed short positions but did not subsequently reenter the market at all on that day.

Now I do not know how you can justify that and I do not know if any member of the exchange can. I say that is one of the things that the exchange is going to get into and find out why, and not only the exchange representative but the other three here, because in the investigation by the SEC it tells where several of these specialists did assume a long position and bought a lot more.

For instance, it says that 1 specialist bought 11,700 shares and sold only 100 shares. Now it said he was really doing his job as was set out in the rules to protect the public, but what about these others who not only liquidated immediately, it says, as soon as they heard of the assassination but started this thing down the line and then sold short.

Mr. FRANK. Mr. Chairman, I believe Mr. Funston has stated earlier these are matters of study and I cannot tell you the final disposition of them.

Mr. STAGGERS. I know but I thought awhile ago you were trying to justify it.

Mr. FRANK. Then my earlier comments were misunderstood.

Mr. STAGGERS. Here are men who know minutes ahead of the public and sometimes hours and they had the inside information. You know that a specialist knows the market when no other broker knows it and no member of the public knows it; is that not right?

Mr. FRANK. At a given moment.

Mr. STAGGERS. At a given moment he knows the market.

Mr. FRANK. He cannot perfectly anticipate.

Mr. STAGGERS. No; but he is the only one that really has this thing. I mean for all practical events he is the man who is right there on that one certain stock; is he not? He knows the spread from the public and he can anticipate, he can sell, he can do this. I am talking about this particular case because I am talking about the SEC report. They took the books, is that not right, to study them?

Mr. FRANK. They took the books.

Mr. FUNSTON. No; we got facts for them in 25 stocks of who were buying and selling this day. They didn't actually take the books.

Mr. STAGGERS. Did you not take them from the specialist books?

Mr. FUNSTON. No; not from the books; from the records of the transactions as they occurred.

Mr. STAGGERS. Yes, sir. Also you have to investigate your books to see whether they were doing their job?

Mr. FUNSTON. Well, you have to investigate the books to police and make sure that they were following the rules and regulations. But the book is not an indication of what happens, the book is just a storage place where the public's intentions away from the market are recorded.

Mr. STAGGERS. In the SEC report which you evidently gave to them——

Mr. FUNSTON. We gave them the information, they wrote their own report.

Mr. STAGGERS. Almost immediately after the news of the assassination, would that not start a "snowball" rolling?

Mr. FUNSTON. Not necessarily, no.

Mr. STAGGERS. Then what makes the market?

Mr. FUNSTON. Sir, may I say something because you have said so basic I would like to get a statement in the record?

Mr. STAGGERS. I have several other questions.

Mr. FUNSTON. You mentioned the question of American Photocopy.

Mr. STAGGERS. Yes, sir.

Mr. FUNSTON. As indicated, that is not a case that we are particularly proud of. Any group of men, any rules, there are always violations.

Mr. STAGGERS. That is true.

Mr. FUNSTON. I do say it is decidedly unfair to take a case like that, occurring on a day of one of the most tremendous panics that has ever been known and thereby condemn the specialist system.

Now, it is true in 1934 that there were a great many people in the studies that were made that said this segregation of the broker-dealer must be effective. However, over the years, this was not done and I believe that this has been found not to be in the public interest to do. When you say that sure, these people are in business to make money, of course they are. But I say this to you, that the specialist is not in a position, as you say, to do as he pleases. He is the most very tightly policed and I won't go into all that but I will if you want me to.

Mr. STAGGERS. No.

Mr. FUNSTON. He is very tightly policed to make sure there are no venal actions. I will say this to you also, that the SEC special study group as you said spent 2 years and a million dollars studying this thing. After a fine tooth comb, they came up with no flagrant violations of self-interest; they came up with no recommendations

that this was not in the public interest. The New York Stock Exchange is the mark of the most liquid efficient market in the whole world.

Mr. STAGGERS. We agree with you on that.

Mr. FUNSTON. European people are coming to our market increasingly because of our market, and the reason for that is the specialist system. Now, it may not be perfect; no group of men are ever perfect. We are not perfect probably in trying to regulate them.

We have a committee. We have outside consultants to tell us how we can police the market better. I say right now for the record that the specialist system is a darned good system; it can be improved on; we are trying to do it, but they are not a group that do as they please or acting in their self-interest.

Mr. STAGGERS. I would say this to you: We don't mean to imply that you have not tried and you are not doing a good job. What we are trying to say to you, Mr. Funston and to the New York Stock Exchange is this: Our job is to protect the investors of this country and to see that all of these shortcomings are checked upon and something is done about them. I think we will all agree that there have been some shortcomings that have come to the front and to the public, and we have had various questions about what is going to be done.

Now, in the study of the 20th Century Fund, you know their report on this specialist, I expect, as to what some of the shortcomings were and so forth;

Mr. FUNSTON. I am not familiar with that; no. The 20th Century Fund?

Mr. STAGGERS. Yes.

Mr. FUNSTON. Is this a long time ago?

Mr. STAGGERS. Not too long ago. They made a report on some of the shortcomings and probably some of the suggestions, but now I gather that the sort of attitude that we may get is that they were lily white. We are not trying to condemn them as a group although it has been maintained by some that they are not necessary to an orderly market. There are those who believe that sincerely, and have so stated, but we do believe that there have been wrongs done here and that it is our job to see that something is done. We want to impress that upon you. I do want to come back to this in a minute or two if I have time because I do want to get this thing of segregation of funds and segregation of customers accounts turned up in the *Haupt* case. I think it is very important that something be done about it.

We would like to have your thinking and what the Securities and Exchange has suggested to you or what they are doing today or what your suggestions would be to them or to us. That is the main reason for your appearance. All of these gentlemen that you have with you who, I know, hold important positions in the New York Stock Exchange and in the financial world. We know that and we respect that.

We are not trying to say that things are wrong; we are trying to say if there is anything wrong, it needs to be looked into and that is our job. We will come to the one thing I would like to ask you before you brought up the floor trader. I would like you to tell the difference between a floor trader, floor broker, and specialist.

Mr. FUNSTON. A specialist is a man who is assigned by the stock exchange to act in the way that Mr. Frank has described in making a

market in a given number of stocks. A floor trader is a person who is a member who is on the floor of the exchange who has no responsibility for buying and selling in any particular securities but who can go across the market buying and selling stock in an effort to make money for himself.

These men are limited in number although the floor trading activity is often carried on by people who don't spend their full time floor trading. These people are making money for themselves or trying to and we believe that they perform a real function in providing liquidity. This group, the SEC has had some very stringent recommendations with respect to them and have been pressing us to discuss this with them. We have asked for time to get special consultants from the outside to come in and see what the SEC says and what we think and see if they can suggest a program. This seems to be the week when our reports are coming in. We expect their report to be in this week. The SEC has asked us to let them have copies of the report as soon as it comes in and then we will sit down and discuss with them the solution to this problem.

We believe that here is an area where we can do considerable tightening up, where we can perhaps impose more responsibilities on the floor trader than are imposed on them now. We have every hope that we will come up with the suggestion that will be somewhere a middle ground between abolition as the SEC has suggested and the way they are now which will satisfy the SEC that it is in the public interest that they be allowed to continue.

Mr. KEITH. Mr. Chairman, I would like to advise Mr. Funston of something that he may have overlooked. He made the statement that the SEC did not find much substantially wrong with the specialists. I would like to quote from the study group's conclusions with reference to this whole subject. I think you should familiarize yourself with them.

Mr. FUNSTON. I didn't say that, sir. That is not what I said. I did not say or intend to say that the SEC had no recommendations about specialists. What I said was that they had found no example of specialists acting in their own self-interest and being venal and preying on the public.

Mr. KEITH. Well, I think they found just the contrary.

Mr. FUNSTON. They were not on our exchange. That is on the American Stock Exchange.

Mr. KEITH. They are specialists.

Mr. FUNSTON. They were on the American Stock Exchange; yes, sir. Again, I am talking about the New York Stock Exchange.

Mr. KEITH. The 20th Century Fund report is a very responsible document and I believe is something that should be brought to your attention and to the attention of your staff. They conclude, and I shall read only the final sentence: "It is for this reason that any program of reform must concentrate heavily on the dominant role of the specialist."

It is well documented. They used the American Exchange in that particular case, but the opportunities and regulations are pretty much the same in both exchanges, are they not?

Mr. FUNSTON. No, sir; quite different.

Mr. KEITH. I think that is a timely observation to make. I am glad to learn that there is a decided difference in the regulation of the specialist between your exchanges.

Has the American Exchange, under its new management, changed their rules with respect to specialists?

Mr. FUNSTON. It is my impression that they have. I have not studied it, but it is my general impression that they have very markedly; yes, sir.

Mr. KEITH. Thank you.

Mr. HARRIS. Would the gentleman yield on that point?

I think since the record is being made on the question as to what the SEC has said concerning the specialist, it might also be noted in order to make the record complete, I received a report from the Securities and Exchange Commission under date of January 21, 1964. They include a memorandum prepared by the Commission to the committee dated December 2, 1963. I want to read this in the record because it goes with what the gentleman said, and it does seem to indicate so far as the Commission is concerned a sort of a pat on the back and at the same time to raise questions as to certain procedures. I am not sure just what their attitude is, very frankly.

On page 3 of the report, it is said, and I quote:

> In its report, the special study found that the New York Stock Exchange specialist system contained no widespread abuses or patterns of illegality.

I think that is very pointed. Continuing:

> However, it was noted that there were "serious problems * * * concerning the system itself and its surveillance and regulation by the exchange." The study also found that "the regulatory framework (governing specialists) permits too wide a tolerance from acceptable norms." Some of these findings were based on the fact that there were wide variations among the various New York Stock Exchange specialist units in financial and other capacities, as well as in performance. This resulted, in the study's words, "in considerable divergence in the nature and quality of markets" on the New York Stock Exchange. In a market under stress, the wide tolerance of the regulatory structure becomes apparent.

Now, that is what the SEC says in its memorandum to us. I think each of us will have to interpret for ourselves what he had in mind.

Mr. FUNSTON. May I comment on that, Mr. Harris?

Mr. HARRIS. Yes; indeed. I suppose you wonder about it, too.

Mr. FUNSTON. Yes.

The first point was the one I was making to Mr. Keith, that they found no widespread, you know, flagrant venal violations.

The second point was that our means of surveillance were probably not as good as they should be and that is what could be improved upon. That is what the outside consultant is coming in on.

Then they also have about nine other specific suggestions with respect to the specialist which are being discussed now by our special committee on specialists. As I indicated in my prepared testimony, these will be brought to the board on March 19 and will be the subject of the discussions with the SEC on April 1.

I might indicate, too, sir, that on these matters the SEC has been on our neck all the time pressing us for faster action on all of these matters, but we just have so many balls in the air that we don't know whether we are coming or going. We have so many special committees. It took 2 years to make the study.

We got the study in August and we think with all the problems that have come up we are entitled to a little bit of time to decide what is best because they are complicated problems.

Mr. HARRIS. Yes. I think probably that is applicable in some other ground, too, Mr. Funston, if I may say so. May I impose on the committee for just one comment at this time? I wanted to ask you about your reaction to the authority of the Commission in the promulgation of the rule 17(a)8.

We wrote the Commission a letter on January 17 in which we referred to their report on pages 199 and 200 of volume 5. At that time they said the Exchange Act does not require the exchange to file rule changes prior to adoption.

Now they seem to come back in this reply which was given to us and seem to think they do. They are going to reach it in a different way which is a thing that disturbs me about many of these regulatory agencies.

I support their efforts to administer the law as was intended but I do raise questions where they have acknowledged that they do not have the authority in a certain realm and then get about and devise ways and means that they can come around some other way and say they are going to do in another way what they did not have authority to do.

Sometimes I think the whole rulemaking procedure ought to be completely revised, the way some of these agencies are trying to go beyond what they admit that they do not have the authority to do or it was not intended for them to do.

We are going to ask more about this.

I would say, Mr. Chairman, I am sorry, I have got an appointment, I have got to go. These matters that we are going to now are not included in the proposed legislation; they are matters that should be considered.

The committee is to be commended for its efforts in going into these things. That busted right in our face at the time we were holding hearings on the legislation. I think that these matters are so delicate and sensitive they necessarily must be gone into deeper and try to develop a better understanding about some of them.

I want to assure this subcommittee that in its work on legislation and in the full committee's work on oversight of keeping a watch over the administration of the law, that I intend to make available to you as much of the staff as you need or as the subcommittee decides it should have in order to go into these matters fully and completely later on.

I do hope, however, that we can conclude these hearings on the specific legislation with Mr. Funston and his group this week and that we can conclude with Mr. Cary as soon as we can get him up here after we can schedule hearings because we need to proceed with trying to develop what legislation the committee is going to propose on the matters which we have developed in the hearings and which are included in the proposal of the Commission.

I hope, Mr. Chairman, the other members could consider that as a matter of procedure.

Mr. STAGGERS. Thank you, Mr. Chairman.

I agree with the chairman of the committee that we must get on with our business. As he said, something broke at this time and needs to be gone into and will be gone into much more fully. I think our

business to a great extent is with Mr. Cary but we wanted to stress to you again the basic issues that you were here for; that we felt we should look into.

I would like at this time to say the suggestion was made to me by the ranking member on the Republican side that before we sit down to mark up this legislation that this committee come to New York, spend 1 day visiting your exchange and the American Exchange and to see the specialists at work, the floor traders at work and the different activities, the different 18 posts, how they do their work and perhaps post 30 on there in active stocks and to then ask questions about the capital requirements.

That is one of the things we are going to have to get into now. I think it has been brought to your attention about the capital requirements and the specialists, the future for your consideration.

I would like to go into the Haupt case just briefly now and I will have to sort of summarize my questions.

Mr. BENNETT. Would you yield?

Mr. STAGGERS. Yes.

Mr. BENNETT. I have to leave, too. I am sorry I was not here to listen to your statement yesterday, Mr. Funston. I confess that even after having read the statement I am still very much confused about the bankruptcy of this broker-dealer.

The one thing that I have been interested in for many years is the ratio of dollars that a broker-dealer had to have for every dollar of customer issued money for the securities that he held. For a long time the ratio has been 20 to 1; is that right?

Mr. FUNSTON. Yes.

Mr. BENNETT. Under Commission rule.

Mr. FUNSTON. It was 20 to 1 under exchange rule and 15 to 1 under Commission rule—no, wait, a minute, it is the other way around.

Mr. BENNETT. The Commission had a 20 to 1 ratio.

Mr. FUNSTON. That is right. They had a 20 to 1 ratio, we had a 15 to 1 ratio and then we hanged and went to 20 to 1 ratio. That is right now.

Mr. BENNETT. If the credit requirements of broker-dealers had been tighter or the ratio had been closer to the amount of capital that they hold as against the assets the customers hold, would this kind of a situation, as in the Haupt case, have occurred?

Mr. FUNSTON. Yes, it would have. The Haupt failure in terms of the—well, let's see. The Haupt failure probably, as best could be told, will be the cause of this inventory being—it will be three times the capital of the firm. So any reasonable relationship would have made no difference at all.

Mr. DINGELL. Would you yield to me at that point?

The Haupt failure really occurred because the failure to have capital requirements applied to other trading, in other words, commodity trading, as opposed to the stock trading, is that not a fact?

Mr. FUNSTON. No, the Haupt failure really occurred because of fraud and $23 million worth of inventory that everybody thought was there that was not there.

Mr. DINGELL. Yes, but also the fact that they did not have sufficient capital in the other areas, the commodities area, as opposed to trading within the framework of your exchange.

In other words, they did not have the capital with regard to the commodity engaged in.

Mr. FUNSTON. Well, yes, that is right. In other words, they didn't have the $23 million capital that they should have had if they are going to have losses of $23 million in commodity trading.

Mr. DINGELL. That is right, but they also did not have enough commodities, they did not have enough capital to meet reasonable costs with regard to their commodity trading.

Mr. FUNSTON. Oh, yes. They had plenty of capital to meet reasonable calls for their commodity trading.

Mr. DINGELL. They did?

Mr. FUNSTON. Oh, yes.

Mr. BENNETT. A 10-percent margin requirement applies as I understand it. Does it have anything to do with this failure?

Mr. FUNSTON. May I ask Mr. Coyle to answer that question? Did you hear the question, Mr. Coyle? Mr. Coyle is vice president in charge of the member firm division of the exchange.

Mr. COYLE. I heard the question but I did not quite understand it, sir.

Mr. BENNETT. The margin requirement for commodity purchases is 10 percent of the purchase price; is that right?

Mr. COYLE. No, sir.

Mr. BENNETT. It is not?

Mr. COYLE. No, sir.

Mr. BENNETT. What is the commodity margin?

Mr. COYLE. Commodity margin requirements, and this should not be confused with commodity clearinghouse requirements—that is what is required by the clearinghouse to be deposited by the firm which has the open contracts.

Their marginal requirements vary. In some instances they have no margin requirements. They may have them now, they are talking about increasing those that they have and instituting some where they have none. But I don't know, 10 percent does not mean anything.

Mr. BENNETT. Well, the Federal Reserve Board sets margin requirements for purchases made on the stock exchange; is that not correct?

Mr. COYLE. That is right.

Mr. BENNETT. And they set it at 70 percent of the purchase price so the customer has to put up 70 percent of the price of the stock and the broker puts up 30 percent; is that right?

Mr. COYLE. Yes.

Mr. BENNETT. Who sets the margin requirement for the commodities?

Mr. COYLE. The commodity exchanges.

Mr. BENNETT. The Federal Reserve Board has nothing to do with that?

Mr. COYLE. No.

Mr. BENNETT. If I want to purchase in the commodities market today, can I make purchases with 10 percent of the purchase price?

Mr. COYLE. The percentage to price of the commodity you bought does not register to me at all. Many of them have margin requirements of so much; a contract for soybean oils, for soybeans, for cottonseed oil or cotton or wheat.

Mr. BENNETT. What I am trying to get at is how much money does the customer have to put up?

Mr. FUNSTON. May I just butt in here for a minute, Mr. Bennett, because I have asked this same question and it is figured in an entirely different way. It is based on dollars per contract. It is a 5 or 10 percent margin.

Mr. COYLE. No, not nearly that high.

Mr. FUNSTON. What is it, 5 percent or below?

Mr. COYLE. Well, a trade customer——

Mr. BENNETT. Can you buy commodities without any money?

Mr. COYLE. Yes.

Mr. FUNSTON. Yes.

Mr. COYLE. Some commodities, yes.

Mr. BENNETT. As a customer I can buy them without any money?

Mr. COYLE. Not unless you are in the trade, sir.

Mr. BENNETT. A customer cannot buy them but a broker-dealer can?

Mr. COYLE. No, no no. In the cocoa market, for example, Hershey Chocolate Co.——

Mr. BENNETT. I am talking about John Q. Public buying in the commodities market. Can he buy without money?

Mr. COYLE. No.

Mr. BENNETT. How much must he put up?

Mr. COYLE. It is a very complicated schedule, sir.

Mr. BENNETT. I certainly believe that.

Mr. FUNSTON. Five percent?

Mr. COYLE. No, I do not believe so.

Mr. FUNSTON. He says it is below 5 percent. The point you are making, and I think it is a good point, compared with the 70 percent on securities, what is required in commodity trading is infinitesimal.

Mr. BENNETT. That is right.

Mr. FUNSTON. But to take the argument of the commodity exchanges, they say they are not comparable because when the 70 percent on securities is on something that you own and the 5 percent or lower on commodities is to carry, they say it is not to carry entirely, they say it is to protect you against future covering under a future contract. Is that right?

Mr. BENNETT. Did not this broker-dealer you are talking about here go broke buying in the commodities market?

Mr. FUNSTON. Pardon?

Mr. BENNETT. Did not this broker-dealer we are talking about here go broke because of purchases in the commodity market?

Mr. FUNSTON. No, sir; it is because a customer of his from whom he had received warehouse receipts for oil that was supposed to be existent, that oil was not existent so the collateral that he had for loan to this customer was not here.

Mr. BENNETT. He went broke making loans to the customer?

Mr. FUNSTON. Yes, sir; and the thing that triggered it was that the customer had margin requirements which he had imposed which he really didn't have to impose but Ira Haupt imposed margin requirements on this firm which they didn't have to because it was one of these in trade. The price dropped so he had to renege, he could not get up his margin.

Mr. BENNETT. But did not the customer use the money that was loaned to him to buy in the commodity market?

Mr. FUNSTON. Did the customer use the money? Yes, he bought commodities and then delivered warehouse receipts to the firm.

Mr. BENNETT. Did he buy those without margin or without money?

Mr. FUNSTON. No, he bought those with margin but——

Mr. COYLE. Don't forget, sir, the warehouse receipts that you are talking about were forgeries; they were not known to be forgeries at the time. So I don't think anybody can say whether he bought those oils or not. He probably did buy a lot of oil but he also had receipts for a lot more oil than he ever bought.

Mr. BENNETT. He bought those on a margin?

Mr. COYLE. No, I don't believe he bought the spot commodity on margin. He might bank them, pledged the warehouse receipts as banks, or as he did in this case at a brokerage firm.

Mr. BENNETT. Mr. Chairman, I know that the time is getting late. I have a number of questions. This question has been a mystery to me and has been for a number of years. Certainly the credit requirements of broker-dealers have been a subject of concern of our subcommittee. I know as one member I have asked about it and made inquiries about it to the Securities and Exchange people every time they have been up here for the last 15 years, probably, or some such time.

I believe that the subcommittee can well devote its time, in addition to the specialist problem, to the problem of the capital requirements of broker-dealers.

Now I had nothing to do with this particular instance and I will take Mr. Funston's word for it but I still say that the average person buying on the securities market, regardless of what it may be, is in a better position to be dealing with a broker that has more than $1 of his money put up for every $20 that he is holding for a customer.

Mr. FUNSTON. Sir, may I make a comment? I do not mean to say that and you said you had taken it on my word that margins on commodities played no part in this picture. I am sure that it did. The only thing that I am trying to say is that the margins that are set on commodities are not something that is within the jurisdiction of our exchange; this is the commodity exchanges and the commodity exchanges' administration problem.

Mr. BENNETT. Thank you very much.

Mr. STAGGERS. I would like to thank the gentleman from Michigan. He heard the chairman of the full committee say that investigators would be furnished the subcommittee from the Oversight Committee to go into these subjects, and I expect that will be done in not only the area that you are talking about but many areas that will open up, I think the time has come that this committee by its own investigation find out some of these activities and some of the questions that have been raised.

Now, Mr. Funston, I wrote you before your appearance to answer this question about the authority of the Commission which Mr. Harris brought up under rule 17a–8.

Would you care to make a brief response?

Mr. FUNSTON. Yes, sir; I would like to.

We have sent to the committee a copy of our reply to the Commission on this subject which, if I might read it very quickly, would give the exchange's opinion on this matter. May I do it?

Mr. STAGGERS. Could you summarize it for us?

Mr. FUNSTON. In essence, we of the exchange do have considerable doubt and our counsel does not believe that the Commission has the authority under the 1934 act to write a rule in this area. However, the particular rule that the Commission proposes is a rule which we can live with. They have given us some assurance that the purpose of this rule was only for getting reports from us and does not represent—well this is the only intent for this. We have said although we would be willing and the other exchanges would all be willing to write such a rule ourselves, which we would prefer to see happen, so that the Commission would get what they wanted that way, that we would not raise any objection to their imposing such a rule although we didn't like it because we thought this was a pretty small case to make a Federal court defense on.

In other words, our counsel does not think that they have the right to write this rule, their counsel does apparently, so that it is a question of that. We would rather see them not put the rule in but we certainly are not going to object to it.

Mr. STAGGERS. All right. We wanted that for the record. I have some questions.

Mr. FUNSTON. May I ask one thing?

I have a letter on the subject before you which states much more explicitly our position on this which, if there is going to be any use made of it, I would much rather have this letter speak for me than the summary which I have given.

Mr. STAGGERS. Would you care to insert it in the record at this time?

Mr. FUNSTON. Yes.

Mr. STAGGERS. It shall be done.

(The letter follows:)

NEW YORK STOCK EXCHANGE,
New York, January 31, 1964.

HON. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance, Washington, D.C.

DEAR MR. STAGGERS: This is to acknowledge your letter of January 27, 1964, and to confirm the fact that I will testify on Tuesday, February 4, 1964, at 10 a.m., before your Subcommittee on Commerce and Finance. As you have requested, I am planning to cover in my prepared testimony, two of the three subjects referred to in your letter.

With respect to your inquiry concerning the exchange's position with respect to the question of Commission authority to issue proposed rule 17a–8, I enclose a copy of a letter to Chairman Cary dated December 19 on this same subject. When this rule was initially suggested by the Commission it was our opinion that it went beyond the statutory authority delegated by the Congress to the Securities and Exchange Commission. Our interpretation of the statute over the years has been that the exchange should govern itself, subject to the oversight of the Securities and Exchange Commission, and when the Commission decides that the exchange has not fulfilled its obligations in any of the areas enunciated in section 19b of the 1934 act, the Commission would institute the proceedings set forth in that section. We do not believe that the SEC's power to require reports under section 17 gives it the power to expand its specific authority beyond that granted in section 6. The Commission has given us assur-

ances, however, that this proposed rule is merely a reporting requirement and does not envision any limitation of the exchange's ability to self-govern. Based on this assurance our board of governors adopted the position set forth in the attached letter.

If you have any further questions on this subject I will be happy to answer them on Tuesday.

Sincerely,

G. KEITH FUNSTON.

NEW YORK STOCK EXCHANGE,
New York, N.Y., December 19, 1963.

Hon. WILLIAM L. CARY,
Chairman, Securities and Exchange Commission, Washington, D.C.

DEAR CHAIRMAN CARY: At its policy meeting today our board of governors studied your letter of November 15, 1963, and the latest revision of your proposed rule 17a–8, and noted that the new version of the proposed rule meets the objections to the language of the earlier draft which were discussed at our November 1 meeting with you. The board appreciates the willingness of the Commission itself to work out mutually a proposal which will meet your needs and at the same time be operable from the viewpoint of the exchange.

The board believes, however, that a Commission rule is not the best way to deal with the problem if the Commission wishes to encourage self-regulation. Furthermore it has grave doubts as to the statutory authority of the Commission to follow such a rulemaking path.

Our concept of self-regulation is that in all matters and respects as much of the regulation as possible should be left to the self-regulatory organizations. We see little excuse for the Commission to adopt rules that the self-regulatory bodies are willing to adopt themselves. This does not seem to us to be permitting the "self-regulatory agencies (to) enjoy such autonomy as will enable them to act as responsible, dynamic partners in a cooperative enterprise" to paraphrase the Special Study Group as quoted in your letter. As stated in Washington on November 1, the exchange would be happy to adopt a rule similar to proposed rule 17a–8, which is substantially the same as has long been in effect under our informal agreement.

I am sure that each of the other exchanges in the United States would also be willing to pass a similar rule. It is hard for us to understand, therefore, why it is necessary for the Commission to make a rule when the same objective could be accomplished through self-regulation. Your desire to establish an "orderly procedure" does not seem to us to be sufficient reason to erode the principle of self-regulation.

Furthermore our counsel does not think that the SEC's power to require reports under section 17 of the Securities Exchange Act of 1934 gives it the authority to delay an exchange from exercising the rulemaking powers envisaged by section 6(c) of that act, or to require any filings of amendments other than "forthwith upon their adoption" as specified in section 6(a)(4).

However, since the proposed rule follows so closely the procedures we proposed to the Commission, and since it undeniably provides for a desirable result, our board is not disposed at this time to test the Commission's authority to adopt this particular rule in the form submitted.

The board of governors, therefore, voted not to oppose the adoption of rule 17a–8 in the form submitted. It wanted me to make clear, however, that the exchange's failure to seek court review at this time should not be interpreted as an abandonment of the exchange's position expressed to the Commission above and at our November 1, 1963, meeting.

Pending a final disposition by the Commission on the matter the exchange will henceforth follow the procedures provided for in the rule. We think this is only appropriate since the board willingly would have adopted today its own rule giving effect to these procedures.

Sincerely yours,

G. KEITH FUNSTON.

Mr. STAGGERS. I have some 30 or 40 questions that I intended to ask you about the Haupt business but the time is short. We have a very important bill on the floor, civil rights, which seems to take most of our attention. I had a great number of questions on the specialists to

clear the record. After counsel talks with the members of the subcommittee, we will transmit these to you in writing for your answers because I think some of them should be cleared.

I consider that the three important areas for you to comment on are the protection of such customers as in the Haupt case, their cash credit balances, their cash credit balances on margin, fully paid securities in the customer's name, fully paid securities in the street name and securities on margin; what your theory was on those.

In your statement, you considered if the banks came in in this Haupt case and did not let it go to bankruptcy or liquidation that the customers could be taken care of first; they would come next before the stock exchange. Am I right on that?

Mr. FUNSTON. Yes.

Mr. STAGGERS. Is this setting a precedent for the New York Stock Exchange?

Mr. FUNSTON. Sir, this agreement that was made with the banks and so on in this particular matter had to do with this particular case. We agreed to subordinate our claims to the banks and so on because we felt that this was the best way to get the job done quickly.

Mr. STAGGERS. I understand in your testimony yesterday you said this would not be a precedent; you didn't want it to be a precedent of paying out customers.

Mr. FUNSTON. Yes, sir. We don't want anybody to think that this particular case represents an underwriting on the part of the stock exchange of any difficulties any customer might have in the future with any member firm of the stock exchange.

Mr. STAGGERS. For that reason, didn't you believe we should have some segregation here or some rules or regulations so that if this occurs in the future there would be protection?

Mr. FUNSTON. No, sir; we don't think so. As I say, we have this committee working on this. We are hoping to come up with a reserve fund or some sort of a pattern that can be arranged for in advance that would take care of these situations in the future and would make it possible for us to protect the integrity of the free credit balances and all of these other things as we have been able to do for these many years without the need for having to push a panic button and make a special arrangement at the time the event happens.

Our plan is, first, to prevent them from happening as we have been able to do very successfully for 25 years; second, to have a plan that if they do happen then that they will be able to be taken care of on an orderly preplanned basis, and in that event we think that any concern of free credit balances or customers' margin net debit balances and so on is academic.

Mr. STAGGERS. Until you do come up with that, it is the concern of this committee?

Mr. FUNSTON. Yes, sir. Until we come up with that, I think that you might well reserve judgment on that until you see what we come up with ourselves.

Mr. DINGELL. Would the gentleman yield on that point?

Mr, Funston, there have been a number of articles in the press and I think it is very unfair to criticize this committee for not having moved more rapidly on this legislation. I wish, for one, to point out that it is my feeling that this committee, having moved as deliberately

and as carefully as it has, is very clear as to its concern on these problems. I want you to know, Mr. Funston, that this committee has been criticized, and I expect we will be considered criticized again, for moving deliberately.

We intend to give you folks on the exchange an opportunity to practice self-regulations. I believe here the public interest requires we investors, from what we saw in the *Haupt* case and that we give every possible protection that we can from the happening of another market break of the kind we say on the 22d, if it be within the power of this committee or within the power of the Federal Government to do.

Mr. FUNSTON. As you say, these matters are very complicated and require deliberate consideration, and that is the problem that we face, too. We have had all these things dumped in our laps in recent months, and, in addition to that, we have had these two catastrophic events happen.

All I can say is we are just working night and day on all of these matters. The staff of the exchange, as I say in here many of them are sick, they are having breakdowns, two of our top officers are out now. If there is any area where you think we are dragging our feet, which I can assure you we are not, I would like the opportunity to tell you what we are doing in that because we certainly don't want the committee to be in the position of being criticized for anything that we are doing slowly. I assure you we are not dragging our feet.

So, if you have any specific problems in mind, please ask me.

Mr. DINGELL. I have no specific problems in mind. I am pointing out general problems; I am sure you can sympathize.

Mr. FUNSTON. Yes; indeed.

Mr. STAGGERS. When we have comments, we will let you know and let the Commission know, too, that we are pressing for some solution. I can assure you of that, and they come in the categories mentioned in the letter to you. I think that you have done a good job in your presentation.

Mr. FUNSTON. Thank you, sir.

Mr. STAGGERS. I want to thank you and all of the other members that came with you including Mr. Frank and your counsel. We hope we can work together for the betterment of the investors and the protection of the investors in the country. We do not intend to stop here. As Mr. Harris has said, it looks like there are some fields that need pursuing and we think that the subcommittee can well do that by working together and perhaps we can come up for the common good of the investing public.

Thank you very kindly. We hope that you and your companions have a good trip back to New York.

Mr. FUNSTON. Thank you. We have a common aim and we appreciate very much your courtesy and attention.

Thank you very much.

Mr. STAGGERS. The committee stands adjourned until notice as to when Mr. Cary will appear before the committee.

(The following material was inserted at this point in the record by Mr. Staggers:)

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., February 12, 1964.

MR. KEITH FUNSTON,
President, New York Stock Exchange,
New York, N.Y.

DEAR MR. FUNSTON: On the occasion of your appearance before the subcommittee on last Wednesday, you may recall that owing to your scheduled meeting that afternoon with your board for taking up the matter of your specialists' activity on the afternon the President was assassinated—a matter with which we have been greatly concerned—I expressed my intention of transmiting to you for your writen reply certain questions which it had been my intention to ask of you in order that we might the better understand what protection your rules afford a customer of a member as to his free credit balances, securities left with the member, or securities purchased on margins.

Accordingly, the subcommittee will welcome your answers to the certain questions:

1. What is the frequency of the New York Stock Exchange's financial examinations of members and are these examinations periodic or unannounced?

2. What type of financial examination is employed and what is its scope?

(*a*) Does the exchange make its own examinations or does it rely on independent accountants?

(*b*) Is the examination an audit?

(*c*) Does the examination cover all of the member's activities, or only his securities business?

(*d*) If it does not cover all activities, how is the exchange satisfied that the member is solvent?

Specifically, was, is, or will there be any check on the members' commodity transactions, obligations, pledges, receivable, and so forth?

3. While there was considerable discussion at the hearings as to segregation of customers credit balances and securities, I think it still is not clear just what is the situation. What are the New York Stock Exchange's rules with respect to segregation, identification, trusteeing, or other type of setting aside of a customer's—

(*a*) Cash credit balance?

(*b*) Cash credit balance when he also has accounts on margin?

(*c*) Fully paid securities in customer's name?

(*d*) Fully paid securities in street name?

(*e*) Securities on margin?

4. Now just how, in the face of these rules, would a member's insolvency owing to overextension in the commodities markets, or any other activity, for that matter, affect the customer who had either cash or securities left with the member? Does this come about from lack of enforcement of your rules, or inadequacy of the rules?

5. You have referred several times in your testimony to the great cooperation received from the creditor banks in deferring their claims pending liquidation of the Haupt customer accounts. You also indicated that the liquidation plan was conditioned upon Haupt's not being thrown into some insolvency proceedings. You further refer to the fact that under the plan the exchange, after providing funds for the release of customers accounts, will have its claim subordinated to those of the banks in any realization of Haupt's assets.

Just what does this mean? Does it mean that in the event of bankruptcy or receivership the law would not recognize the segregation, identification, etc., of cash or securities required by the exchange's rules pertaining to customer's accounts? In other words, would Haupt securities customers—had the firm been thrown into bankruptcy or receivership—come after the creditor banks in priority regardless of whether the customer securities accounts had been segregated, identified, etc., in accordance with the exchange's rules?

6. I am certain that in your consideration of the action which you would take toward Haupt's securities customers and the relative position that they or you would be in under voluntary liquidation bankruptcy or receivership, you had the advice of excellent counsel, and thus would be in a position to inform us just what is the position of a securities customer in the event of insolvency.

In the event of insolvency of the member firm, what status does each of the categories specified in question 3 occupy in the scale of priority under—

(*a*) The Federal Bankruptcy Act?

(*b*) The New York State law on receivership?

Assuming the firm's compliance with exchange rules on segregation, identification, etc.?

With respect to each of the categories in question 3, what burdens of proof or otherwise must a customer assume in asserting his claim under—

(*a*) The Federal Bankruptcy Act?

(*b*) The New York law on receivership?

7. (*a*) Did the exchange subordinate its claims to the banks as a consideration of the banks holding off taking any action into throwing Haupt into bankruptcy or receivership?

(*b*) Would you identify the banks together with the amount of Haupt's indebtedness to each who were parties to your agreement?

8. I recognize that in your testimony you said that you had referred the questions raised by the Haupt case to several committees who were going to report to you and on the basis of their reports the board of governors would take some action. I recognize that you said you so far could not anticipate this action. Nevertheless, I wish that you would try to tell us just what you can suggest can be done now to prevent a repetition of the Haupt case. (I should imagine your members would wish to avoid continual assessments of this type.)

I suppose there are alternate ways to treat this. One would be to require complete segregation or trusteeship of all customer accounts, so that in the event of insolvency they would accrue to the individual customer and not to all general creditors. I presume that this would work a great change in exchange members capital requirements for I understand that generally broker-dealer capital is based on using their customers capital, not their own. The editorial from the Washington Post of January 2, 1964, which was inserted in the record, states that the capital so used may amount to some $1.2 billion.

On the other hand, what you actually have done in the Haupt case leads me to wonder whether you have not already embarked on a completely new route for reaching a solution. It is obvious that the question of what kinds of segregation should be adopted that would really be effective in protecting the customer becomes moot if you are going to guarantee or insure each customer's account. This is the route, of course, which we have followed in our banking and savings institutions. If each account is guaranteed, it does not matter, of course, whether the assets are commingled. Is this what you are contemplating? Have you, wittingly or unwittingly, put yourself in position now where you have underwritten the customer accounts of all your members? That is, would you have to do the same when the next insolvency occurs as you have done in the Du Pont Homsey and the Haupt cases?

But regardless of how you do it, just what are you, and what are you and the Commission, going to do to protect the investing public in this situation?

9. So that we might have it for the record, would you include a copy of the New York Stock Exchange's capital rule, the violation of which gave rise to the initial suspension of Haupt & Co.

There are other questions relating to other matters which I did not have the time to present to you last week which I am considering and upon which I am writing you in a separate letter.

Sincerely yours,

HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance.

NEW YORK STOCK EXCHANGE,
New York, N.Y., March 3, 1964.

Hon. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance,
House of Representatives,
Washington, D.C.

DEAR CHAIRMAN STAGGERS: This letter, I hope, answers the questions concerning protection of customers' funds and securities posed in your February 12, 1964, letter. Before getting into those answers I would like to correct the record of the committee hearings on one count.

During the questioning of Chairman Cary on February 19, 1964, you indicated at page 1207 of the transcript that when the New York Stock Exchange testified, we had a commodities dealer with us who was unclear as to commodity capital requirements. As I recall the testimony, Congressman Bennett was asking about commodities margins and Mr. Frank J. Coyle, vice president in charge of our department of member firms, attempted to explain that margins differed depending on the commodity contract involved rather than being a flat percentage as in the case of securities. We did not mean to give the impression that Mr. Coyle is a commodities dealer and if we did give that impression I apologize and hope that the transcript can be changed to clarify this matter.

Turning now to the questions raised in your letter, I would like to answer them in order by restating each question asked and then trying to answer it. Enclosed is a copy of our capital rule 325 requested in question 9.

QUESTION

1. What is the frequency of the New York Stock Exchange's financial examinations of members and are these examinations periodic or unannounced?

RESPONSE

The exchange aims to have an examiner visit every individual member who services any accounts of customers and all member organizations at least once in each calendar year. The visit is unannounced in advance of the appearance of the examiner at the organization's office and to avoid anticipation of the examinations they are made at different times during the year than the preceding year's examination.

QUESTION

2. What type of financial examination is employed and what is its scope?
(*a*) Does the exchange make its own examinations or does it rely on independent accountants?
(*b*) Is the examination an audit?
(*c*) Does the examination cover all of the member's activities, or only his securities business?
(*d*) If it does not cover all activities, how is the exchange satisfied that the member is solvent? Specifically, was, is, or will there be any check on the member's commodity transactions, obligations, pledges, receivables, and so forth?

RESPONSE

The exchange examines the financial condition of its members through its requirement calling for answers to financial questionnaires. All individual members who service any customers' accounts introduced on a disclosed basis to a member organization (individual members are not permitted to carry accounts on their own books) and all member organizations must answer such financial questionnaires. Such individual members and those member organizations who have no dealings with other than members and member firms must submit at least two special financial questionnaires, one of which is submitted as of a date within each of the halves of the calendar year. Member organizations which

do not carry accounts of customers on their own books or deal as a principal with nonmembers but introduce customers' accounts on a disclosed basis answer two financial questionnaires each calendar year with one of them based upon an audit by an independent public accountant as of a date unknown to the member in advance. Member organizations which carry accounts of customers or deal as principal with nonmembers are called for three financial questionnaires each calendar year. One questionnaire is based on an audit by an independent public accountant as of a date unannounced in advance. The date as of which these questionnaires are prepared fall in each of the three thirds of the year.

The exchange also examines the financial condition of its members and member organizations who are required to answer financial questionnaires at the time of an examiner's visit to their offices.

The exchange has its own staff of 45 examiners. Six of these are office supervisory personnel which include the chief and assistant chief examiners, 14 senior examiners, 17 examiners, 2 junior examiners, and 6 trainees. Independent accountants are not employed by the exchange to assist in its visitation program but reliance is placed upon the "surprise" audits performed by the firms' independent accountants and the reports submitted in connection with such audits.

The examination conducted by exchange personnel is not an audit. Each examination covers a review of the affairs of the member organization through a spot checking of all phases of the firm's business including commodities transactions. The findings of the initial review of a particular area of the firm's business determines the extent to which the examiner carries out his investigation of that phase of the firm's business. Where there appears to be inadequate control or conformance with expected practice, the review may lead to an examination of all accounts to determine the full extent of the deficiency.

In the normal course of his visit the examiner satisfies himself that the financial condition of the firm has not materially changed since the last questionnaire date. If a material change has taken place a current capital position is prepared for inclusion in his report.

I want to emphasize that the examination covers all the activities of each member organization and is not limited to its securities business. And every member organization which carries on a commodities business was, is, and will be reviewed to determine the impact of this phase of its business on the firm's minimum net capital requirements.

Our examiner had commenced an examination of Ira Haupt a few days before the firm was discovered to be in trouble. The examiner had started to review the securities accounts of the firm and would have subsequently reviewed the other aspects of Ira Haupt's business, including the commodity accounts, if they had gone into liquidation.

QUESTION

3. While there was considerable discussion at the hearings as to segregation of customers credit balances and securities, I think it still is not clear just what is the situation. What are the New York Stock Exchange's rules with respect to segregation, identification, trusteeing, or other type of setting aside of a customer's—

(*a*) Cash credit balance?
(*b*) Cash credit balance when he also has accounts on margin?
(*c*) Fully paid securities in customer's name?
(*d*) fully paid securities in street name?
(*e*) Securities on margin?

RESPONSE

Rule 402 of the board of governors governs the use of customer's securities. It prohibits a member's pledging or lending any securities without a separate written authorization. If the securities to be loaned are fully paid or excess margin the customer's authorization must designate the securities to be loaned.

Where a specific written agreement has not been given by the customer, any securities held for him which have been fully paid for or represent excess margin as established by the exchange's minimum maintenance margin rule must be promptly set aside in segregation for his account.

The exchange does not require the segregation of cash credit balances owing to customers. Such cash credit balances are not required to be segregated when a customer also has a margin account. All accounts of a single customer are combined to determine the segregation status of the securities held in such accounts. If the net money balance of all accounts of one customer is a credit, then all of his securities are to be segregated.

Fully paid securities held in customer's name must be segregated specifically and may not be placed in bulk segregation. Fully paid securities in street name must be segregated either specifically or under the exchange's system of bulk segregation. Stocks carried in a customer's margin account which represent market value in excess of 140 percent of the debit balance in his account should be segregated for his account, except that 100 share certificates need not be broken into smaller lots to accomplish this limitation. Where bonds are concerned the basis on which the member organization is or can borrow on such bonds should be taken into consideration in determining the amount of bonds to be segregated.

Attached is a memorandum from our counsel discussing the legal questions raised in your questions 4, 5, 6, which makes it clear that the law is quite uncertain on these matters.

QUESTION

4. "Now just how, in the face of these rules, would a member's insolvency owing to overextension in the commodities markets, or any other activity for that matter, affect the customer who had either cash or securities left with the member? Does this come about from lack of enforcement of your rules or inadequacy of the rules?"

RESPONSE

As appears from counsel's memorandum, the involvement of securities customers when a firm fails for any reason is because of legal complications, rather than the lack of enforcement or inadequacy of our rules relating to the securities business of our member organizations.

QUESTION

5. "You have referred several times in your testimony to the great cooperation received from the creditor banks in deferring their claims pending liquidation of the Haupt customer accounts. You also indicated that the liquidation plan was conditioned upon Haupt's not being thrown into some insolvency proceedings. You further refer to the fact that under the plan the exchange, after providing funds for the release of customers' accounts, will have its claim subordinated to those of the banks in any realization of Haupt's assets.

Just what does this mean? Does it mean that in the event of bankruptcy or receivership the law would not recognize the segregation, identification, etc., of cash or securities required by the exchange's rules pertaining to customers' accounts? In other words, would Haupt securities customers—had the firm been thrown into bankruptcy or receivership—come after the creditor banks in priority regardless of whether the customers' securities accounts had been segregated, identified, etc., in accordance with the exchange's rules?"

RESPONSE

The aim of the exchange and the banks was to free customers' accounts and reduce running and legal expenses as soon as practicable. If this result could be promptly and economically achieved, the exchange was willing to advance its funds and the banks were willing to defer payment on their loans. What would ultimately have happened to each of Haupt's customers in bankruptcy or receivership proceedings cannot be definitively stated for the reasons set forth in counsel's memorandum. However, even if each customer ultimately recovered his securities and cash balances, the delay would have been protracted and the cost greater than that incurred in an orderly liquidation.

QUESTION

6. "I am certain that, in your consideration of the action which you would take toward Haupt's securities customers and the relative position that they or you would be in under voluntary liquidation, bankruptcy, or receivership, you had the advice of excellent counsel, and thus would be in a position to inform us just what is the position of a securities customer in the event of insolvency.

In the event of insolvency of the member firm, what status does each of the categories specified in question 3 occupy in the scale of priority under—

(*a*) The Federal Bankruptcy Act?

(*b*) The New York law on receivership?

RESPONSE

We cannot, for the reasons set forth in counsel's memorandum, give definitive answers to these questions.

As to the filing of claims of customers in a bankruptcy proceeding, section 67(n) of the Bankruptcy Act provides, within certain exceptions, that claims must be filed within 6 months of the first date set for the first meeting of creditors. In a receivership proceeding the date for, and the manner of, filing claims is usually fixed by the court.

Section 57(a) of the Bankruptcy Act and general order in bankruptcy No. 21 prescribe in some detail the manner in which claims are to be filed.

QUESTION

7. (*a*) Did the exchange subordinate its claims to the banks as a consideration of the banks holding off taking any action into throwing Haupt into bankruptcy or receivership?

(*b*) Would you identify the banks together with the amount of Haupt's indebtedness to each who were parties to your agreement?

RESPONSE

The exchange subordinated its claims to the banks as a part of the general plan to assist Haupt customers rather than for the purpose of having the banks refrain from taking any bankruptcy or receivership action.

The names of banks which are parties to the agreement and the unadjusted amount of their claims on day loans, commodity loans, and unsecured loans to Ira Haupt & Co., as they stood at November 25, 1963, are set forth in annex A to the liquidation agreement, a copy of which is enclosed.

I will not restate question 8 because of its length. However, I do want to make it clear from the beginning of this discussion on the points you have made in question 8, that the exchange did not intend to set a precedent of underwriting losses to customers of our member firms. After the *Dupont Homsey* case, we developed an insurance program for our members firms to take care of losses to customers due to fraud of a partner. This, combined with the employees' blanket bond, seemed to give good protection to customers; however, we did provide added coverage by getting a $10 million excess bond for any loss over and above that covered by the firm's assets and insurance. Having taken these steps, we felt that it was clearly established that the exchange was not liable for any losses.

The Ira Haupt difficulty was caused by the overextension of credit to a commodities customer of the firm. The exchange felt, as in Dupont Homsey, that we should try to make the customers of the firm whole even though there was no legal liability to do so. A committee of the board of governors was appointed to tackle the immediate problem that caused the difficulty. That committee has recently reported to the board and the board has agreed, in principle, to adopt their recommendations which will be presented in rule form at the March 19 policy meeting. Enclosed for your information is a copy of the committee's report and a draft of the proposed amendments to our rules.

A second committee was appointed by the board of governors to examine the possibilities of developing some permanent method for dealing with comparable problems in the future. This committee has been carrying on preliminary deliberations while waiting for the report of the committee on member firm's commodities business. Now that that report is in, they are proceeding to deal with the complex problems involved in working out a more permanent program. Some of the suggestions to date have included a guarantee fund, an insurance program, and a combination of both. In any event, we are clear that the exchange is not liable for losses of customers.

The interim solution suggested in your letter of segregating customers' accounts would, at most, provide limited protection of doubtful value because of problems of the Bankruptcy Act, spelled out in the attached memorandum of counsel, and would, as you have indicated, substantially increase costs to our member firms, with the result that services now rendered free to customers would have to be curtailed, service charges would have to be imposed, or commissions would have to be increased. Such a solution would obviously be unsatisfactory because of the uncertain nature of the protection afforded and the added cost that would have to be borne by investors. It seems far better to

us that our capital rules be amended to guard against a recurrence of an Ira Haupt type situation, and that we pursue vigorously the development of some more permanent form of protection.

I think this letter answers all the questions you have asked and you may want to make it and the enclosures part of the record before the subcommittee. I would ask, however, that annex A to the Ira Haupt & Co. liquidation agreement not be made part of the public record.

Sincerely,

G. KEITH FUNSTON.

MEMORANDUM OF COUNSEL TO ACCOMPANY G. KEITH FUNSTON REPLY TO FEBRUARY 12, 1964, LETTER OF HON. HARLEY O. STAGGERS

Questions 4, 5, and 6 basically involved the impact of section 60(e) of the Federal Bankruptcy Act on stockbrokers. You have asked that I prepare a memorandum outlining the problems which exist hereunder.

Prior to the passage of section 60(e) which was part of the Chandler Act amendments to the Bankruptcy Act of June 1938, the rights of customers of bankrupt stockbrokers were in a large measure dependent on the customers' ability to trace securities. Over the years the court decisions developed marshaling procedures governing the priorities of various classes of customers of bankrupt stockbrokers. The decisions were not wholly consistent and the tracing rules were intricate and complex.

In 1938 the National Bankruptcy Conference recommended the addition of section 60(e) to the Bankruptcy Act. Their purpose was to secure greater uniformity and equality among customers in the liquidation of the assets of bankrupt stockbrokers. Generally speaking, the section (a copy of which is attached as app. A) was intended to permit (1) the reclamation of segregated securities by cash customers, (2) the pooling of all customers' property which was not reclaimed, in a "single and separate fund" out of which customers' claims would be paid and (3) if the single and separate fund was not large enough to satisfy all customer claims, the customers would have a claim against the general assets of the bankrupt which would rank equally with the claims of the bankrupt's general creditors.

Unfortunately there are inconsistencies in section 60(e) and there are constitutional questions which raise doubt as to how far the draftsmen of the section have achieved their goal.

Many, but not all, of the unanswered questions are discussed in an article by John A. Gilchrist in 21 Minnesota Law Review pages 52–80 (1939). A copy is attached as appendix B.[1] It would unduly prolong this memorandum to repeat the various arguments favoring one or another of the conflicting interpretations of this section. Mr. Gilchrist, who has since died, was associated with general counsel to the exchange when he prepared the article.

I am of the opinion that if at the time of bankruptcy all cash customers' fully paid securities are on hand and were segregated either individually or in bulk for cash customers while the broker was solvent, or more than 4 months prior to bankruptcy, would be reclaimable if the bankrupt's records showed for whom they were segregated. If fewer securities are on hand and so segregated at the time of bankruptcy than the records indicate should be segregated, I feel that the cash customers for whom a particular issue of securities had been segregated while the broker was solvent or more than 4 months prior to bankruptcy, the securities should be reclaimable pro rata by the customers for whom the records show they were segregated. I have, greater doubt that, customers' cash credit balances could be reclaimed even though segregated.

The Honorable Jerome Frank, then Chairman of the SEC stated in a January 1940 letter to the chairmen of the House and Senate Judiciary Committees:

"The limited scope of the definition of a 'cash customer' and other provisions in the section [sec. 60(e)] make it a very genuine possibility that in the event of bankruptcy, many customers with either free credit balances or securities held in safekeeping in the hands of their brokers may nevertheless be unable to reclaim their cash or property, and, as a consequence, may be remitted to a mere general claim against the single and separate fund."

[1] Appendix B was placed in the subcommittee files.

However, it is important to remember that all customers' claims against that fund have priority over all other unsecured creditors of the bankrupt stockbroker.

Experience has shown that the uncertainties envisaged by Chairman Frank and Mr. Gilchrist were warranted. Three decisions of U.S. courts of appeal have dealt with the interpretation of section 60(e). The first case involved the bankruptcy of a Philadelphia over-the-counter firm (*In re McMillen, Rapp & Co.*, 123 F. 2d 428, Third Circuit, 1941.)

In that case four customers had bought and paid for securities which had been received by the broker in street name and transferred to the customers' names sometime within 4 months of bankruptcy while the broker was insolvent. Each of these customers was permitted to reclaim the securities under section 60(e)(4) on the ground that they were cash customers whose securities had remained in the identical form in which they were received by the broker when they came back from transfer in the customers' names. The fact that the securities were originally received by the broker for the account of the customers in street name and then transferred to the customers' names suggests some doubt as to the correctness of the interpretation, though the result reached by the court seems desirable. The opinion suggests that if the firm, which was primarily a dealer, had not acted as agent; i.e., brokers in these particular purchases the buyers may not have been entitled to the protection of section 60(e).

The second circuit court case involved a bankrupt Birmingham, Ala., over-the-counter firm. (*Gordon* v. *Spalding*, 268 F. 2d 327, USCA Fifth Circuit 1959.)

In this case, about 2 weeks before bankruptcy, the customer (Thompson) ordered 100 shares of Vulcan Life & Accident Insurance Co. stock from Lucas, the bankrupt. Lucas bought the stock in his own name, and sold it to a third person though he confirmed the sale of the stock to Thompson. Thompson paid $7,735.32 for the securities and sought to reclaim $3,639.44 the balance in the bankrupt's bank account at the time of bankruptcy. The $7,735.32 check was traced into this account.

A divided court held that in this transaction Lucas (the broker) had acted as principal and not as agent and therefore section 60e was not applicable. The court said each transaction has to be examined to see whether the bankrupt acted as a broker or a dealer. Chief Judge Rives, in a vigorous dissent, said that the bankrupt was a stockbroker within the meaning of section 60e.

In the third case (*Tepper* v. *Chichester*, 285 F. 2d 309, USCA 9th Circuit, 1960) the customer ordered the bankrupt California over-the-counter dealer to sell 30 shares of Ford Motor Co. stock, the bankrupt broker sold the stock and credited the proceeds to the customer's account a few days before bankruptcy. The customer delivered the stock to the broker before bankruptcy and apparently the same certificate was in the broker's possession at the time of bankruptcy. A majority of the court, admitting that the customer could reclaim the certificate under California law held that section 60e applied and that under it, the customer "was not entitled to immediate possession" of the certificate and therefore was not a cash customer and could not reclaim the certificate. The majority summarily brushed the customer's constitutional contention aside.

The dissenting circuit judge said that there was a constitutional question and that inasmuch as the broker was insolvent when the sale was made, his insolvency terminated the agency and therefore section 60e did not apply.

When three circuit judges cannot agree on the basic issues raised in the *Gordon* and the *Tepper* cases, it is apparent that it is not possible to tell with any certainty how the courts will ultimately interpret the conflicting provisions of section 60e.

If a State court receiver were to be appointed the courts would probably fall back on the old tracing cases. However, as a practical matter, it seems likely that if a State court receiver were appointed, customers of the firm would put the firm in bankruptcy hoping to get the intended benefits of section 60e; unless it were clear that all customers and other creditors would be paid in full. Furthermore, under the pre-1938 bankruptcy cases each customer's rights were dependent on the particular facts of his case.

Despite the fact that many unique problems have arisen and delayed the completion of the transfer of customers' securities in the *Haupt* case. I think it is safe to say that attempting to free customers' accounts either in a bankruptcy or receivership proceeding would be much more costly and would take much more time than the orderly voluntary liquidation of Ira Haupt & Co. In

a bankruptcy proceeding involving a firm as large and diversified as that of Ira Haupt & Co., there would be months, if not years, of litigation before customers' claims could be resolved under 60e of the Bankruptcy Act. Under a receivership proceeding the same would be true if the firm were insolvent.

SAMUEL L. ROSENBERRY.

APPENDIX A

PREFERRED CREDITORS

d. If a debtor shall, directly or indirectly, in contemplation of the filing of a petition by or against him, pay money or transfer property to an attorney and counselor at law, solicitor in equity, or proctor in admiralty for services to be rendered, the transaction shall be reexamined by the court on petition of the trustee or any creditor and shall be held valid only to the extent of a reasonable amout to be determined by the court, and the excess may be recovered by the trustee for the benefit of the estate.

60e. (1) Where the bankrupt is a stockholder, the following definitions and provisions of this subdivision shall apply; "Property" shall include cash, securities, whether or not negotiable, and all other property of similar character; "customers" of a stockbroker shall include persons who have claims on account of securities received, acquired, or held by the stockbroker from or for the account of such persons (a) for safekeeping, or (b) with a view to sale, or (c) to cover consummated sales, or (d) pursuant to purchases, or (e) as collateral security, or (f) by way of loans of securities by such persons to the stockbroker, and shall include persons who have claims against the stockbroker arising out of sales or conversions of such securities; "cash customers" shall mean customers entitled to immediate possesion of such securities without the payment of any sum to the stockbroker; the same person may be a cash customer with reference to certain securities and not a cash customer with reference to other securities; the "net equity" of a customer's account shall be determined by excluding any specifically identifiable securities reclaimable by the customer and by subtracting the indebtedness of the customer to the stockbroker from the sum which would have been owing by the stockbroker to the customer had the stockholder liquidated, by sale or purchase on the date of bankruptcy, the remaining securities or security commitments of the customer.

(2) All property at any time received, acquired, or held by a stockbroker from or for the account of customers, except cash customers who are able to identify specifically their property in the manner prescribed in paragraph (4) of this subdivision and the proceeds of all customers' property rightfully transferred or unlawfully converted by the stockbroker, shall constitute a single and separate fund; and all customers except such cash customers shall constitute a single and separate class of creditors, entitled to share ratably in such fund on the basis of their respective net equities as of the date of bankruptcy: *Provided, however*, That such fund shall to the extent approved by the court be subject to the priority of payment of the costs and expenses enumerated in clauses (1) and (2) subdivision a of section 64 of this act. If such fund shall not be sufficient to pay in full the claims of such class of creditors, such creditors shall be entitled, to the extent only of their respective unpaid balances, to share in the general estate with the general creditors.

(3) Any property remaining after the liquidation of a pledge made by a stockbroker shall be apportioned between his general estate and such single and separate fund in the proportion in which the general property of the stockbroker and the property of his customers contributed to such pledge.

(4) No cash received by a stockbroker from or for the account of a customer for the purchase or sale of securities, and no securities or similar property received by a stockbroker from or for the account of a cash customer for sale and remittance or pursuant to purchase or as collateral security, or for safekeeping, or any substitutes therefor or the proceeds thereof, shall for the purposes of this subdivision be deemed to be specifically identified, unless such property remained in its identical form in the stockbroker's possession until the date of bankruptcy, or unless such property or any substitutes therefor or the proceeds thereof were, more than 4 months before bankruptcy or it a time while the stockbroker was solvent, allocated to or physically set aside for such customer, and remained so allocated or set aside at the date of bankruptcy.

(5) Where such single and separate fund is not sufficient to pay in full the claims of such single and separate class of creditors, a transfer by a stockbroker of any property which, except for such transfer, would have been a part of such fund may be recovered by the trustee for the benefit of such fund, if such transfer is voidable or void under the provisions of this act. For the purpose of such recovery, the property so transferred shall be deemed to have been the property of the stockbroker and, if such transfer was made to a customer or for his benefit, such customer shall be deemed to have been a creditor, the laws of any State to the contrary notwithstanding. If any securities received or acquired by a stockbroker from a cash customer are transferred by the stockbroker, such customer shall not have any specific interest in or specific right to any securities of like kind on hand at the time of bankruptcy, but such securities of like kind or the proceeds thereof shall become part of such single and separate fund: *Provided, however*, That a customer shall have a specific title to securities (a) which have been physically set aside by a stockbroker, more than 4 months before his bankruptcy or while solvent in safekeeping for such customer, and so retained until the date of bankruptcy, regardless of the name in which such securities are registered, or (b) which a stockbroker, more than 4 months before his bankruptcy or while solvent, caused to be registered in the name of such customer.

APPENDIX B

(The document labeled "Appendix B" and entitled "Stockbrokers' Bankruptcies: Problems Created by the Chandler Act" and written by John A. Gilchrist with reference 21 Minnesota Law Review, pp. 52–80 (193), was placed in the subcommittee files.)

3525

Operation of Member Organizations

Capital Requirements

(Rules and Policies Administered by the Department of Member Firms.)

¶ 2325 Capital Requirements for Member Organizations and Individual Members

General provisions

Rule 325. (a) No member or member organization doing any business with others than members or member organizations or doing a general business with the public, except a member or member organization subject to supervision by State or Federal banking authorities, shall permit, in the ordinary course of business as a broker, his or its Aggregate Indebtedness to exceed 2000 per centum of his or its Net Capital, which Net Capital shall be not less than $50,000 in the case of a member organization carrying any accounts for customers and shall be not less than $25,000 in the case of any other member or member organization subject to this rule, unless a specific temporary exception is made by the Exchange in the case of a particular member or member organization due to unusual circumstances.

The initial Net Capital of a member corporation shall be at least 120% of the Net Capital required to be maintained by this rule.

The Exchange may at any time or from time to time in the case of a particular member or member organization prescribe greater requirements than those prescribed herein.

Each member or member organization shall promptly notify the Exchange if his or its Net Capital does not equal or exceed the minimum required by this rule.

Definitions

(b) For the purpose of this rule—

(1) The term "proprietary accounts" shall include capital accounts of partners or sole proprietor, investment and trading accounts, participations in joint accounts, accounts of partners which are covered by agreements, approved by the Exchange, providing for the inclusion of equities therein as partnership property and borrowings covered by subordination agreements approved by the Exchange;

(2) the term "aggregate indebtedness" shall include the total money liabilities of the member or member organization in all accounts other than customers' and brokers' accounts for commodity future contracts; plus equities in customers' and brokers' accounts for commodity future contracts; plus the market value of securities borrowed (other than for delivery against customers' sales) for which no equivalent value is paid or credited, exclusive of the following:

(A) money borrowed (adequately collateralized) on securities, spot commodities or other assets owned by the member, member firm

3526 **Rules of Board—Capital Requirements**
Administered by Department of Member Firms.

¶2325 Continued

or general partner thereof, or a member corporation and on those subordinated to general creditors;

(B) money payable against securities loaned which are owned by the member, member firm or general partner thereof, or a member corporation and those subordinated to general creditors;

(C) money payable against securities failed to receive in connection with transactions for the account of the member, member firm or general partner thereof, or a member corporation and for accounts subordinated to general creditors;

(D) money borrowings adequately collateralized by securities exempted from registration under the Securities and Exchange Act of 1934, otherwise than by action of the Securities and Exchange Commission;

(E) liabilities subordinated to general creditors pursuant to a separate agreement approved by the Exchange;

(F) equities in customers' commodity accounts segregated under the Commodity Exchange Act;

(G) equities in general partners' commodity accounts and credit balances in other accounts of general partners; and

(H) liabilities on open contractual commitments.

(3) The term "net worth" shall be the excess of total assets over total liabilities, after provision for current dividends declared and unpaid by a member corporation (except that credit balances and equities in "proprietary accounts" shall not be considered as liabilities) with securities, spot commodities, commodity future contracts in "proprietary accounts" and all other assets marked to market or fair value. A loss, at market, in an individual contractual commitment shall be deducted in determining Net Worth and a profit shall not be included. (See (c)(10) "Special Provisions" below.)

(4) the term "net capital" shall be Net Worth, less the following:

Debit Items

(A) Amounts included in Net Worth for:

(i) Memberships, furniture and fixtures, real estate and other fixed assets;

(ii) the value of securities which have no ready market;

(iii) unsecured loans and advances to partners and deficits in partners' accounts including those unsecured (see (c)(10) below);

(iv) deficits in customers' accounts including unsecured accounts and notes receivable (see (c)(9), (10) and (11) below); and

(v) prepaid rent, insurance and expenses and unsecured advances to employees and salesmen.

Long Positions

(B) 30% of the market value of securities and spot commodities long in "proprietary accounts" and in customers' accounts in deficit (10% of the market value of spot commodities if they are hedged). (See (c) Special Provisions below.)

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Excess Short Positions

(C) The amount determined on the excess of the market value of short positions in securities over the market value of long positions in "proprietary accounts." The excess of the market value of short positions shall be determined separately for each percentage group set forth in this rule and in (c) "Special Provisions" thereof, except that bonds and stocks shall be considered separately. The amount of this debit item shall be 30% of the excess market value of short positions or the lesser percentage indicated in (c)(1) through (8) below. (See (c)(10) below.)

Commodity Futures—Proprietary Accounts

(D) 30% of the market value of all long and all short future commodity contracts (other than those contracts representing spreads and straddles in the same commodity and those contracts offsetting or hedging any spot commodity positions) in "proprietary accounts."

Credit Lines

(E) Total of credit lines granted on open commodity contracts in "trade" accounts with net long positions or in "trade" accounts with net short positions, whichever is greater, plus any credit lines granted on open commodity contracts in "trade" accounts with no net long or net short position. (In computing the credit line granted in the case of each account, deduct the amount of the equity or the amount of the deficit therein, provided such amount is not in excess of the credit line granted, and the deficit, if any, is comprehended in other "Debit Items.") (See (c)(9) below.)

Commodity Futures—Customers' Accounts

(F) ½ of 1% of the market values of the total long or total short future contracts in each commodity, whichever is greater, carried for all customers. Contracts in each customer's account representing purchases and sales of a like amount of the same commodity in the same market may be eliminated. (See (c)(11) below.)

Cash Margin Deficiency

(G) Cash required to provide proper margin in customers' undermargined accounts in accordance with Rule 431 [¶2431]. (See (c)(9) and (11) below.)

(H) Cash required to provide margin equal to:

(i) the pertinent commodity exchange maintenance requirements on all future commodity contracts in each customer's account. Cash required should be exclusive of liquidating deficits (see (c)(9) and (11) below.)

(ii) 20% of the market value in each customer's account in equity containing spot commodity positions not hedged by future contracts in the same commodity (see (c)(9) and (11); and

(iii) 10% of the market value in each customer's combined account in equity when such account contains spot commodity positions hedged by future contracts in the same commodity (see (c)(9) and (11) below).

¶2325 Continued

Other

(I) Any other amounts rightly to be comprehended as "Debit Items" in the computation of Net Capital.

Special provisions

U. S. Government and Municipal Bonds

(c)(1) In the case of obligations of:

(A) The United States or any agency thereof and obligations guaranteed as to principal or interest by the United States or any agency thereof the following percentages of market value shall be deducted:

(i)	Less than one year to maturity	0%
(ii)	One year but less than two years to maturity	1%
(iii)	Two years but less than three years to maturity	1½%
(iv)	Three years but less than four years to maturity	2%
(v)	Four years but less than five years to maturity	2½%
(vi)	Five years or more to maturity	3%

(B) A State, territory or possession of the United States or any political subdivision thereof and obligations guaranteed as to principal or interest by such State, territory, possession or political subdivision thereof, which are not in default as to interest, the following percentages of market value shall be deducted:

(i)	Less than one year to maturity	0%
(ii)	One year but less than two years to maturity	1%
(iii)	Two years but less than three years to maturity	2%
(iv)	Three years but less than five years to maturity	3%
(v)	Five years or more to maturity:	
	a) covered by the 1st and 2nd ratings by any of the nationally known statistical services	4%
	b) covered by the 3rd rating by any of the nationally known statistical services	5%
	c) covered by other ratings or not rated	10%

(C) Any authority, commission or agency of a State, territory or possession of the United States or any political subdivision thereof which are payable as to principal and interest solely from specified revenues and which are not in default as to interest, the following percentages of market value shall be deducted:

(i)	Less than one year to maturity	1%
(ii)	One year but less than two years to maturity	2%
(iii)	Two years but less than three years to maturity	3%
(iv)	Three years or more to maturity:	
	a) covered by the 1st and 2nd ratings by any of the nationally known statistical services	5%
	b) covered by the 3rd rating by any of the nationally known statistical services	7½%
	c) covered by other ratings or not rated	10%

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Other Government Obligations

(2)—Deleted—Included in (1) above, effective December 1, 1958.

Redeemable Securities

(3) In the case of obligations or preferred stocks which the issuer has officially declared will be redeemed within ninety days, the full market value or the cash redemption value, whichever is lower, shall be included in computing Net Worth and Net Capital.

Preferred Stocks

(4) In the case of preferred stocks (other than those above) on the "exempt" list shown in the NYSE GUIDE and senior nonconvertible preferred stocks of issuers whose interest bearing obligations are covered by the first three ratings by any of the nationally known statistical services, 20% of the market value shall be deducted.

Non-Convertible Bonds

(5) In the case of interest bearing obligations which do not have a conversion or exchange feature, covered by the first four ratings by any of the nationally known statistical services, the following percentages of market value shall be deducted: First rating—5%; second and third ratings—10%; fourth rating—15%, except that, in the case of such obligations having five years or less to maturity, covered by the first three ratings, the following percentages of market value shall be deducted: Maturity one year or less—1%, two years—2%, three years—3%, four years—4% and five years—5%.

Convertible Bonds

(6) Interest bearing obligations which have a conversion or exchange feature and which are covered by the first four ratings by any of the nationally known statistical services, may be included in the computation of Net Capital at the lower of 100% of the principal amount or the market value less the applicable percentage designated for bonds which do not have a conversion or exchange feature.

Exchangeable Securities

(7) In the case of securities which are exchangeable or convertible, a security sold shall be considered, in computing Net Worth, as a sale of a security held, after adjustment of the cost or proceeds of such securities for any money to be paid or received in connection with such exchange or conversion provided the security held is, without restriction other than the payment of money, exchangeable or convertible into the security sold within a period not exceeding thirty days. With respect to a case involving a longer period of time, the Department of Member Firms will consider a written application for permission to deduct a percentage of the proceeds of sale (in lieu of 30% or some other percentage of the market value of the security held).

Preferential Treatment Upon Application

(8) In the case of securities coming within the scope of any of the following clauses, the Department of Member Firms will consider a

[The next page is 3529-3.]

¶ 2325 Continued.

written application for permission to deduct a lesser percentage of the market value than heretofore provided.

(A) Interest bearing obligations and serial equipment trust certificates which are to be the subject of a primary distribution but for which a published rating is not yet available;

(B) obligations of any authority, commission or agency of a State, territory or possession of the United States or any political subdivision thereof which are payable as to principal and interest solely from specified revenues and which are not in default as to interest, which have less than nine months to maturity.

(C) obligations of a State, territory or possession of the United States or any political subdivision thereof or any authority, commission or agency thereof which are not rated by any of the nationally known statistical services.

Exclusion

(9) Exclusive of bona fide cash transactions for customers in issued securities and after application of current outstanding calls for margin, marks or other deposits.

Contractual Commitments

(10) Net Worth and "Debit Items" (A)(iii), (A)(iv), (B) and (C) of paragraph (b)(4) of Rule 325 should be adjusted for open contractual commitments which will include delayed delivery, underwriting and "when issued" contracts, endorsements of puts and calls and commitments in foreign currencies and spot (cash) commodity contracts but will not include open commodity future contracts and uncleared regular way purchases and sales of securities, by applying the amounts due thereon and any valuation of securities involved as though such amounts and valuations were actual, except that this treatment of any individual commitment shall not operate to increase Net Worth or Net Capital. A series of contracts of purchase or a series of contracts of sale, of a stated amount of the same security conditioned, if at all, only upon issuance shall be treated as an individual commitment and the profit, at market, in each individual commitment used to reduce the debit item (B) or (C) relating to that commitment.

Accounts not Covered By Agreements

(11) Accounts of partners which are not covered by agreements, in form approved by the Exchange, providing that the securities and equities therein are to be included as partnership property, accounts of officers and accounts of holders of stock of a member corporation shall be considered as customers' accounts.

Amendments.
Rule 325(c)(1), (2) and (8)(B) amended October 16, 1958, effective December 1, 1958.

• • • ***Supplementary Material:***

.10 Computation of net capital under Rule 325.—

Credits:

(1)	Credit balances in accounts for Capital stock	$.....
(2)	Net credit balances in accounts for surplus and undivided profits (after provision, in the case of a corporation, for current dividends declared and unpaid)	.....
(3)	Credit balances in "proprietary accounts"	.....
(4)	Net profits, at market, in future commodity Exchange contracts carried for "proprietary accounts"	.....
(5)	Market value (or value indicated by accompanying instructions) of securities and spot commodities long in "proprietary accounts"	.....
(6)	Reserves (other than liability reserves) which are available as capital	.....
(7)	Total credits	$

Debits:

(8)	Surplus deficit and undivided losses	$.....
(9)	Debit balances in "proprietary accounts"	.....
(10)	Deficits in customers' accounts (other than bona fide cash accounts) after application of current outstanding calls for margin, marks or other deposits	.....
(11)	Market value of securities short in "proprietary accounts"	.....
(12)	Net losses, at market, in future commodity Exchange contracts carried for "proprietary accounts"	.....

[Net worth is equal to total of credits (1) through (6) (*i. e.*, item (7)), less total of debits (8) through (12) ..... $.....]

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(13) Debit balances in accounts for fixed assets, prepaid items etc. such as:

Memberships	$.....
Furniture, fixtures & Equipment	.....
Prepaid expenses	.....
Profits and commissions receivable from syndicates	.....
Real estate (See Instruction 10)	.....
Miscellaneous advances and receivables	.....
Dividends receivable—non-current (See Instruction 8)	.....
.....	.....
.....	.....
.....	.....
.....	.....
.....	.....
.....	.....
.....	.....
Total of Item (13)	$.....

(14) 30% (or pertinent percentage of market values indicated in Rule 325 [¶ 2325] or (c)(1) through (8) thereof or as indicated in the accompanying instructions) of the market values of all securities and spot commodities long in "proprietary accounts" and in customers' accounts in deficit (other than bona fide cash accounts and after application of current outstanding calls for margin, marks or other deposits):

Market values etc.	*Percentage charge*	*Amount of charge*
$.....	30%	$.....
.....	20	.....
.....	15	.....
.....	10	.....
.....		.....
.....		.....
.....		.....
.....		.....
.....		.....
.....		.....
Total Amount of Charge		$.....

(15) The amount determined on the excess of the market value of short positions in securities over the market value of long positions in "proprietary accounts" (See Debit Item (C) Rule 325 [¶ 2325]. See also Instruction 23 at .15, below.) ..... $.....

(16) 30% of the market value of all long and all short future commodity contracts (other than those representing spreads or straddles in the same commodity or hedging any spot commodity positions) carried for "proprietary accounts" ..... $.....

¶ 2325.10 Continued

(17) Total of credit lines granted (See Instruction 24) .....

(18) ½ of 1% of market values of total long or total short future contracts in each commodity (See Instruction 25) .....

(19) Cash required to provide margin in accordance with Rule 431 [¶ 2431] after application of current outstanding calls for margin, marks or other deposits .....

(20) Cash required to provide margin in customers' commodity accounts, after application of current outstanding calls for margin, equal to:

The pertinent commodity exchange maintenance requirements .....

20% of the market value in each account containing spot commodity positions not hedged by future contracts (10% if hedged) .....

(21) Total Debits ..... $

(22) Net Capital (item 7 less item 21) ..... $

(23) Aggregate Indebtedness per Rule 325 [¶ 2325], Section (b)(2):

Total liabilities per Section (b)(2) .... $.....

Less exclusions per Section (b)(2)

(a) ..... $.....
(b) ....
(c) ....
(d) ....
(e) ....
(f) ....
(g) ....
(h) ....

Total exclusions ....

Aggregate Indebtedness ..... $.....

(24) Minimum capital required to be maintained or 1/20th of item 23, whichever greater ..... $

(25) Net Capital in excess of minimum requirements (item 22 less item 24) ..... $

(26) Ratio of Aggregate Indebtedness to Net Capital (item 23 divided by item 22) ..... %

Instructions

.15 General.—

(1) Questions as to the computation of Net Capital or the treatment of items entering into such computation should be directed to the Department of Member Firms or phone HAnover 2-4200, extensions 325 or 326.

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(2) The term "proprietary accounts" includes capital accounts of partners or sole proprietor, investment and trading accounts, participations in joint accounts, accounts of partners which are covered by agreements, approved by the Exchange, providing for the inclusion of equities therein as partnership property and borrowings covered by subordination agreements approved by the Exchange.

(3) Individual accounts of limited and general partners of a member firm which are not covered by "equities" agreements approved by the Exchange and those of holders of stock of a member corporation shall be considered as customers' accounts. However, equities in general partners' commodity accounts and credit balances in other accounts of general partners shall not be included in Aggregate Indebtedness.

(4) If a limited partner contributes securities as capital and the partnership agreement limits his liability to an amount other than the market value thereof, enter in item (3) the lower of the amount to which his liability is limited or the market value reduced by the percentage to be deducted in accordance with ¶ 2325(c)(1) through (8). Do not include the value of such securities in item (5) or (14).

(5) Any borrowing for capital purposes which has not been approved by the Exchange, shall not be considered as a credit in computing Net Capital.

(6) Shares of the Board of Trade Clearing Corporation (Chicago) shall be considered as a current asset at the amount for which they can be sold to the Clearing Corporation. The excess of such amount over the ledger balance in the account for such shares shall be included in item (3). Any excess of the ledger balance over the current value shall be included as a debit in item (9).

(7) Cash surrender value of life insurance policies, which have been approved by the Exchange or which, in the opinion of firm's counsel, meet the requirements of the Exchange, shall be considered as a current asset. Any excess of such cash surrender value over the ledger balance shall be included as a credit in item (3). Any excess of the ledger balance over the cash surrender value shall be included as a debit in item (9).

(8) Dividends receivable recorded after the ex-dividend date shall be considered as a current asset unless they represent claims which are not readily collectible.

(9) Good faith deposits on commitments in securities shall also be considered as a current asset.

(10) The debit balance for Real Estate shown in item (13) may not be reduced by the amount of mortgages thereon unless such procedure has been approved by the Department of Member Firms.

(11) If non-exempt securities of customers are pledged against a borrowing of "Exempt" securities, the market value of the securities borrowed shall be included in Aggregate Indebtedness.

(12) Unrecorded assets and liabilities, other than contractual and contingent items, should be treated as though recorded when computing Net Capital and Aggregate Indebtedness. Consideration should also be given to sufficiency of liability reserves in connection with any lawsuits pending, accommodation endorsements, rediscounted notes, guarantees or any other contingent liability.

¶2325.15 Instructions.—Continued

Long and short positions, endorsed puts and calls—proprietary accounts

(13) If a firm does no business with others than members or member organizations, the market value of all readily marketable securities in "proprietary accounts" shall be included in items (5) and (14). The percentage charge and amount of charge in items (14) and (15) shall be zero.

(14) In the case of long securities which have no ready market, no value should be included in items (5) or (14).

(15) In the case of obligations or preferred stocks which the issuer has officially declared will be redeemed within 90 days, enter in item (5) the full market value or the cash redemption value, whichever is lower. Do not enter in item (14).

(16) In the case of interest bearing obligations having a conversion or exchange feature which are covered by the first four ratings by any of the nationally known statistical services, include the market value thereof in item (5) and item (14). Include in item (14) as the "Amount of charge," the excess of market value included in item (5), over the principal amount or over the market value less the applicable percentage for bonds which do not have a conversion or exchange feature, whichever amount is greater. For example, if convertible bonds with maturities exceeding five years, have a second rating, the "Amount of charge" would be determined as follows:

(A) Market value included in item (5)		$115,000
(B) Principal amount	$100,000	
(C) Market value $115,000 less 10% for second rating	103,500	
Lower of (B) or (C)		100,000
Amount of charge item (14)		$ 15,000

(A) Market value included in item (5)		$105,000
(B) Principal amount	$100,000	
(C) Market value $105,000 less 10% for second rating	94,500	
Lower of (B) or (C)		94,500
Amount of charge item (14)		$ 10,500

On convertible bonds selling at 142⅞ or over, the maximum "Amount of charge" in item (14) will be 30% of market value as Rule 325 [¶2325] does not require a charge in excess of 30% of the market value of readily marketable securities.

(17) In the case of securities which are exchangeable or convertible, a security sold may be considered as a sale of a security held, after adjustment of the cost or proceeds of such security for any money to be paid or received in connection with such exchange or conversion, provided the

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security held is, without restriction other than the payment of money, exchangeable or convertible into a security sold within a period not exceeding 30 days. The proceeds of such securities, after adjustment, should be included in item (3) or used to reduce the debit in item (9). If the period exceeds 30 days and the Department of Member Firms has granted permission to include a percentage of the proceeds of sale, only the amount determined in accordance with such percentage, reduced by any amounts to be paid or increased by any amounts to be received in connection with such exchange or conversion, shall be included in item (3) or used to reduce the debit in item (9). Do not include the market value of the long securities in item (5) or the market value of securities sold in item (11).

(18) If the Department of Member Firms has, upon written application, granted permission to deduct a lesser percentage of the market value of a security than the percentage specifically provided by Rule 325 [¶ 2325], include the market value of such securities in item (5). Also include the market value in item (14), the percentage charge and the amount of charge.

(19) In the case of a long security against which the firm has sold a call and bought a put endorsed by a member firm (conversion account), such security shall be valued at the lower of the put or call price in lieu of the market price and such value included in item (5). Such value shall also be included in item (14) and 15% thereof shall be included in the amount of charge.

(20) If a call has been sold against a security held for "proprietary accounts" the market value of the security shall be included in items (5) and (14). The amount of charge in item (14) should be at 30% (or pertinent percentage) *provided* the contract amount of the call is greater than 70% (or pertinent percentage) of the market value. If the contract amount of the call is less than 70% (or pertinent percentage) of the market value then the excess of the latter over the contract amount should be included in item (9).

(21) If a put has been sold against a short position in "proprietary accounts" the excess of the contract value over the market value shall be included in item (9).

(22) Where a put or a call has been endorsed and there is no offsetting security position, each such put or call shall be considered separately. The contract value of a put shall be included in item (9). The market value of the securities represented by the put shall be included in item (5). The market value and the amount of charge based on the pertinent percentage should be included in item (14). If the market value included as a credit in item (5) exceeds the debit included in item (9) plus the amount of charge included in item (14), such excess shall be included as a debit in item (9). In the case of a call, the amount by which the market value exceeds the contract value shall be included in item (9). However, if a put and a call have been sold for the same number of shares of the same security, only the option resulting in the greater reduction in Net Capital should be considered as a contractual commitment.

(23) The amount required by item (15), relates to "excess" short positions in securities in "proprietary accounts" and is determined in the following manner:

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¶ 2325.15 Instructions.—Continued

The actual positions long and short in such accounts are adjusted for open contractual commitments. There should be eliminated from the resulting long and short positions:

(A) All long and short positions, actual and contractual, bonds and stocks, which will be cleared by eventual conversion of such long securities for delivery of such securities sold;

(B) long positions and all puts and calls in "conversion" accounts where a security is purchased, a call is sold and a put is held which has been endorsed by a member firm;

(C) short positions and all puts and calls in "conversion" accounts where a security is sold, a put is sold and a call is held which has been endorsed by a member firm;

(D) long positions and calls where a security is held and a call has been sold.

(E) a put and a call sold for the same number of shares of the same security.

Also, in regard to item (15), a put sold by the firm should not be used to eliminate a short position nor should the put be considered as a long position.

A put or call owned by the firm should be disregarded for the purpose of determining long or short positions.

After the above eliminations have been made for the purpose of item (15), the valuations of long and short positions should be determined separately for stocks and for bonds and separately for each percentage category.

The market value of longs in a category is compared with the market value of shorts in that category for purposes of item (15). In each category where the short values exceed the long values, a charge results based on the percentage charge in that category applied to the excess short value. An example follows:

		— *Market Values* —			
	Category	*Long*	*Short*	*Excess Short*	*Amount of Charge*
Common and Pfd. Stocks	30%	$100,000	$120,000	$20,000	$6,000
Preferred Stocks	20%	30,000	—	—	—
Bonds	30%	50,000	—	—	—
Bonds	15%	10,000	15,000	5,000	750
Bonds	10%	100,000	—	—	—
Bonds	5%	50,000	—	—	—
Bonds	2%	—	50,000	50,000	1,000
Total Debit, Item (15)					$7,750

The excess long values in a category should not be used to offset excess short values in another category.

The above relates only to charges on "excess" short positions in the accounts covered by item (15). It does not affect the charges on long positions in such accounts or the determination of any other debit item or credit item.

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"Credit lines" and "½ of 1% overall"

(24) The amount required by item (17), total of credit lines granted, is determined by multiplying the number of contracts in an account, on which credit has been granted, by the amount of credit granted on each such open contract. From the amount so determined, deduct the equity or deficit in that account (after application of current outstanding margin calls). The deduction, however, cannot exceed the amount of credit granted.

After the amount of credit granted has been determined for each customer's account, the amounts are totalled for accounts which have net long positions and separately for accounts which have net short positions. The amount required by the accounts with net longs or with net shorts, whichever amount is greater, is used. To this amount is added the amount determined for accounts with no net positions.

If an account has open positions in only one commodity, the number of contracts determines the net position. If it has a net long position in one commodity and a net short position in a different commodity, the market value determines the net position.

(25) The amount required by item (18), ½ of 1% of market values of total long or total short future contracts in each commodity, may be determined by eliminating from each customer's account purchases of a commodity in one contract month and sales of the same commodity in a different contract month provided such contracts were made in the same market.

After such eliminations, the total market values of the remaining contracts long and short in all customers' accounts are determined separately for each commodity. The greater of the long value or short value of each commodity enters into the computation of the ½ of 1% as in the following example:

	— *Market Value* —		
	Long	*Short*	*Greater of Long or Short*
Coffee	$ 200,000	$ 100,000	$ 200,000
Cotton	1,500,000	1,000,000	1,500,000
Sugar	300,000	200,000	300,000
Corn	500,000	700,000	700,000
Oats	150,000	150,000	150,000
Wheat	1,000,000	1,300,000	1,300,000
			$4,150,000
Amount Required, ½ of 1% of Total			$ 20,750

Contractual Commitments

Proprietary accounts and customers' accounts in deficit

(26) Debit and credit items shall be adjusted for contractual commitments other than uncleared regular way purchases and sales of securities.

¶ 2325.15 Instructions.—Continued

Contractual Commitments—continued

When issued contracts, underwriting commitments and delayed delivery contracts

(27) A position in each security shall be considered as actual. The net cost of a long position should be included in item (9). The market value of a net long position should be included in item (5). Such market value and the amount of charge based on the pertinent percentage should be included in item (14). If the market value included as a credit in item (5) exceeds the debit included in item (9) plus the amount of charge included in item (14), such excess shall also be included as a debit in item (9). Where no position exists, any loss should be included in item (9) and any profit disregarded. In the case of a short position any excess of the short position, at market, over the net proceeds should be included in item (9) and any profit, at market, disregarded.

If when issued transactions will be consummated within 30 days, they may be considered as actual without restriction.

Spot (cash) commodities contracts

(28) A position in each commodity shall be considered as actual and treated the same as when issued contracts. Net sales should be considered as hedges of any spot position in the same commodity which is included in item (14).

Commitments in foreign currencies

(29) Any loss, at market, in each foreign currency shall be included as a debit in item (9). Any profit, at market, shall be disregarded.

Joint trading and investment accounts in which the firm particpates

(30) Include firm's portion of debit or credit balance (without adjustment for any deposit) in item (9) or item (3) respectively. Include its portion of short position, at market, in item (11). Include in item (5) its portion of the market value of long securities. Such market value of long securities and the amount of charge at the pertinent percentage should be included in item (14). Any margin deposit is not to be included as a debit in computing capital.

Joint foreign and domestic arbitrage accounts in which the firm participates

(31) Money balances and securities positions carried by the firm and by a participant may be combined and considered on a net basis (offsetting positions in the same security may be eliminated). Adjustments may be made where different clearance dates apply to transactions made on the same day in the same security.

Include firm's portion of net debit or credit balance in item (9) or item (3) respectively. Include its portion of short positions, at market, in item (11). Include in item (14) its portion of the market value of long securities and the amount of charge at the pertinent percentage. Do not include, in item (19), any cash margin deficiency in connection with the participant's share of such account carried by the firm.

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Information Regarding Capital Requirements

.16 Applications for higher percentage treatment.—Applications under .10 of Rule 325 [¶ 2325] should be submitted in writing to the Department of Member Firms. Such applications, in addition to clearly reciting the nature of the request for higher percentage treatment, should include the following information:

(1) Complete description of the security, including the number of shares of stock or principal amount of bonds involved;

(2) statement as to whether the shares of stock or principal amount of bonds are presently reflected in proprietary accounts. If not, an indication should be made as to the date on which the security is to be purchased or on which there will be a contingent commitment to purchase; and

(3) the rating assigned the security by a nationally-known statistical service and the name of such statistical service. If a rating is not available, it should be so stated.

.17 General partners' securities and equities in computation of net capital.—No securities and equities in partners' individual accounts will be included as partnership property in computing the Net Capital of a member firm unless the partnership articles of the firm or some supplemental agreement specifically provide for such inclusion.

The phraseology of such provisions will necessarily vary as between different firms and therefore no standard form has been prescribed. However, a suggested form, containing the essential features of such provisions may be obtained from the Division of Documents, Department of Member Firms. Member firms are particularly cautioned to consider this suggested form merely as a guide and to consult their own counsel before adopting it or any other form of agreement, since substantial rights of the firm and of the individual partners may be affected. Before adopting any particular wording, member firms are urged to submit their proposed form of agreement to the Division of Documents, Department of Member Firms, in order to ascertain whether or not it is satisfactory from the Exchange's point of view.

If the partnership articles or supplemental agreement merely subordinates the claim of a partner to the claims of creditors of the partnership arising out of any matters occurring before the partner ceases to be a partner in the firm, the Exchange, in the event of the death of such partner, will immediately upon his death have to disallow the securities and equities in the partner's individual accounts in computing the firm's Net Capital. If the partner desires to have such equities and securities treated as firm capital after his death the agreement which is in effect at his death must specifically provide that the securities and equities in his account at the time of his death are to continue as capital of the firm at the risk of the business for a stated period of time after his death and all claims of the estate of the deceased partner must be subordinated to the claims of all present and future creditors of the firm arising out of any matters occurring prior to the end of the stated period.

.18 Deceased or withdrawing partner's interest in continuing firms.—

I.

Where the partnership articles of a member firm do not include specific and legally adequate provisions to the effect that the claim of the personal representative of a deceased partner to the partner's interest in the firm shall be

¶ 2325.18 **Information Regarding Capital Requirements.**—Continued

subordinated to the claims of all present or future creditors of the continuing firm (or any successor firm) arising out of matters occurring subsequent to the partner's death, the Exchange cannot, upon the partner's death, regard his interest as continuing to be part of the Net Capital of the continuing or successor firm.

Provisions in a deceased partner's Will permitting executors to continue a partner's capital interest at the risk of the business should not be relied upon as being effective immediately upon the partner's death, inasmuch as such provisions cannot, in any event, be availed of for a considerable period thereafter. Unless there are appropriate provisions in the partnership articles subjecting such capital to the risk of the business during the interim, the Exchange upon the partner's death cannot treat his interest as part of the firm's Net Capital. In many cases such a situation might render it necessary for the continuing firm to find additional capital immediately upon the death of the partner in order to meet the Exchange's capital requirements.

While the inclusion in the partnership articles of provisions continuing a deceased partner's interest at the risk of the business after his death is a matter to be determined in every case by the wishes of the partners, if it is the desire and intention of the partners of any firm that the interest of a deceased partner shall be considered, without interruption after his death, as a part of the capital of the continuing or successor firm for a specified period, the partnership articles should effectively provide in substance:

(1) That the payment of the deceased partner's interest in the firm to his estate be deferred for a stated period; and

(2) that until such payment, the interest of the deceased partner shall remain at the risk of the business of the continuing or successor firm and shall be considered as capital of such firm in the same manner and to the same extent as capital contributed by a limited partner; and

(3) that any claim of the personal representative of the deceased partner to such interest shall be subordinated in right of payment and subject to the prior payment or provision for payment in full of claims of all present and future creditors of the continuing firm (and any successor firm) arising out of any matters occurring before the end of the stated period.

If the partnership articles provide that such provisions are not effective unless affirmatively consented to by the personal representative of the deceased partner or if the personal representative is given the right, either to withdraw the capital or to terminate the continuing or successor firm before the end of the stated period, the deceased partner's capital can not be allowed by the Exchange in computing the firm's net capital after the date when the personal representative's consent is required or when the withdrawal of the capital or termination of the firm may be made effective except as follows: If the partnership articles give the personal representative the right to withdraw the capital prior to the end of the period during which it is otherwise kept at the risk of the business, all of such capital will not necessarily be disallowed by the Exchange from and after the date when such withdrawal might be effected, if the following additional conditions exist:

(1) The right to give notice (which may not be less than on 30 days) of a future withdrawal of capital may not accrue prior to the

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expiration of at least three months following the date of the personal representative's appointment.

(2) The personal representative shortly prior to the time when he may first give notice of withdrawal (whether he intends to give such notice or not) should submit to the Exchange an affidavit setting forth the known and estimated liabilities of the estate (including taxes), the estimated value of the estate's assets, a statement showing whether any income tax returns of the decedent have not yet been audited by the tax authorities and a statement that to the best of his knowledge and belief, the decedent made no gifts during his lifetime which might be construed as being subject to estate or inheritance taxes, and the Exchange must be satisfied that the indications are that the estate will prove solvent.

(3) The Will of the deceased partner must contain specific affirmative authority to the personal representative to leave the deceased's capital in the firm in the executor's discretion, notwithstanding his option of withdrawing it.

(4) The representative and the firm should both undertake to advise the Exchange promptly upon discovery that there appears to be any substantial increase in the estate's liabilities or decrease in its assets as compared with the figures given in the affidavit which might indicate a greater possibility than theretofore of estate insolvency.

Even if all of the foregoing conditions are fully met, a right of withdrawal in the personal representative will necessitate disallowance by the Exchange of the deceased partner's capital if one or more of the representatives of the deceased partner is also a partner in the firm. In any case, the Exchange reserves the right, in its sole discretion, to disallow the deceased partner's capital at any time.

In drafting provisions for inclusion in partnership articles, it should be borne in mind that if the partnership has a stated termination date and the capital of a deceased partner is placed at the risk of the business until the end of the partnership term, the death of a partner near the end of the term might necessitate a disallowance by the Exchange of his capital interest within a very short time. In order to avoid this difficulty, it may be desirable to make appropriate provision for the continuation of the capital at the risk of the business of a successor firm for a further stated period after the termination of the firm of which the deceased partner was a member.

If the surviving partners (rather than the personal representatives of the deceased partner) are to be given the right to elect whether or not the capital of a deceased partner is to be continued at the risk of the business of a continuing or successor firm, it may be desirable to provide that the capital is left absolutely at the risk of the business for a specified period, with the right in the surviving partners, prior to the expiration of such period, to elect to continue it for a longer time. Such a provision should obviate the necessity of making such an election immediately upon the death of the partner. If any of the surviving partners are also executors or administrators of the deceased partner the Exchange may not, for capital purposes, be able to give effect to such election.

If it is the desire of the partners to have a deceased partner's capital continued for a stated period immediately following his death, with the option in his personal representatives (rather than the partners) to continue it for

¶ 2325.18 Information Regarding Capital Requirements.—Continued

a longer period under the provisions of the deceased partner's Will, it is suggested that the stated period in the partnership agreement be made sufficiently long so as to permit the conditions discussed below with respect to testamentary provisions to be complied with.

II.

With respect to provisions in a deceased partner's Will (as distinguished from those in a partnership agreement) providing that the personal representative shall or may become a limited partner in the firm or subordinate the claim of the estate to decedent's interest to the claims of firm creditors who become such after the decedent's death, the Exchange's determination whether or not to allow a deceased partner's capital interest in computing the Net Capital of the firm will depend on the facts and circumstances of each case as they exist at the time of such determination. However, in no case will such testamentary provisions be considered as effective in connection with the Exchange's computation of Net Capital unless at least the following conditions are met:

(1) The Will must contain provisions specifically authorizing the personal representative of the deceased partner either to continue the deceased's capital interest in the firm as limited capital, or otherwise to subordinate the estate's claims against the firm to the claims of creditors. Moreover, unless a change in the personnel of the successor firm is to terminate such authority, the Will must provide that the capital can be continued at the risk of the business of the continuing or successor firm despite changes in personnel in that firm.

(2) The period prescribed by law within which creditors of the decedent are required to file their claims against the estate must have expired.

(3) The Exchange must be furnished with affidavits setting forth the financial status of the decedent's estate.

(4) The Exchange must be furnished with a satisfactory opinion of counsel to the estate, to the effect that (A) the personal representative is duly authorized to become a partner in the firm or otherwise to subordinate the deceased partner's capital interest, (B) that there is no State tax lien on the decedent's interest, (C) that the decedent's interest is at the risk of the business for a stated period, and (D) that any claim which any legatees or creditors of the decedent may have is subordinated in right of payment to the claims of all firm creditors arising during the stated period.

(5) The Exchange must be furnished with a release of the Federal Estate Tax lien or satisfactory evidence that such tax has been paid in full and that there are no further claims against the estate in connection therewith.

(6) The personal representative of the decedent must have taken appropriate action either to become a limited partner in the firm or to subordinate the capital interest of the deceased partner as indicated above.

III.

In view of the fact that many partners of member firms may be serving in the Armed Forces, with the possibility that receipt of any knowledge of death

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may be considerably delayed, it is suggested that member firms having partners in the Armed Services consider the inclusion of provisions in their partnership articles continuing such partner's capital interest at the risk of the business until official notice of death is received and for an adequate length of time thereafter. It may also be desirable to specify the effect of an official notice that a person is "missing", e. g., that for the purposes of the articles such a notice shall be deemed the equivalent of notice of death or, on the other hand, that such a "missing" notice shall not be deemed notice of death until confirmation of actual death is received.

IV.

In drafting partnership articles, it is suggested that consideration be given to the question of whether or not appropriate provisions should be included with respect to the disposition and status of a partner's capital interest upon his withdrawal from the firm (as distinguished from his death). It is desirable to specify when his capital is to be repaid to him and whether or not, until such payment, it is to remain at the risk of the business of the continuing or successor firm.

V.

It is recommended that member firms consult their own counsel with respect to the advisability of incorporating in their partnership articles provisions of the sort discussed in this Section. Any member firm which decides to adopt such provisions should submit the proposed provisions, prior to execution, to the Division of Documents, Department of Member Firms. Such member firm will then be advised whether, upon the adoption of such provisions and in the event of the death of a partner, the Exchange will be in a position to consider his interest in the firm as part of its net capital for the specified period following his death.

Information regarding the procedure followed by the Exchange in connection with indicating the interest, if any, of a deceased partner in a member firm in the listing of member organizations in the "Member Organizations" Section of the Directory, Vol. 1, N. Y. S. E. Guide, may be obtained from the Office of the Secretary.

.19 Borrowings of cash and securities by members, partners and stockholders of member organizations for capital purposes.—All borrowings, regardless of size or description, and whether collateralized or not, of cash or securities, where the proceeds represent or will represent capital of an individual member or a member organization under Rule 325 [¶ 2325], should be reported promptly to the Exchange.

As a matter of policy, the Exchange requires that the documents which evidence these borrowings for capital purposes conform to certain standards and that copies be submitted to the Department of Member Firms before the cash or securities involved may qualify as capital acceptable for inclusion in the computation of net capital under Rule 325 [¶ 2325].

The character of the documents varies, depending upon whether the lender is an individual, a member of a national securities exchange, bank, estate, trust, corporation, partnership, etc.

Borrowings for capital purposes should be executed on a time basis of at least six months' duration or, preferably, for a longer period of time. Capital borrowings of shorter duration are not acceptable unless, due to exceptional circumstances, they have received the prior approval of the Exchange.

¶ 2325.19 Information Regarding Capital Requirements.—Continued

It is, therefore, important that borrowers of cash or securities for capital purposes communicate with the Department of Member Firms (Extension 229, 387 or 455) prior to the consummation of any such borrowing to be sure the terms of the arrangement will permit the borrowed funds to be considered as capital under Rule 325 [¶ 2325].

A change in the amount or in any of the terms of a borrowing should be reported promptly to the Department of Member Firms in order that the Exchange will at all times have a current record of the status of such borrowed capital.

With respect to borrowings by a member organization on a subordinated basis, where the proceeds are to be considered in the computation of net capital under Rule 325 [¶ 2325], see .20, below.

.20 Subordinated borrowings by member organizations.—All subordinated accounts and all subordinated borrowings by a member organization—whether of cash or securities or both—where the proceeds are to be considered in the computation of net capital under Rule 325 [¶ 2325] must receive prior approval of the Exchange. Such borrowings may be arranged with anyone acceptable to the Board of Governors and are subject to the following provisions:

(1) Subordinated borrowings of cash

(A) The lender may be paid interest not exceeding 8%.

(B) If the lender is

(i) a member of the family of one of the borrowing organization's general partners or holders of voting stock, or of a deceased general partner or holder of voting stock;

(ii) an estate of or trust established by or for one of the borrowing organization's general partners or holders of voting stock;

(iii) one of the borrowing organization's employees or the employee pension, retirement or profit-sharing plan of the borrowing organization; or

(iv) a limited partner or holder of non-voting stock of the borrowing organization

he may also share in organization profits to a reasonable extent.

(2) Subordinated borrowings of securities; subordination of equities in customers' accounts

(A) If the lender is a person listed in (1)(B) above, he may be paid interest not exceeding 8%. He may also share in organization profits to a reasonable extent.

(B) If the lender is anyone other than those listed in (1)(B) above

(i) the lender's major account shall have been with the borrowing organization for at least two years, unless the lender had not been a customer of any organization for two years.

(ii) the number of such borrowings by a member organization shall be reasonable in relation to the size of the organization, and the total dollar amount of such borrowihgs shall not

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constitute more than 25% of the total capital of the borrowing organization.

(iii) compensation for the loan or subordination of the account shall not exceed 4% on the value of the securities.

(3) Application of the borrowing member organization shall be filed with the Exchange together with application signed by the lender, in form prescribed by the Exchange, which shall contain at least the following information:

(A) name of the lender; (in the case of subordinated borrowings of securities or of subordination of equities in accounts, identify the relationship of the lender to the organization or one of its general partners or holders of voting stock).

(B) amount of borrowing;

(C) effective date;

(D) expiration date;

(E) compensation for the subordinated loan or subordination of the account, and

(i) interest rate, if fixed, or

(ii) details as to how it is to be calculated if it is to be measured by profits of the firm or by any direct or indirect interest in the distribution of the profits of the corporation.

(4) At the time the application for approval to make a subordinated borrowing is submitted to the Exchange for posting, there should accompany such application:

(A) signed copy of the subordination agreement in form prescribed by the Exchange;

(B) opinion of counsel to the borrowing organization stating that the subordination agreement is binding and enforceable in accordance with its terms upon the lender,

(C) check of the applying member organization for $100 covering Exchange fee for consideration of the application. While the fee is payable at the time of posting, a member organization may request that the charge be placed on the regular quarterly statement from the Exchange.

(5) A statement of a proposed lender for approval to make a subordinated loan to a member organization is ordinarily not acted upon by the Board of Governors until after notice of the proposal has been posted on the Bulletin Board of the Exchange for a period of two weeks. Such notice is posted upon submission, in proper form, of all required papers in connection with the proposal.

(6) The minimum time basis for a subordinated loan by a member organization shall ordinarily be at least one year, except that (A) in the case of a member firm, if the partnership agreement provides that limited partners may withdraw their capital contributions upon written notice of 90 days or less, and (B) in the case of a member corporation, the Certificate of Incorporation authorizes the redemption of the non-voting stock upon written notice of 90 days or less, provision may be made for payment in full of principal and interest prior to the expiration of the loan 90 days after written demand.

3546 Rules of Board—Capital Requirements
Administered by Department of Member Firms.

¶ 2325 Information Regarding Capital Requirements.—Continued

.30 Disclosure of subordinated borrowings in financial statements to customers.—Subordinated liabilities of member organizations shall be disclosed in the body of condensed financial statements issued to customers and such disclosure shall not be made solely by means of footnotes to such statements.

The subordinated liabilities may be shown in a separate section on the liability side of the statement following current liabilities and preceding net worth or capital or may be shown, for example, as follows:

* Subordinated Liabilities and Capital:

Liabilities subordinated to claims of general creditors ..... $.....

Capital (net worth or other acceptable title)... ....

* If desired, this caption may be eliminated.

If any subordinated liability is covered by an agreement which will expire within a short time and which will not be renewed, the time of expiration of such agreement should be clearly shown.

(See Rule 419 [¶ 2419] *for requirements re financial statements to customers.)*

[The next page is 3571.]

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FEBRUARY 12, 1964.

To: Henry M. Watts, Jr., chairman of the board of governors.
From: Special committee on member firms' commodity business.
Subject: Report of special committee on member firms' commodity business.

This committee, appointed by your memorandum dated November 29, 1963, was instructed to study the broad question of whether or not the exchange should change some of its rules and regulations in order to protect better the securities customers of its member firms also doing commodity business against losses which might occur in the commodity end of the business. It was also suggested that the committee might well consider such specific questions as:

(1) Divorcing the NYSE firms from any involvement in commodity transactions.

(2) Pro's and con's of incorporating—or setting up a separate entity for commodity business for member organizations.

(3) Reports to the New York Stock Exchange or other agency on the size of commitment by individual clients. Should the exchange be sent copies of the daily reports presently sent to the Commodity Exchange Authority?

(4) No credit for spot or cash transactions by NYSE members.

(5) Possibility of increasing haircut to 1 from one-half of one percent, i.e., money charge to net worth for commodity business.

The committee was helped in its consideration of these questions by numerous communications from our member firms. In addition, we met with a special committee of the Chicago Board of Trade and with representatives of the Cocoa Exchange and Coffee & Sugar Exchange and explored at length and in detail what each of us might do to avoid any future occurrence of a situation similar to the *Ira Haupt & Co.* case. It is anticipated that the various commodity exchanges will amend their rules to attempt to prevent a recurrence, but we have prepared our recommendations to you on the assumption that the New York Stock Exchange should amend its own rules in whatever way necessary to endeavor to better protect the securities customers of its member firms.

NYSE FIRMS AND THE COMMODITY BUSINESS

Divorcing New York Stock Exchange firms from any involvement in commodity transactions appears to be the simplest solution to the problem and, as might be expected, has the support of a substantial number of member firms not now doing a commodity business. However, most of the larger member firms are included in the approximately 80 NYSE member firms that carry or introduce commodity accounts. Were these firms to withdraw from the commodity business the commodity market system would, in all probability, be severely disrupted. A substantial amount of the speculative as well as trade futures business in commodities is generated by the extensive and expertly equipped commodity departments of these firms. It appears that without speculative business the commodity futures markets could not perform their important economic function of providing hedging facilities for the trade. Most producers and handlers of commodities try to offset the risk of fluctuating prices by hedging in the futures markets. In this way, the cost of materials is known in advance, and the producer, distributor, or processor can concern himself with the operations of the business rather than the speculative risks involved in inventory. In fact, it has been stated that users of commodities could not run a high-volume, low-price business without the protection offered by the hedging facilities of the futures markets. In addition to providing the risk position necessary for hedging operations of the trade, the speculator gives the market liquidity, keeps delivery positions and interrelated markets in alinement through arbitrage activity and helps to set the real value for a commodity. As was mentioned before, NYSE firms are uniquely equipped to generate this speculative futures business without which the movement of commodities might be critically handicapped. This committee, therefore, does not recommend divorcing NYSE firms from the commodity business.

However, if member firms are to be allowed to continue to involve themselves with commodity transactions, the committee feels that exchange member firms must have sufficient excess capital to minimize the risks to all customers of all New York Stock Exchange firms. The committee below proposes such modifications of the capital requirements to achieve this objective.

The question of setting up a corporate affiliate for the commodity business also received extended consideration. A corporate commodity affiliate, unlike a corporate securities affiliate, would be carrying commodity customers' ac-

counts and positions over extended periods of time. If the corporate commodity affiliate is to carry customers' accounts and positions it appears to us that the capital charges recommended below should be applicable to it. We do not believe it is in the interests of the exchange community to have a member firm's commodity affiliate get into financial difficulties, even though the firm itself might not be liable to the affiliate's commodity customers and creditors. It is, therefore, the committee's opinion that the recommendations made below are more desirable and basically more effective than mandatory incorporation.

On the question of requiring daily reports to the exchange on the size of commitments by individual clients, the committee believes it is not desirable or administratively feasible for the exchange to be in a position where it may be asserted that the exchange is responsible for day-to-day surveillance of the commodities business of member organizations.

THE ALLIED CRUDE PROBLEM

As a preliminary step, the committee studied the situation that led to the serious financial problems of J. R. Williston & Beane, Inc., and the liquidation of Ira Haupt & Co.

Before its failure the Allied Crude Vegetable Oil Refining Corp. was regarded as one of the major and most efficient processors of crude vegetable oils. Exactly what happened is not yet clear but it appeared, after the corporation filed under chapter XI of the Bankruptcy Act on the afternon of November 19, 1963, that quantities of crude vegetable oil were missing from tanks of the warehouse companies whose warehouse receipts Allied had put up as collateral, and numerous forged warehouse receipts had been accepted as collateral by various brokers, banks, and other creditors, involving a loss running into many millions of dollars.

It appears that Allied and its affiliated companies by November 15, 1963, had purchased large percentages of the outstanding open interest in futures contracts of both soybean oil and cotton seed oil through Ira Haupt & Co., and J. R. Williston & Beane. As a user or processor of oils Allied was a so-called trade customer. Commodity exchange rules require brokers for trade customers to deposit with the clearinghouse minimum dollar amounts for each contract. The commodity exchange rules applicable in the circumstances, in one instance did not require the broker to obtain similar margin from its trade customer but did require that the trade customer keep his position with the broker marked to the market. Allied was able, apparently, to meet variation margin calls at least partially by the proceeds of money made available to it by Williston & Beane and Haupt on advances collateralized by field warehouse receipts for spot oils. The brokers in turn rehypothecated the warehouse receipts with banks.

Haupt was first approached by Allied for the carrying of its account and the financing thereof in the fall of 1962. Haupt at first rejected the account but after credit checks, including commodity specialists, legal counsel, and banking associates, decided to accept the account but limited credit on warehouse receipts to $2.5 million. Haupt's net worth at the time was about $7.9 million. It appears that if the credit limitation had been maintained Haupt would nevertheless have had a problem on meeting exchange capital requirements upon the bankruptcy of Allied, but probably would have avoided the need for liquidation.

It appears that on September 26, 1963, Allied's total position at Haupt in oil futures was approximately 2,800 contracts. This position spiraled rapidly thereafter to a position of 15,144 contracts on November 15. Haupt during this period had accepted additional warehouse receipts as collateral. It is not clear why Haupt did not maintain its original credit limitations. There are indications that during this period the firm's supervisory control failed to function properly. The partner who had been in charge of the firm's commodities operations retired from the firm in July 1963, and apparently no other partner was assigned clear responsibility thereafter.

On Thursday, November 14, the commodity markets slumped, and over the next 5 days Haupt issued margin calls to Allied totaling approximately $15.5 million, none of which was paid.

Williston & Beane had also accepted an Allied account in 1959 which after some initial activity remained inactive until August 1961. The exchange in January 1963 in the course of its normal surveillance of member firm financial affairs, noted a growing commodities exposure in the Williston accounts. Subsequent discussions between the exchange and Williston officers resulted in the firm agreeing with the exchange to reduce its commodities debits in the Allied spot account to $1½ million and to not exceed that figure and to limit the contracts in the Allied futures accounts to 1,000; 1,200.

On Friday, November 15, most of Williston's commodity debits were in the Allied account. Their calls to Allied after the commodities market breaks were similarly not honored by Allied. The amount of the losses, however, was curbed because of the debit limitation which had been suggested by the exchange. In the case of Haupt, however, the latest New York Stock Exchange financial questionnaire was as of September 26, 1963, before the major buildup of commodities position in October and November. It was received by the exchange in October and analyzed. On Tuesday, November 12, an exchange examiner was sent to the firm to make the annual spot check of the firm's operations. Such an inspection begins with a verification of the accuracy of the latest financial questionnaire. This verification was underway when the Allied problem became acute. The exchange examiner had not yet reached the point of spot checking commodity records.

Over many years, the exchange has developed in rule 325 a system of financial control which, absent fraudulent conduct had been 100 percent effective for more than 25 years. Since 1900, the solvency record of member firms compares very favorable with that of the Nation's banks. Between 1938 and 1960 there was no failure among member organizations. The Du Pont, Homsey failure in 1960 was a result of fraud by a partner, against which the exchange has now arranged fidelity insurance coverage of partners by firms and the exchange itself.

The question arises as to how exchange rules can be amended to limit exposure resulting from involvement in commodity markets. In the committee's opinion, the answer lies in providing for additional capital charges.

COMPARISON OF SECURITIES AND COMMODITIES ACCOUNTS

When a member firm carries customers' accounts on margin, the firm is financing the customer whether securities or commodities are involved. However, a commodities margin account is not strictly comparable to a securities margin account. At present, in a securities margin account on an initial purchase the customer must put up $70 and the member firm finances $30 of every hundred dollars purchased. The member firm in turn usually borrow $30 from a bank against a reasonable amount of the margined securities to finance its advances made for the customer. The exchange maintenance margin rule requires that an equity equal to at least 25 percent of the market value must be maintained on securities held long in margin accounts. When there is a margin deficiency in a customer's securities account, such margin deficiency becomes a charge against capital.

Initial deposits of money in a commodity futures account do not represent a partial payment of the total value of the contract, as is the case with a securities margin account, but rather represent protection for the firm and the clearinghouse against the possible fluctuation in the price of the commodity between the date the futures contract is purchased and the month of delivery. These commodity exchange requirements which may be changed from time to time are based on experience in the price movements of the particular commodities. In addition, margin requirements of commodity exchanges are different for speculative customers than they are for trade customers. The philosophy behind this difference is that the trade customer in most instances is using his futures contracts as a hedge against purchases or sales of spot commodities which he has made in order to operate his business.

The exchange has an overall capital charge of one-half percent of the total value of all longs or shorts (whichever is the greater) in all customers' commodity accounts carried by the firm.

The commodity exchanges impose a daily limit fluctuation on the price of each commodity. In the case of cottonseed oil this daily trading limit at the time of the Haupt episode was $0.02 a pound or $1,200 on a contract. Consequently an account with 1,000 contracts of cottonseed oil could, if the daily trading limit were reached, require additional margin of $1,200,000 as a result of marking to the market on the basis of 1 day's fluctuation. In a similar situation an account with 15,000 contracts would require additional margin of $18 million.

The committee makes the following recommendations, some involving capital charges and some involving training and supervision requirements to be invoked upon member firms doing a commodities business:

1. Charge to capital resulting from advances on warehouse receipts:

The full amount of any advance against a warehouse receipt shall be a charge against capital, except in respect of an advance for a period not exceeding 90 days, against a commodity tendered on an exchange for delivery on a contract, in

respect of certified stock or deliverable grades, against a warehouse receipt issued by a warehouse licensed by a commodity exchange.

This should effectively eliminate the risk incurred by the use of spot commodities to provide margin for futures contracts, as was done in the Allied Crude Vegetable Oil Refining Corp. accounts at two member firms.

2. If the daily limit fluctuation of all futures contracts in a customer's account amounts to more than 10 percent of the carrying member firm's net worth, the excess thereof over such 10 percent of net worth will be a charge in the computation of the member organization's net capital.

This has the effect of limiting the size of a customer's commodity positions. In the *Ira Haupt* case, the imposition of this capital charge would have prevented the growth of the Allied position beyond 1,180 contracts, having a value of approximately $7,316,000. (The positions ran as high as 15,165 contracts having a value of $95,032,000.)

3. The New York Stock Exchange should not adopt any commodity margin requirements. The requirements of respective commodities exchanges shall govern, except that if the relevant commodity exchange does not prescribe original margin, the clearinghouse margin shall prevail. Further, when such original margin is depleted 50 percent thereof, a margin call for restoration shall be made to bring it up to the original requirement, and if not so restored the margin deficiency shall become a charge against capital.

4. That the present overall capital charge of one-half percent of the total value of all longs or shorts (whichever is the greater) be increased to 1½ percent and that in computing total longs and shorts, the existing privilege of exempting straddles be confined to straddles in the same crop year.

5. That every firm doing a commodity business shall have in charge of such department a general partner or voting stockholder, and so registered with the exchange.

6. That persons engaged in the commodity business, either partners or employees, should be tested for their qualifications, and if the commodity exchanges do not develop such a program, the New York Stock Exchange should.

Your committee believes that the rules it proposes for adoption by the board of governors, outlined in the preceding paragraphs, should be adequate to prevent the endangering of securities customers' assets in the conduct of commodity business by a member firm.

In retrospect, it is clear that the exchange's capital requirements as they apply to commodities accounts must be strengthened. Providing that these changes are made, your committee believes that the exchange margin and capital requirements are still the most effective method of protecting customers of member organizations and avoiding insolvencies.

CHARLES B. HARDING, *Chairman.*
HARRY B. ANDERSON.
WILLIAM K. BECKERS.
RICHARD M. CROOKS.
HERMAN S. KOHLMEYER.
WILLIAM REID.
HOMER VILAS.
DAVID WELD.

CAPITAL RULE 325

The following amendments to the definition of "Net capital" in rule 325 would effectuate the recommendations of the Special Committee on Member Firms' Commodity Business:

Rule 325(b)(4)(A), add the following:

(vi) Debit balance in customer's spot (cash) commodity account other than the result of a tender made on a futures contract within the past 90 days and evidenced by a warehouse receipt issued by a warehouse licensed by a commodity exchange. (See (c)(11) below.)

Rule 325(b)(4)(F)—Commodity futures, customers' accounts, substitute the following:

(F)(i) Total of amount by which the daily limit fluctuation of all future commodity contracts carried for a customer's account or accounts controlled by a customer exceeds 10 percent of the net worth of the member organization. Contracts in each customer's account representing purchases and sales of a like amount of the same commodity in the same market and in the same crop year may be eliminated. The daily limit fluctuation for future contracts effected in

foreign markets is to be considered the same as if such contracts had been effected in a domestic market. (See (c) (11) below.)

(ii) One and one-half percent of the market values of the greater of either the total long or total short future contracts in each commodity carried for all customers. Contracts in each customer's account representing purchases and sales of a like amount of the same commodity in the same market and in the same crop year may be eliminated. (See (c) (11) below.)

Rule 325(b) (4) (H) substitute the following:

(H) Cash required to provide margin equal to—

(i) the amount required to restore the original margin required by the pertinent commodity exchange (or the clearinghouse requirement, per contract, if the commodity exchange has no original margin requirement) when the original margin has been depleted by 50 percent on all future commodity contracts in each customer's account. Cash required should be exclusive of liquidating deficits. (See (c) (9) and (11) below.)

(ii) Twenty percent of the market value in each customer's account in equity containing spot commodity positions, evidenced by a warehouse receipt issued by a warehouse licensed by a commodity exchange, which are the result of future contracts tendered through an exchange within the past 90 days, but not hedged by future contracts in the same commodity. (See (c) (9) and (11); and

(iii) Ten percent of the market value in each customer's combined account in equity when such account contains spot commodity positions, evidenced by a warehouse receipt issued by a warehouse licensed by a commodity exchange, which are the result of future contracts tendered through an exchange within the past 90 days, and hedged by future contracts in the same commodity. (See (c) (9) and (11) below.)

(Whereupon, at 12:10 p.m., the committee recessed, subject to call of the Chair.)

INVESTOR PROTECTION

TUESDAY, FEBRUARY 18, 1964

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE OF THE
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to recess, in room 1334, Longworth Building, Hon. Harley O. Staggers (chairman of the subcommittee) presiding.

Mr. STAGGERS. The committee will come to order for the continuation of hearings on H.R. 6789 and H.R. 6793.

Chairman Cary, the subcommittee is pleased to have you back with us this morning to discuss with us the pending legislation and other aspects of your lengthy study into the adequacy, for the protection of investors, of the rules of the stock exchanges and of the National Association of Securities Dealers.

It is our hope that with your testimony we shall be able to complete this phase of our hearings into the results of your study and your recommendations for legislation and for changes in the rules of these associations and of the Commission.

It is my understanding that in your reappearance you wish to address yourself to a number of matters, questions, and problems which have come up during the course of the hearings these past weeks, such as the extension of your jurisdiction to require the registration of presently unlisted companies, including stock insurance companies; and the expansion of your authority over broker-dealers to permit you to compel their membership in a national association, to move against individuals in their firms, and to cover all their intrastate activities.

You have been requested, in addition, to discuss several other topics including two major ones relating to the protection received by investors in the treatment of cash credit balances or securities left with broker-dealers, and in the combination of broker-dealer functions in the activities of the specialist.

Since you were here 90 days ago, Mr. Cary, two very significant things occurred—the day you were here the New York Stock Exchange suspended two of its members for failure to meet the exchange's capital rule; 2 days later the President was assassinated. The effects of both events reach right to the fundamentals of the exchange and thus to the fundamentals of your regulatory responsibilities. The Haupt insolvency again brings into focus broker-dealer use of customer capital and the scope of the audits or examinations being made; the sharp drop in prices on the exchange on November 22 and rebound on November 26 again poses the question of the role of the specialist.

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While I have mentioned these two events of 90 days ago, I am sure you appreciate that the committee is well aware that these, and other matters, were before you long before last November. Both subjects were part of your special study which was first proposed nearly 3 years ago. Indeed, it is now over 2 years since you issued your report on the specialist activities on the American Stock Exchange.

Two weeks ago we heard from President Funston of the New York Stock Exchange on what that exchange has done, and partially what it currently is proposing to do about these two problems. In your reappearance here we wish to hear from you on what you and the Commission intend to do about them.

Before you proceed, however, I wish to include in the record at this point certain correspondence between the committee and the Commission, the exchanges, and the NASD, which relate to these subjects.

Correspondence with the Commission with reference to the *Ira Haupt & Co.* case, as follows:

1. Chairman Harris' inquiry of December 10, concerning what is the scope of the Commission's audit of registered broker-dealers, in view of the fact that the New York Stock Exchange does not make a complete audit, and the Commission relies on the exchange.

2. Chairman Cary's reply of December 19 to the effect that the *Haupt* case is leading the Commission to reassess both its audit procedures as well as the adequacy of existing rules and regulations governing the financial responsibility of broker-dealers.

3. Chairman Cary's letter of January 3, enclosing copy of memorandum prepared by the Division of Trading and Exchanges relating to the scope of the SEC examinations of broker-dealers.

4. Chairman Harris' letter of January 20 expressing the desire that when the hearings were reconvened, Chairman Cary might indicate exactly the Commission's intentions with respect to the protection of customers of a broker-dealer.

5. Chairman Cary's acknowledgment of this request.

This is the first insertion in the record.

(The material referred to follows:)

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., December 10, 1963.

HON. WILLIAM L. CARY,
Chairman, Securities and Exchange Commission,
Washington, D.C.

DEAR MR. CHAIRMAN: As you know, for some time I have been interested in the activities of the Commission in carrying out the special study that the Congress directed it to make relating to the adequacy, for the protection of investors, of the rules of national stock exchanges and national securities associations, and during the past few weeks of hearings upon the Commission's recommendations for legislation growing out of this study, I have followed with close attention your testimony both as to the legislative recommendations and as to other matters which the Commission has taken up or intends to effectuate through its rulemaking powers.

In the midst of these hearings has occurred the most unfortunate insolvency of a member of the stock exchange, stemming apparently from an overextension of the member's position in commodities rather than in securities.

I am informed that it is the practice of the New York Stock Exchange in making the financial audits of its members to confine such audit only to its members' activities in the securities fields and does not cover the members' activities in the commodities or other fields. This is most amazing and I hardly can believe that I am accurately informed inasmuch as it has appeared over the years and appears now in connection with the current Commission's special study that

there is very limited protection to the securities customer through any rules requiring the segregation or trusteeing of customers' accounts in the securities and of the business.

I am aware that during the past years we have had several occasions to discuss the Commission's audit activities and on those occasions have made inquiry into the frequency of the Commission's audit and how often the Commission covered all of the members of the exchange as well as the Commission's reliance upon the audit of the exchange. It appears that our questioning at that time properly should have concerned itself also with the question of the scope of the Commission's audit as well as its frequency, and accordingly I now am writing to determine just what is the scope of the Commission's audit of its registered broker-dealers.

Sincerely yours,

OREN HARRIS, *Chairman.*

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., December 19, 1963.

HON. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: Thank you for your letter of December 10, 1963, in which you request information concerning the scope of the Commission's audit of registered broker-dealers in light of the recent insolvency of a New York Stock Exchange member firm; namely, Ira Haupt & Co. I have requested the Commission's Division of Trading and Markets to prepare a detailed memorandum on existing audit and inspection procedures which will be forwarded to you shortly.

As you know, the Commission's program of routine inspection of broker-dealer firms generally excludes member firms of the New York Stock Exchange. The Commission does, however, require most registered broker-dealers, including all exchange member firms who do business with the public, to file annual financial reports, certified by an independent public accountant who must state that he performed an audit in accordance with generally accepted accounting principles. Financial reports filed by broker-dealers with the Commission contain information about customers' and firm commodity accounts for the purpose of evaluating the financial condition of the filing broker-dealer.

The Commission has exempted member firms of the New York Stock Exchange and certain other exchanges from the provisions of its net capital rule on the ground that the rules and procedures of these exchanges impose requirements more comprehensive than the requirements of the Commission's net capital rule. Similarly, the exclusion of member firms from the Commission's routine broker-dealer inspection program has been based upon the apparent adequacy of the exchange's examination of its own members which, among other things, covers the commodity activities of member firms.

Recently, the exchange has appointed a special committee of its members to study the adequacy of its own rules and procedures, in order to give greater protection to the securities customers of member firms carrying commodity accounts. In view of the existing exclusion of member firms from the Commission's broker-dealer inspection program and its net capital rule and our own residual responsibility over exchange rules and procedures, we intend to review carefully existing exchange rules and procedures in light of the events which transpired in the *Ira Haupt* case and any findings and recommendations of the exchange committee.

The circumstances surrounding the insolvency of Ira Haupt & Co. also call for a reassessment of the Commission's broker-dealer inspection procedures to insure that we are aware of situations involving substantial exposure risks, such as an overextension of credit, which may imperil customers' funds and securities. Such a reassessment is now underway. In addition, we have instituted a formal investigation of those aspects of the Ira Haupt situation relating to activities within the jurisdiction of this Commission to determine, among other things, the adequacy of existing rules and regulations governing the financial responsibility of broker-dealers. This inquiry, together with the report of the special study, should provide a basis for making an informed evaluation of the adequacy of such rules and regulations.

If we can be of further assistance in connection with this or any other matter, please let me know.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., January 3, 1964.

HON. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: In accordance with my letter of December 19, 1963, I am enclosing a memorandum prepared by the Commission's Division of Trading and Markets on the scope of the Commission's audit of registered broker-dealers. You had requested information on this matter in a letter dated December 10, 1963.

If we can be of any further assistance in connection with this or any other matter, please let me know.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

MEMORANDUM PREPARED BY THE DIVISION OF TRADING AND MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION IN RESPONSE TO A LETTER DATED DECEMBER 10, 1963, FROM HON. OREN HARRIS

In this letter of December 10 to the chairman, the Honorable Oren Harris made inquiry as to the scope of the Commission's audit of registered broker-dealers. This memorandum has been prepared in response to that request.

Section 17(a) of the Securities Exchange Act of 1934 ("Exchange Act") authorizes the Commission to conduct periodic, special, and other examinations of the books and records of registered broker-dealers. These examinations include the physical examination of the books and records, business practices, and activities of registered broker-dealers for the purpose of determining whether there have been any violations of the Federal securities laws. These examinations are not audits in the sense that that term is used in accounting parlance. In lieu of a Commission audit procedure, registered broker-dealers are required to file annual reports of financial condition certified by an independent certified public accountant, who must state that he performed an audit in accordance with generally accepted accounting principles.

The Commission generally does not examine the books and records of members of the New York Stock Exchange. The exclusion of member firms from the Commission's routine broker-dealer inspection program has been based upon the apparent adequacy of the exchange's examinations of its own members as well as the workload and budgetary considerations involved in a Commission program of inspection of such firms. Member firms of the New York Stock Exchange are also exempt from the Commission's net capital rule—rule 15c3–1—under the Exchange Act—because that exchange's "rules and settled practices are deemed by the Commission to impose requirements more comprehensive" than the requirements of the Commission's net capital rule.

In making an examination, Commission examiners seek to determine the general financial condition of the broker-dealer, his pricing and selling practices, the nature of safeguards employed in handling customers' funds and securities, whether adequate and accurate disclosures are made to customers, whether his books and records are maintained in accordance with the Exchange Act and rules thereunder, whether regulation T of the Federal Reserve Board has been complied with, and whether he has engaged in unlawful selling practices such as excessive trading or switching of customers' accounts. Broker-dealers are also examined with respect to underwritings, distributions, and dealer transactions.

A major purpose of Commisison examination is to ascertain compliance with rule 15c3–1, which is designed to safeguard customers' funds and securities by limiting the amount of indebtedness that may be incurred by a broker-dealer in relation to its capital or—stated in another way—by insuring that broker-dealers maintain a margin of liquid assets in relation to their indebtedness. Under the rule, "aggregate indebtedness" may not exceed 20 times the amount of "net capital."[1] Analysis is made of the items and accounts which comprise the firm's

[1] "Aggregate indebtedness" means the total money liabilities (arising in connection with any transactions), including debts not the subject of satisfactory subordination agreements of the broker-dealer, which are not adequately collateralized by its own assets and which are not segregated in accordance with the provisions of the Commodity Exchange Act, 7 U.S.C. 1–17a; "net capital" is essentially the net worth of the broker-dealer, reduced by certain percentages of the market value of most securities and certain commodities futures contracts, carried by the firm or partners, but including appropriately subordinated debt.

aggregate indebtedness and its net capital. The examiner must review all of the liabilities of the firm, certain asset valuations, and the components of the firm's net capital position.

The great majority of firms subject to examination do not deal in commodities contracts.[2] Commodity acocunts of broker-dealers are examined thoroughly, however, to determine compliance with the Commission's net capital rule.

An examination may be made to determine the adequacy of the safeguarding of customers' funds and securities, and in general to evaluate the financial responsibility of the firm. Although no rule of the Commission requires registered broker-dealers to segregate customers' free credit balances or fully paid securities, examiners ascertain whether there is such segregation, in connection with their review of the firm's net capital position. In this connection, the rules of the New York Stock Exchange and certain other exchanges require segregation and identification of customers' excess margin and fully paid securities. Subordination agreements are thoroughly scrutinized in order to determine compliance with the net capital rule. Extensions of credit to and from customers are examined with reference to compliance with regulation T of the Federal Reserve Board, as well as the net capital rule.

All registered broker-dealers are required to file annually certified reports of financial condition pursuant to rule 17a–5 under the Exchange Act. The prescribed form for the annual financial report calls for detailed statements with respect to the financial obligations and capital of the reporting firm. Moreover, the prescribed minimum audit requirements include appropriate comparisons of accounts and physical examination, verification and confirmation of specified items.

The financial questionnaire calls for data concerning borrowing by the firm; use of customers' securities or commodities as collateral for loans of the firm; securities borrowed, loaned, and failed to deliver; and securities and commodities accounts of the firm and its customers. Information is also required with respect to ledger balances, securities and spot commodities valuations, and net losses or gains on future commodity contracts in accounts of the reporting firm, officers, directors, or partners. Lastly, certain information is required regarding capital, contractual commitments, and contingencies. Information contained in these reports is utilized in conjunction with the Commission's examination program.

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., January 20, 1964.

Hon. WILLIAM L. CARY,
Chairman, Securities and Exchange Commission,
Washington, D.C.

DEAR MR. CHAIRMAN: I acknowledge your letter of December 19, 1963 responding to my request for information concerning the scope of the Commission's audit of registered broker-dealers. I note that you state—

"In view of the existing exclusion of member firms from the Commission's broker-dealer inspection program and its net capital rule and our own residual responsibility over exchange rules and procedures, we intend to review carefully existing exchange rules and procedures, in light of the events which transpired in the Ira Haupt case and any findings and recommendations of the exchange committee.

"The circumstances surrounding the insolvency of Ira Haupt & Co. also call for a reassessment of the Commission's broker-dealer inspection procedures to insure that we are aware of situations involving substantial exposure risks, such as an overextension of credit, which may imperil customers' funds and securities. Such a reassessment is now underway. In addition, we have instituted a formal investigation of those aspects of the Ira Haupt situation relating to activities within the jurisdiction of this Commission to determine, among other things, the adequacy of existing rules and regulations governing the financial responsibility of broker-dealers."

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[2] According to the Special Study of Securities Markets, 8 broker-dealers of the approximately 5,790 registered with the Commission reported commodities trading as their primary activity in 1961; another 34 reported commodities trading as their secondary activity. However, it should be pointed out that particularly among members of the New York Stock Exchange, commodities trading provides an important source of income even though such trading may not be a primary or secondary activity of the member.

It would seem to me highly appropriate that there should be underway such "reassessment" of these inspection procedures as well as of the adequacy of the Commission's and the exchanges' rules and regulations governing the financial responsibility of broker-dealers. I am somewhat puzzled, however, by your statement in this regard, for it was my impression that this was exactly one of the items that House Resolution 438 proposed should be studied and reported upon by the Commission.

I do hope that when you return to discuss some of the questions which have arisen in the course of hearings on H.R. 6789 and H.R. 6793, you will be able to give us some indication of precisely what action the Commission intends to take, or what recommendations the Commission may have for legislation to give the Commission authority to take action, to see to it that investors have the protection in this area which I think they have reason to believe they had been receiving under the Securities Exchange Act of 1934.

Sincerely yours,

OREN HARRIS, *Chairman.*

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., January 29, 1964.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. HARRIS: Thank you for your letter dated January 20, 1964, acknowledging my letter of December 19, 1963, concerning the Ira Haupt matter.

You may be sure that when I return to discuss some of the questions which have arisen in the course of the hearings on the legislation now pending before your committee I will have a statement on what action the Commission intends to take in the area of financial responsibility of broker-dealers.

I did not intend in any way to indicate in my letter of December 19, 1963, that we were restudying the same matters which the special study had carefully pursued in its report. However, while making recommendations designed to protect customers against misuse of their assets and in the event of an insolvency of a broker-dealer, the special study did not consider the specific problem of the exposure of securities customers to the risks of the commodity business—the cause of the failure of Ira Haupt & Co. In fact, the report of the special study stated that no attempt was being made to discuss financial responsibility problems arising in connection with commodity accounts. We are therefore, so far as I know, dealing in the *Haupt* case with a problem which has not heretofore been focused upon by the Commission. It is for this reason that we have instituted a formal investigation and are reassessing our own rules and procedures in light of the particular facts and circumstances of that case.

If I can be of further assistance, by all means, let me know.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

Mr. STAGGERS. Second, correspondence with others concerning the questions raised by the *Ira Haupt & Co.* case.

(1) On January 2, I requested both the American Stock Exchange and the National Association of Securities Dealers to indicate to us the extent of their examination of their members. The American Exchange has indicated it would furnish this information, but I believe it has not yet done so.

I wish to include here in the record the reply of the National Association of Securities Dealers. The reply is a very comprehensive statement of what the association does in its examinations and gives a helpful picture on the extent to which the association examines their members activities in the light of compliance with their rules.

This reply, however, insofar as it relates to the matters and problems of the *Haupt* case may be summarized in three sentences:

1. The association does not have any rules requiring members to maintain customers' credit balances in a segregated or trusted fashion;

2. The association's members engage regularly in many other lines of business such as insurance and real estate; and

3. The association makes no audit of its members' financial position which would enable the association to determine whether its members were overextended in activities other than the securities business and thus in a position where the accounts of their securities customers might be jeopardized.

(Statements referred to follow:)

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,
Washington, D.C., January 15, 1964.

HON. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance,
House of Representatives,
Washington, D.C.

DEAR MR. STAGGERS: I have your letter of January 2, 1964, in which you refer to my testimony before the Subcommittee on Commerce and Finance relating to the nature of the examinations of its members conducted by this association. You state that it would be helpful to have the record indicate the breadth of our audits as well as the number of audits made by the association "* * * with particular reference not only to he solvency of the member in his securities business but the solvency of the member as a whole in all his activities." Further, you have requested comment as to the extent to which rules of this association require members "* * * to maintain customers credit balances in securities in segregated or trusteed accounts rather than commingled and available for members for use as they may desire."

I have instructed the staff of the association to prepare a statement with regard to the breadth of our audits and the number of audits made, and I will have this information in your hands as soon as possible. At that time, we will submit comment as to the rules of the association which may bear on the segregation of customers funds and securities.

Sincerely,

HUDSON B. LEMKAU, *Vice President.*

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,
Washington, D.C., January 23, 1964.

HON. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance,
House of Representatives, Washington, D.C.

DEAR MR. STAGGERS: In response to your letter of January 2, 1964, we submit the following information with respect to the association's examination of its members.

The association's examination procedures are designed to review the various aspects of a member's activities which are covered by our rules and interpretations thereunder, or by those Federal securities regulations which we enforce. The standard procedure is to spot check a representative sampling of a firm's business to determine whether there is compliance with these rules and regulations. If during the course of inspecting there are apparent violations, the scope of the examination is broadened to determine whether the possible violations are isolated or indicate a pattern of noncompliance. Upon completion of an examination a report is submitted to the appropriate district business conduct committee for its review and possible action.

The vast majority of our examinations are so-called regular examinations, during which the examiner looks for general compliance with our rules. We also conduct examinations for special reasons (special examinations), which are limited to the specific subject in question. In this latter category we might inspect a firm solely to determine whether its financial condition meets the requirements of the Securities and Exchange Commission.

The net capital rule of the SEC does not require a specified minimum amount of capital for every broker-dealer. Rather, it states that the broker-dealer must not permit his "aggregate indebtedness" to exceed 20 times his "net

capital." In general terms, aggregate indebtedness means all liabilities except those secured by assets owned by the firm, while net capital means the liquid capital represented by assets readily convertible into cash. The rule exempts members of most stock exchanges since the latter have more stringent requirements.

During examinations, it is our practice to obtain a current financial statement from which computations can be made in order to test compliance with the SEC net capital rule. This statement may be, and often is, in the form of a trial balance, since all broker-dealers are required to prepare and retain monthly trial balances of their accounts. We immediately report any apparent violations of this rule to the Commission.

We generally maintain closer surveillance over firms which have shown a borderline financial condition under the SEC rule, and often these firms are required to submit monthly statements to district business conduct committees. They are also usually reexamined within a shorter period of time than normal. In cases where a member is in compliance but only by a small margin, he is sometimes put on notice by a committee to attempt to improve the situation.

The association has not been empowered to adopt a minimum capital rule, and we have supported H.R. 6789 which would permit us to require our members to have minimum net capital in order to enter or continue in the securities business as a member.

Our examination program includes both main offices and branch offices. Because the ultimate responsibility for adherence to the rules centers on the firm through its main office, inspections of the main offices are generally more comprehensive than those of branches. Examinations of the latter concentrate largely on supervision and handling of customer accounts, although the extent and scope are broadened as circumstances dictate the need. For example, the organizational structure of some firms gives more autonomy to particular branch offices than the normal practice in the industry, and in these cases an examination is conducted more along main office lines.

Generally speaking, an examination is conducted in two phases. First, a senior official is interviewed, during which background information is obtained and firm policies are discussed, as well as specific details which bear on how the firm says it complies with certain rules. The second phase is the actual checking of the firm's practices and procedures to obtain facts upon which to determine whether the rules are being followed. This second phase usually involves the discussions with other personnel of the firm.

The association attempts to maintain a 3-year cycle of examinations of all members' offices. In 1963, there were 1,785 main office examinations and 1,571 branch office examinations, which amounted to 41 percent and 33.5 percent, respectively, of the current total offices in each group. For the 3-year period 1961–63, the inspection figures are 5,009 main offices and 2,703 branches, amounting to 115 percent and 58 percent of the totals. However, it should be pointed out that these examination totals include some firms that were examined more than once and also examinations of some firms which are not now members, so that the percentage figures are somewhat overstated to this extent.

In this regard, we have increased our examining force substantially within the past 2 years in order to be in a better position to meet our goals.

The scope of a regular main office examination includes the following:

1. General information as to the size of the firm and the types of business engaged in, including those other than the securities business, and the relative importance of the various types. Also facts as to the types of clientele and accounts handled, the methods of financing the business, and any clearance arrangements with or for other broker-dealers.

2. Whether the books and records are maintained and kept current in accordance with Securities and Exchange Commission requirements, which the association enforces under its rules of fair practice.

3. Whether the disclosures on confirmations to customers are adequate and accurate, including such items as commissions charged, the required legends involving hypothecation of securities and disclosure of the opposite parties in agency transactions, and disclosure of common control with an issuer of securities.

4. A recorded sampling of the member's principal transactions with the public, in order to judge the fairness of its pricing policies.

5. A review of the member's agency transactions in order to disclose any unfair commission charges or any situations where a firm may have acted as principal on one side of a transaction and as agent on the other.

6. A review of transactions in investment company shares which includes:

(*a*) Whether the public offering price was maintained.

(*b*) Whether the customer has been taken unfair advantage of in being sold shares in amounts just below the amount at which he could have obtained a lower sales charge (the so-called breakpoint).

(*c*) Whether the firm has made a practice of using impending dividends or distributions to unfairly induce the purchase of shares, and

(*d*) Whether the firm is making prompt payment for shares purchased from underwriters.

7. A review of brokers' ledgers or accounts to determine whether the member is dealing with nonmembers, including suspended members, on a preferential basis.

8. A review of the firm's supervisory procedures.

9. Whether the firm's financial condition is in compliance with the Securities and Exchange Commission capital rule.

10. Whether the member has filed an accurate report to the association for assessment purposes.

11. Whether the member has allowed any individual to engage in activities which require his registration with the association without having so registered him, and also whether the firm has terminated all registered representatives who have left his employ.

12. A review of the customer accounts in order to disclose any irregularities in the handling thereof, including:

(*a*) Any infractions of regulation T of the Federal Reserve Board, particularly the prompt payment requirement for cash accounts, and

(*b*) Possible excessive activity induced by the firm or its representatives, sometimes referred to as "churning."

13. A review of most, or often all, of the customer accounts as to which any personnel of the firm has discretionary power, with particular emphasis on the amount of activity therein.

14. A review of the disposition of new issues in which there was an immediate open-market premium (so-called hot issues), in order to determine whether there were unfair allotments to the firm, its personnel, or other insiders as defined in the board of governors' interpretation on this subject.

15. A check of any hypothecation of customers' securities to determine compliance with Securities and Exchange Commission regulations, as well as a check of the member's procedures for the segregation and identification of customers' securities held in safekeeping.

This check would include a determination securities carried for the cash account of a customer had been commingled with securities or other customers and pledged for firm loans, and if so, whether there was prior written consent of the customer. It would also be determined whether securities carried for the account of customers had been pledged under a lien with securities of the broker-dealer, and further whether the liens against customers' securities pledged were greater than the indebtedness of all such customers to the firm. The association has an additional rule in this area, which requires that there be a reasonable relationship between the amount of a customer's securities hypothecated and the amount of such customer's indebtedness.

It might be stated here that it is not a general practice for firms doing a cash account business to hypothecate or lend customers' securities, since this usually occurs with firms handling margin accounts. The latter are almost exclusively restricted to stock exchange members.

16. A review of any general advertising or sales literature for content and proper internal filing.

17. A review of any investment company advertising or sales literature to determine whether proper filing and clearance with the executive offices of the association has been made. If not, copies are obtained to determine compliance with the Securities and Exchange Commission's statement of policy, which we enforce for our members.

18. A review of the member's correspondence file for indications of customer complaints or other irregularities, and a check of the methods of supervising outgoing correspondence of registered representatives.

We have no rules relating to the solvency of firms which might be affected by activities outside of the securities field. In response to your question regarding the breadth of our audit with particular reference not only to the solvency of the member in the securities business but as a whole, our examinations are confined to ascertaining compliance with the SEC net capital rule described above.

In the case of sole proprietors, that rule provides that net capital be adjusted by deducting "the excess of (i) liabilities which have not been incurred in the course of business as a broker or dealer over (ii) assets not used in the business." This portion of the rule does not apply to partnerships or corporations.

The rule also provides that there be a deduction from net capital amounting to "30 percent of the market value of all 'long' and all 'short' future commodity contracts (other than those contracts representing spreads or straddles in the same commodity and those contracts offsetting or hedging any 'spot' commodity positions) carried in the capital, proprietary or other accounts of the broker or dealer and, if such broker or dealer is a parternership, in the accounts of partners * * *."

We do have a number of members who engage in other activities on a regular basis, particularly insurance and real estate. Frequently these are smaller members who are often in the mutual fund retail business as a secondary field.

The Securities and Exchange Commission Special Study Group has recommended certain minimum net capital requirements for every broker-dealer ranging from $5,000 upward, the amounts to vary depending on the number of branch offices and salesmen of the firm and the dollar amount of underwriting commitments. These points have been given consideration by the board, and await passage of enabling legislation before standards and rules can be implemented.

The association does not have a rule which requires members to maintain customers' credit balances in a segregated or trusteed fashion. The liquidity of a member is judged in terms of the Commission capital rule, in the computation of which these credit balances would be considered aggregate indebtedness.

We are attaching a copy of each of the following forms which we use for examination:

Forms EX–100–1, EX–100–2, and EX–100–3 (main office regular).[1]

Form EX–100–4 (branch office regular).[1]

Form EX–100A (may be used in connection with any examination).[1]

Schedules A and B (main office regular, where applicable).[1]

You will appreciate that not all of the items on the report forms apply to every firm. Conversely, some matters are disclosed in the course of an examination which are not specifically referred to on the forms, but are covered on the essay sheet, EX–100A, or attached supporting schedules.

We hope this answers your questions satisfactorily. If you wish any further details please feel free to call upon us.

Sincerely,

HUDSON B. LEMKAU,
Vice Chairman.

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[1] Forms were placed in the subcommittee files.

EXAMINATION REPORT—PAGE 1

INTERVIEW:

1. DATE(S) CONDUCTED _____ 2. DISTRICT # _____

3. MEMBER _____ (PLEASE PRINT)

4. FULL ADDRESS _____

5. INTERVIEWED _____ 6. TITLE _____

7. PROP _____ PART _____ CORP _____ 8. # OF BR. OFF _____ REGISTERED _____ SEE EX-100A _____

9. EXCHANGE MEMBERSHIPS: NYSE _____ ASE _____ BSE _____ MWSE _____ PBSE _____ PCSE _____ OTHER _____

10. TYPE OF BUSINESS
UNDERWRITINGS _____ OTC–INV. CO. SHS _____
EXEMPTS _____ OTC–PRINCIPAL _____
LISTED _____ OTC–AGENCY _____
AFFILIATED CO.'S OR OTHER BUSINESS _____

11. CLIENTELE RETAIL INDIVIDUAL _____ INSTITUTIONAL _____ PROF. TRADING _____

12. TYPE OF ACCOUNTS CASH _____ MARGIN _____ SPECIAL LOAN A/C'S _____ DISC. A/C'S _____ INV. ADV. A/C'S _____ OTHER A/C'S _____

13. FINANCING OF BUSINESS CASH BASIS ____ OMNIBUS A/C FOR/WITH OTHERS _____ COLLATERAL LOANS WITH _____

14. CLEARANCE OTC SELF _____ OTC THRU/FOR OTHERS _____
LISTED SELF _____ LISTED THRU/FOR OTHERS _____

15. SAFEKEEPING NONE ____ INCIDENT TO TRANS. ONLY ____ VOLUME OF SK _____

16. COMMISSION POLICY OTC NYSE RATE ____ NO SET POLICY ____ OTHER _____
LISTED REG. RATE ____ WITH OVER-RIDES OF _____ OTHER AS ATTACHED _____

17. SUPERVISION BY WHOM _____ (TRANSACTIONS) _____ (CORRESPONDENCE)
APPROVAL STATED AS BEING EVIDENCED ON:
SALES MEMOS ____ CONFIRMS ____ BLOTTER ____ OTHER _____

18. INV. CO. SHS. BUY FROM SPONSORS ONLY ____ OTHER SOURCES _____
ADVERTISING AND SALES LITERATURE
SPONSORS', ETC. _____ OWN _____ MEDIA _____ FAMILIAR WITH FILING REQ. _____
REDEMPTION POLICY
NO CHARGE _____ COMM. _____ TAKE POSITION _____

19. GEN. ADV. POLICY NONE ____ MEDIA _____

TYPE OF EXAMINATION

(CIRCLE TWO ITEMS)
REGULAR OR SPECIAL
MAIN OFF. OR BRANCH

FORM EX-100-1

Wherever possible, answer all questions YES, OK, NO, NONE, NA (not applicable) or with an asterisk (*) which will refer to form EX-100A.

EXAMINATION REPORT—PAGE 2

EXAMINATION:

1. DATE CONDUCTED _____ 3. MEMBER _____

20. RECORDS MADE AVAILABLE BY _____ (OFF. MGR. - CASHIER - ACCT. - BKKPER.) 21. LOCATION OF BR. OFF. RECORDS _____

CONFIRMATIONS — CAPACITY DISCLOSURE — 22. FORM _____ 24. U.P.C. SEC. 9 _____ 26. HYPO. LEGEND _____ 28. AGENCY LEGEND _____

23. ERRORS _____ 25. COPIES KEPT _____ 27. CONTROL DISCL. _____ 29. OTHER _____

PRINC. TRANS. — 30. SCHED. A—# OF TRANS. _____

SCHED. B—# OF TRANS. _____ PERIOD FROM _____ TO _____ 31. ANALYSIS ATTACHED _____

AGENCY TRANS. — 32. COMM. RATES _____ 33. IRREGULAR TRANSACTIONS—NONE NOTED _____ SEE EX-100A _____

INV. CO. SHS. — 34. PUB. OFF. PRICE MAINTAINED _____ 35. LETTERS OF INTENT, BREAKPOINTS, ETC. _____

36. RULE 26 (f) (1 & 2) _____ 37. "SELLING DIV." _____ 38. PROMPT PMT. _____

NON-MEMBER TRANSACTIONS — 39. NONE NOTED _____ SEE EX-100A FOR COMMENTS _____

SALES MEMOS — 40. TIMED ON RECEIPT _____ 41. TIMED ON EXEC./CANC. _____ 42. CANCELED ORDERS KEPT _____ 43. SUPERVISION EVIDENCED S.M. _____ CONF. _____ BLOTTER _____

BLOTTERS — 44. PURCH. & SALE _____ 45. SEC. REC. & DEL. _____ 46. CASH REC. & DISB. _____

LEDGERS — 47. GEN. LEDGER _____ 48. CUST. LEDGER _____ 49. POS. RECORD _____

50. BROKER FAIL RECORD _____ 51. REG. BROKER LEDGER _____ (CHECK EITHER ITEM 50 OR 51) 52. MONTHLY TRIAL BAL. _____ 53. A/C'S CURRENT _____ 54. BASIS T. _____ S. _____

55. OTHER RECORDS _____

FINANCIAL CONDITION — 56. CAPITAL $ _____ (GROSS OR ADJ. NET CAPITAL) 57. 20:1 RATIO _____ 58. CERT. _____ NOT CERT. _____

59. SOURCE—BAL. SHEET _____ ANNUAL REPORT _____ MONTHLY T/B _____ OTHER _____ DATED _____

FORM EX-100-2

Wherever possible, answer all questions YES, OK, NO, NONE, NA (not applicable) or with an asterisk (*) which will refer to form EX-100A.

EXAMINATION REPORT—PAGE 3

EXAMINATION:

ASSESSMENT REPORT

60. TOTAL ALL PERSONNEL (AS OF JUNE 30TH) _____ ASSESSABLE PERSONNEL REPORTED _____ SHOULD BE _____

61. UNDERWRITING (AS DEF.) $ _____

INV. CO. SHS. $ _____ 62. ASSESSMENT REPORT OK _____ AMENDED FORM FILED _____

REGISTERED REP. RESENTATIVES

63. NO CHANGE _____ ADDITIONS _____ TERMINATIONS _____ EX-101 _____

NASD INS

64. NONE _____ LIFE _____ HOSP. AND SURG _____

CHURNING

65. A/C'S CHECKED _____ PERIOD _____ NOT INDICATED _____ SEE EX-100A _____

REGULATION T

66. A/C'S CHECKED _____ PERIOD _____ NO VIOLATIONS _____ SEE EX-100A _____

DISC. A/C'S

67. # OF A/C'S CHECKED _____ ACTIVITY NORMAL _____ SEE EX-100A _____ PRINC. TRANS. W/O PROFIT DISCLOSURE _____

FREE-RIDING

68. ISSUES CHECKED _____ NOT INDICATED _____ SEE EX-100A _____

HYPOTHECATION & SAFEKEEPING

69. POSS. HYPOTHECATION CHECKED _____ 70. CERT. SEGREGATED AND IDENTIFIED _____

GEN. ADV.

71. NONE _____ 72. FILE KEPT _____ 73. REVIEWED _____ 74. USE OF THE ASSOC. NAME _____

CORRESPOND. ENCE

75. FILED AS REQUIRED _____ 76. SUPERVISION _____ 77. REVIEWED _____ 78. COPIES ATTACHED _____

TIME SPENT IN MEMBER'S OFFICE _____

TIME SPENT ON EXAMINATION REPORT _____ EXAMINER _____
(EXAMINER) (OTHERS)

FORM EX-100-3

Wherever possible, answer all questions YES, OK, NO, NONE, NA (not applicable) or with an asterisk (*) which will refer to form EX-100A.

EXAMINATION REPORT

BRANCH OFFICE

1. DATE(S) CONDUCTED_____ 2. DISTRICT #_____

3. MEMBER_____
(PLEASE PRINT)

4. BRANCH OFFICE ADDRESS_____

5. INTERVIEWED_____ 6. TITLE_____

7. TYPE OF BUSINESS
UNDERWRITINGS_____ OTC - INV. CO. SHS_____
EXEMPTS_____ OTC - PRINCIPAL_____
LISTED_____ OTC - AGENCY_____

8. TYPE OF ACCOUNTS
CASH_____ MARGIN_____ OTHER_____

9. CLIENTELE INDIVIDUAL_____ INSTITUTIONAL_____ PROF. TRADING_____

10. SAFEKEEPING
NONE_____ INCIDENT TO TRANS. ONLY_____ VOLUME OF SK_____

11. SUPERVISING OFFICE_____ ADDRESS_____
INDICATE WHETHER MAIN OFFICE, OTHER BRANCH OFFICE OR LOCALLY

BY WHOM_____ TITLE_____

IF LOCALLY APPROVED, EVIDENCED ON:_____
NAME RECORD

12. LOCATION OF BOOKS & RECORDS_____
INDICATE MAIN OFFICE OR BRANCH OFFICE AND ADDRESS

13. IF NOT ALL BOOKS AND RECORDS ARE AVAILABLE, LIST THOSE WHICH ARE AVAILABLE ON EX-100A WITH ANY PERTINENT COMMENTS AS TO THE ADEQUACY OR CONDITION OF SUCH BOOKS AND RECORDS. IF ALL BOOKS ARE AVAILABLE FOR EXAMINATION, USE PAGES 2 AND 3 OF THE MAIN OFFICE REPORT FORM.

14. REG. REPS. NO CHANGE_____ ADDITIONS_____ TERMINATION_____ EX-101 ATTACHED_____

15. GEN. ADV. NONE_____ FILE KEPT_____ REVIEWED_____ PROPER USE OF THE ASSOC. NAME_____

16. CORRESPONDENCE FILED AS REQUIRED_____ SUPERVISED OR APPROVED_____
REVIEWED_____ COPIES ATTACHED_____

TIME SPENT IN MEMBER'S OFFICE_____

TIME SPENT ON EXAMINATION REPORT_____

EXAMINER_____

FORM EX-100-4

Wherever possible, answer questions YES, OK, NO, NONE, NA (not applicable) or with an asterisk (*) which will refer to form EX-100A.

FEBRUARY 12, 1964.

Mr. HUDSON B. LEMKAU,
Vice Chairman, National Association of Securities Dealers, Inc., Washington, D.C.

DEAR MR. LEMKAU: I acknowledge your letter of January 23, replying to my inquiry of January 2, relating to the scope of the association's examination of its members.

I do appreciate on behalf of the committee the extensiveness of your reply and your thorough treatment of just what you do in your examinations of your members, not only insofar as their financial position may be concerned, but insofar as they carry out their own business activities with their customers and with other members in light of the rules of the association which may be applicable.

You can appreciate, I am sure, that the comprehensiveness of your reply will entail attentive consideration on my part for the complete understanding of just what it is you are doing. On cursory examination, however, I do reach the conclusion as to certain specific subjects which have been highlighted by virtue of the insolvency of Ira Haupt & Co., a member of the New York Stock Exchange, and our study of the rules of that exchange; namely, that your association does not have a rule requiring members to maintain customers' credit balances in any segregated or trusteed fashion; that many members of your association engage in other activities as a regular business such as insurance and real estate and, accordingly, it would appear as though there were a grave question of just what might be the position of your members' securities customers in the event of insolvency in view of the absence of rules in this field; and that your association does not make an audit of its members' financial position which would enable your association to determine whether or not your members are overextended in their activities other than their securities business and are thus in a position in which the accounts of their securities customers may be jeopardized.

Sincerely yours,

HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance.

AMERICAN STOCK EXCHANGE,
New York, N.Y., February 19, 1964.

Hon. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance, Interstate and Foreign Commerce Committee, House of Representatives, Washington, D.C.

DEAR MR. STAGGERS: This is a belated reply to your letter of January 2 to Mr. Etherington. We have been studying the matter of financial responsibility in recent weeks and appreciated the opportunity to consider fully the questions you asked. Since Mr. Etherington is away I am replying for him, but he has reviewed the material included in this letter.

To be fully responsive to your questions, I would like to summarize our present rules and policies with respect to customers' credit and securities balances, outline our procedures for implementing them, and suggest our plans for the future.

EXCHANGE RULES AND POLICIES

The exchange's net capital rules which were outlined in Mr. Etherington's letter to you of December 26, 1963, are the principal tools for limiting the exposure of customers' funds to risks of member activities. Rule 446 requires a member organization carrying accounts for public customers to maintain a minimum net capital of $50,000. Rules 466 (for partnerships) and 467 (for corporations) provide that a member organization's aggregate indebtedness to all other persons must not exceed 2,000 percent of its net capital. These rules also prescribe the method for computing net capital and the various liabilities to be included in determining aggregate indebtedness.

Rule 412 deals with the matter of customers' securities balances This rule prohibits a member organization from pledging or loaning more of a customer's securities than is reasonable in view of his indebtedness to the firm. In enforcing this rule, the exchange requires that customers' securities held by a member organization be promptly segregated and identified, if they are fully paid for or otherwise ineligible to be loaned or pledged. Exchange examiners, in the course of their inspections, are specifically instructed to check to see that member organizations have effective procedures for implementing this requirement.

EXAMINATIONS OF MEMBER ORGANIZATIONS

Exchange rule 443 requires member organizations to have an annual audit on a date fixed by the independent public accountants conducting the audit, and without prior notice to the member organization.

In addition, exchange examiners make at least two field examinations each year of member organizations which are not also members of the New York Stock Exchange. The examinations are designed to complement the full audit performed by independent accountants.

The examinations supplementing the complete audit are in themselves thorough. They encompass a check of the financial accounts of the member organization and a review of its practices and procedures as they relate to all phases of its business, including commodity transactions. The purpose is to ascertain compliance with all pertinent rules and regulations of the exchange and the Securities and Exchange Commission, as well as to gain a clear picture of the member organization's financial position in the light of all its activities.

I have attached a copy of the program followed by exchange examiners in their check of the books, records, practices, and procedures of member organizations. Although this is a detailed statement, it should be emphasized that it is a "minimum coverage guide" and more extensive examinations in specific areas are made if conditions warrant. You will note the procedures for checking customers' commodity accounts on pages 3 and 4 of the program. These procedures have been part of the exchange's examination program for a number of years and have been printed in the program in view of recent events.

Since September of 1961, the exchange has also required three financial statements each year from each individual specialist or specialist unit active on the exchange. These statements enable the exchange to determine the capital position of its specialists and to ascertain compliance with the minimum specialist capital requirements of rule 170. Following receipt of the statements, exchange examiners visit all specialist clearing agents, including those that are also members of the New York Stock Exchange, and inspect all specialists' accounts for compliance with exchange rules and Federal regulations. Specialists' capital requirements were increased, as noted by the special study, in early 1962.

PLANS FOR THE FUTURE

In the months preceding September 1962 and since then, the exchange has felt that first priority should be given to strengthening its enforcement procedures. Thus, although certain rules have been adopted and others have been amended, our major effort to date has been to make existing rules more effective. We have directed our energies to improving procedures, developing new methods of enforcement where necessary, and increasing the scope of our inspection activities.

With this task well underway, we initiated last year a full review of the constitution, rules and policies of the exchange, including those pertaining to customers' credit and securities balances. In addition, we are preparing for detailed discussions with the Securities and Exchange Commission of the related recommendations of the Special Study of Securities Markets.

As mentioned in Mr. Etherington's letter of December 26, the New York Stock Exchange has appointed a special committee of industry leaders to explore possible problems connected with commodity accounts of customers of member organizations. The committee members are representatives of firms which are member organizations of this exchange as well as the New York Exchange and we are keeping in close contact with the committee. However, in order to avoid unnecessary duplication, we have not done our own study. You can be assured that we will review the work of the committee in detail and that our board will give immediate and serious consideration to its recommendations.

In addition, the Securities and Exchange Commission has proposed a rule requiring that customers be informed as to the status of their free credit balances, the use of these moneys by the broker-dealer, and the vulnerability of credit balances in the event of insolvency. Since the proposal would affect all registered broker-dealers and is of concern to the entire industry, we have suggested to the Securities and Exchange Commission that industry and commission representatives meet to discuss the proposed rule in light of existing practices. As you know, this procedure has been followed in the past, and I can assure you that we will approach any conference that may be scheduled with a constructive attitude.

I hope these comments will be helpful.

Sincerely,

PAUL KOLTON.

PROGRAM FOR FIELD EXAMINATIONS OF THE BOOKS AND RECORDS AND THE PRACTICES AND PROCEDURES OF MEMBER ORGANIZATIONS

NOTE.—The following program is to be used as a minimum coverage guide and does not preclude more extensive checking if conditions warrant.

(1) Compare trial balances obtained from general ledger, customers' ledger and other subsidiary ledgers with the answers to the questionnaire as submitted to the exchange.

(2) Check bank reconciliations at questionnaire date and for following month, if available. Verify large or unusual reconciling items such as deposits in transit, etc.

(*a*) How often are bank accounts reconciled?

(*b*) Are they reconciled by other than cash receipts and disbursement clerks?

(*c*) Check other deposits such as "good faith," etc.

(3) Check statements from other brokers and determine that money and security positions are in agreement or have been reconciled.

(*a*) Are separate accounts maintained for customer and firm transactions?

(4) Examine bank loan records.

(*a*) Are separate loans made against customers' collateral as distinguished from firm-owned collateral? What margin is required on customer loans?

(*b*) Compare borrowings on customers' collateral with aggregate indebtedness of customers.

(5) Check "fails to receive" and "fails to deliver" records.

(*a*) How often is detail balanced ao ledger control? (Must be at least monthly.)

(*b*) Examine for and investigate old uncleared items.

(*c*) Are "marks-to-market" necessary?

(6) Check stocks borrowed and loaned accounts.

(*a*) Are customers' securities loaned without a letter of authorization?

(*b*) Are open items "marked-to-market"?

(7) Check customers' accounts as follows:

(*a*) *Margin accounts*

1. Are signed margin agreements obtained and are they approved by an officer or a partner?
2. Are they properly margained (regulation T and rule 464)?
3. Are "special miscellaneous" memo cards maintained?
4. Are margain deposits obtained on time? Is a record maintained of margin calls?
5. Are excess securities segregated? Do the records so indicate?
6. Prepare a list of representative items purported to be segregated and check to the actual securities.
7. Is interest charged on debit balances? Any evidence of special or unusual rates?
8. Test-check current margin card balances and security positions to ledger accounts and determine that they are maintained currently.

(*b*) *Cash accounts*

1. Are the pertinent provisions of regulation T complied with?
2. Are fully paid for securities placed in safekeeping? Do the records so indicate?

3. Prepare a list of representative securities purported to be in safekeeping and check to actual securities.

4. Does the firm make a practice of prepaying customers for securities sold? If yes, investigate the circumstances. Is interest charged on the prepayment?

(*c*) *Customers—General*

1. Are "new account" forms required? Do they contain sufficient information to satisfy rule 411? Are they approved in writing by an officer or partner? Are proper documents on file from corporate customers?

2. Are open security positions "brought down" monthly in ledger accounts?

3. Are statements mailed? How often?

4. Is there any evidence of churning? If yes, investigate.

5. Is there any evidence of highly concentrated positions in one or more securities on the part of one customer or a small group of customers?

6. Have any customers given powers of attorney to others for trading purposes? If yes, investigate transactions.

7. Is there any evidence of matched orders to create false markets?

8. Are proper commissions charged? (Also transfer taxes and registration fees.)

9. Are there any accounts of employees of banks, insurance companies, or other brokers without letter of permission?

10. Do confirmations disclose—

(i) Where and how orders were executed.

(ii) Commission charged.

(iii) Commingling "clause" required by rule X–15c2–1 (1934 act).

(*d*) *Commodity accounts*

1. Are proper documents on file?

2. Are the pertinent commodity exchange margin deposits obtained? Maintained?

3. Is a record of margin calls maintained?

4. Review margin cards and test-check computations of equities. Test-check open positions to commodity ledger.

5. Determine that equities in regulated accounts are properly segregated.

6. Are transfers from regulated accounts authorized in writing?

7. Review for possible concentration by a customer, or related customers, in specific commodities. Refer to commodity ledger and daily clearinghouse sheets. Discuss unusual positions with partners.

8. Is the member firm registered with the CEA?

9. Are large positions in regulated commodities reported to the CEA?

10. Have credit lines been extended to "trade" accounts? Have they been approved by a partner?

11. Spot commodities:

(*a*) Are spot positions financed?

(*b*) Are they financed for other than recognized commodity processors?

(*c*) What margin is required.

(*d*) Are spot positions required to be hedged?

(*e*) Are field warehouse receipts being accepted as collateral?

(*f*) What procedures are followed to ascertain validity of receipts?

(*g*) Does member firm carry additional insurance on warehouse receipts?

(8) Spot check order tickets on file.

(*a*) Do they show time of entry?

(*b*) Do they show time of execution?

(*c*) Are sales of listed securities marked "long" or "short"?

(9) Spot check stock record.

(*a*) Are total "long" positions counterbalanced against total "short" positions?

(10) Is a blotter or other record of original entry used? Does it show:

(*a*) Purchases and sales.

(*b*) Cash received and disbursed.

(*c*) Securities received and delivered.

(*d*) Journal entries.

(*e*) Certificate numbers.

(11) Unclaimed dividend account.

(*a*) How often is the detail balanced to the general ledger control?

(*b*) What approvals are necessary to make payments?

(12) Are over-the-counter trades made in Amex securities? Are they reported to the exchange?

(13) Examine character of members' principal trades.
(*a*) Is there a markup policy on principal trades with customers?
(*b*) Does it meet the "5 percent philosophy" of the NASD?
(14) Does firm participate in underwritings? Are weekly reports on open commitments submitted to the exchange?
(15) If firm participated in distributions as underwriter or member of a selling group, did examination disclose any indication of violations of:
(*a*) Section 11(d)(1), 1934 act (extension of credit on a security subject to primary distribution).
(*b*) Antimanipulative provisions of 1934 act (trading in such securities during or in the period immediately prior to the period of distribution)?
(16) Examine minute book of member corporations.
(17) Inquire into contingent liabilities.
(18) Investigate any unusual activity in firm or general partners' accounts prior to or subsequent to questionnaire date.
(19) Does the firm make periodic computations of its net capital?
(20) Does the insurance coverage as in effect meet the standards set forth in Exchange Circular J-38?
(21) Compare firm transactions, if any, as reported on MT reports (at least for a 1-week period) with postings in the firm trading account.
(22) If firm carriers accounts of members floor traders, compare transactions on MT reports filed by such traders and check to postings in his ledger account.
(23) If the firm examined is a specializing firm or clears for other specialists and also carries the accounts of member floor traders, do such traders deal actively in stocks specialized in by the firm or by specialists whose accounts are cleared by the firm?
(*a*) Investigate unusual transactions.
(24) Is the firm at present under investigation by an authority which might lead to disciplinary action against the firm? Advise them of rule 521 requiring a prompt report of any disciplinary action.
(25) Is there any indication that the firm obtained secret profits in agency transactions, discretionary accounts, or other accounts involving fiduciary duties?
(26) Is there any indication that partners, officers, proprietors, or principal employees have accounts with other brokers?
(27) Discuss with a partner or officer the provisions of the following rules under the 1934 act and the compliance therewith:
(*a*) Rule 10b-6 (prohibition against trading by persons interested in a distribution).
(*b*) Rule 15c1-5 (disclosure of control).
(*c*) Rule 15c1-6 (disclosure of interest in distribution).
(28) Do the books and records as maintained meet the requirements of exchange circular I-36 (rules 17a-3 and 17a-4 of the 1934 act)?

Mr. STAGGERS. The third inclusion for the record, further inquiry of President Funston of the New York Stock Exchange on the Haupt case.

Also, I think it well to insert in the record, a letter I have addressed to him in accordance with the understanding at that time owing to his leaving for a meeting in New York, which sets forth certain questions I had wished to ask of him concerning the Haupt case, the nature of the exchange examinations of its members, its rules on segregation of customer credit balances, and the like. His reply, when received, will be included.

I think it best if this correspondence between Mr. Funston and myself be placed in the record of February 5, 1964, immediately following Mr. Funston's testimony.

Fourth, the inclusion in the record, correspondence with the Commission with reference to the role of the specialist on the exchanges:

1. I have hitherto included in the record my request of December 2 concerning the activities of the specialists on the New York Stock

Exchange in the few minutes that the exchange was open after the President's assassination, and

2. I have also already included the Commission's reply of January 21 concerning its examination of the specialists' activities in 25 stocks.

3. I wish to include here a copy of my request of January 27 that Chairman Cary, when he returned for these hearings, tell us just what the Commission's present position may be relating to the specialist.

4. Inasmuch as the SEC report of January 21 on the specialists also contained certain letters and comments concerning the early closing on November 22, 1963, I believe it well to include at an appropriate place in the record a letter from Mr. E. D. Etherington, president of the American Stock Exchange, to Mr. Ralph S. Saul, of the Commission, dated January 24, 1964, outlining new procedures that exchange has adopted for handling emergencies.

(The material mentioned above follows:)

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., January 27, 1964.

Hon. WILLIAM L. CARY,
Chairman, Securities and Exchange Commission,
Washington, D.C.

DEAR CHAIRMAN CARY: I acknowledge receipt of your letter of January 22, 1964, enclosing a memorandum prepared by your Division of Trading and Markets on specialist and floor trader activity on the New York Stock Exchange on November 22, 1963, the date of the President's assassination, and on November 26, 1963, the day the exchange reopened, together with a copy of the study upon which the memorandum is based.

Very naturally, in view of the testimony which you have hitherto presented to the subcommittee concerning the findings of your special study on the activity of the specialists and the recommendations of that study and of the Commission with respect to the role of the specialist, and in view of the testimony before the subcommittee by the heads of the major exchanges concerning the role of the specialist, I am greatly shocked by some of the statements in your memorandum relating to what went on or did not go on in the operations of certain specialists on these 2 days.

I trust that when you return to the committee for further hearings on the legislation now pending before us which grew out of the special study you conducted for the purpose of studying and making recommendations relating to the adequacy for the protection of investors of the rules of the stock exchanges, that you will be in a position to discuss more fully with us just what your thoughts now may be in this particular area.

Sincerely yours,

HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., February 3, 1964.

Hon. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, Washington, D.C.

DEAR MR. STAGGERS: I am transmitting herewith a letter from Mr. Edwin D. Etherington, president of the American Stock Exchange, concerning certain emergency procedures adopted by that exchange.

I thought you might be interested in having Mr. Etherington's letter in view of the statement made on page 5 of the memorandum of the Commission's Division of Trading and Markets on specialist and floor trading activity on November 22 and 26, 1963, that both the New York exchanges were working on improvements in emergency procedures.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

AMERICAN STOCK EXCHANGE,
New York, N.Y., January 24, 1964.

Mr. RALPH S. SAUL,
Director, Division of Trading and Markets,
Securities and Exchange Commission,
Washington, D.C.

DEAR MR. SAUL: This letter is to confirm our telephone conversation this morning related to the following statement from page 5 of the memorandum submitted by the Commission on January 21, 1964, in reply to the letter of Chairman Staggers dated December 2, 1963:

"With respect to the procedures employed in closing the exchanges, we understand that both exchanges are working on improvements in these procedures in the event of future market crises. We intend to follow closely developments in this area."

In your letter to me of December 31, 1963, you asked (among other things) for the name of the official or group directing the closing of the exchange on November 22, 1963. In answering that question and others in my letter of January 14, 1964, I did not think to advise you that we had already taken action to set up a new procedure for halting trading in an emergency situation.

At a special meeting of our board of governors held on November 25, 1963, a new procedure was established and the decision was reached to consider the adoption of an amendment to our constitution. The complete minute on this subject is as follows:

"The board discussed the procedures for halting trading in all securities on the floor in the event of an emergency and agreed (1) that the establishment of a clear, flexible procedure should be considered in connection with the review of the constitution now in progress, and (2) that an interim procedure should be established through a specific delegation of authority by the board at this time. The president recommended that the board:

"(1) Delegate authority to halt trading on the floor in the event of an emergency to a three-man committee consisting of the chairman, the vice chairman and Mr. Edward Kraebel;

"(2) Determine that the action could be taken by any two members of this committee;

"(3) Determine that if either two or three members of this committee should be unavailable, the next senior governor or governors would serve in the place of the governor or governors then unavailable; and

"(4) Determine that a decision pursuant to this delegated authority would be review at a meeting of the board at the earliest time possible in light of the conditions then existing.

"After discussion, on motion duly made and seconded, the recommendation was unanimously carried."

I might note that Mr. Kraebel is the senior governor whose term does not expire this February. Thus there will be appropriate continuity for the period during which this interim delegation of authority is expected to last.

Trading was halted on November 22 after the board delegated emergency authority as stated in my January 14 letter. This procedure was followed because the board was convening for a different purpose when the emergency occurred. Had this not been the case, a meeting of governors might have been called or action might have been taken by the chairman, in consultation with the president, subject to ratification by the board.

The delegation of authority by the board on November 25 is useful in that it anticipates any future emergency that may arise and provides a specific procedure which will assure prompt action, when necessary, subject to appropriate review.

Since the memorandum for Chairman Staggers states the intention of the SEC to follow closely the developments in this area, I thought you should be appraised immediately of the action we have taken and of the priority we have given to this question in the course of our current review of the constitution.

Sincerely,

EDWIN D. ETHERINGTON.

Mr. STAGGERS. Again for inclusion in the record, correspondence with the Commission with reference to section 16(b) and short-swing profits arising from insider transactions:

1. My inquiry of January 2 asking why the Commission had not come up with any legislative recommendations to strengthen section 16(b) in view of the Supreme Court's position in *Blau* v. *Lehman*.

2. Chairman Cary's reply of January 30 that the reason the Commission has not done so is that the Commission reached an agreement with the industry that it would not do so.

(The correspondence mentioned follows:)

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., January 2, 1964.

Hon. WILLIAM L. CARY,
Chairman, Securities and Exchange Commission,
Washington, D.C.

DEAR MR. CHAIRMAN: In connection with your testimony you presented to the committee relating to the Commission's proposals for further study before recommending legislative amendments of the section 16(b) problem contained in the Supreme Court decision in *Blau* v. *Lehman*, it would seem to me that you might wish to elaborate upon the record as it now reads.

I note that you associated yourself in your brief as amicus curiae with the position of the dissenting Justices; that is, Justice Douglas with whom the Chief Justice concurred, that the present language covered the situation. Even though the majority did not accept this reasoning it said, "Congress can and might amend section 16(b) if the Commission would present to it the policy arguments it has to us, but we think that Congress is the proper agency to change an interpretation of the act unbroken since its passage, if the change is to be made."

In view of the position which you took and in view of the position which the majority of the Court took, it would seem to me pertinent for you to explain to the committee why you have not come up at this time with legislative recommendations on this subject, which was discussed by the subcommittee at considerable length in its hearings on House Joint Resolution 438 giving rise to your study.

Sincerely yours,

HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., January 30, 1964.

Hon. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance,
Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. STAGGERS: This is in reply to your letter of January 2, 1964, in which you refer to the Supreme Court decision in *Blau* v. *Lehman*, and inquire as to why we have not presented legislative recommendations with respect to the problem considered in that opinion; i.e., the question of whether or not the entire profit from short-swing trading by a brokerage firm, which has a partner on the board of the issuer, should be recoverable under section 16(b).

Section 16(b) provides an important safeguard against misuse of inside information for the profit of insiders, and a proposal to extend its application to the larger companies in the over-the-counter market is included in H.R. 6789. At the same time section 16(b) is highly controversial and, as Professor Loss observes at page 1087 of his book, it "is probably the most cordially disliked provision in all these statutes from the point of view of those whom it affects." In addition, certain interpretations which the courts have given to section 16(b) have likewise been controversial. For example, in the computation of profit recoverable under section 16(b), the U.S. Court of Appeals for the Second Circuit held that "the statute was intended to be thoroughgoing, to squeeze all possible

profits out of stock transactions" and that recoverable profits, therefore, should be computed by matching transactions having the lowest purchase price with transactions having the highest sales price. (*Smolowe* v. *Delendo Corporation*, 136 F. 2d 231, 239, certiorari denied, 320 U.S. 751.)

Notwithstanding these matters, section 16 has served its intended purpose well. Short-swing trading by insiders for the purpose of profiting by inside information in the stock of corporations subject to section 16 has largely disappeared, as Congress contemplated. It must be recognized, nevertheless, that section 16 has aroused strong feelings, and there has been a persistent demand for its revision or repeal. For example, in 1941, when your subcommittee undertook a major review of the securities laws, the exchanges proposed the repeal of section 16(b).

In considering the scope of its legislative program, the Commission had to decide whether to include the recommendation of the special study report proposing a statutory reversal of the decision reached in *Blau* v. *Lehman*. The Commission decided against such an amendment for essentially two reasons:

1. The problem created by the decision may well be mitigated by the conclusion of the Supreme Court that the result could be otherwise if the evidence showed that a partner had been placed on the board of directors of the issuer to represent the brokerage firm. It might be possible to make such a finding in a good many cases.

2. The Commission believed that any amendment to section 16(b) would invite numerous proposals for general revision of this section. Basically we had no desire to see our vital legislative program impeded in any way by a presumably long drawn out, bitter, and often technical controversy over various aspects of section 16.

I would point out that, when the Commission subsequently met with the securities industry and its representatives on the present legislative program, the Committee on Securities Regulation of the Association of the Bar of the City of New York did in fact submit to us a comprehensive proposal for the revision of section 16(b). They suggested a series of unrelated amendments, which taken in combination, would have substantially reduced the scope of section 16(b) and would have made its operation in a number of areas dependent upon affirmative rulemaking by the Commission. After presentation of the Commission's point of view with respect to the problems that would arise from revision of section 16(b), it was agreed that proposals for the section's amendment would not be included in the legislative program now pending before your subcommittee. It would, of course, have been inconsistent with this determination to include legislative proposals in the limited but important area represented by *Blau* v. *Lehman*.

In essence, we concluded that the primary task before us during the 88th Congress was to proceed with the completion and then the implementation of the special study of securities markets, and that, insofar as legislative proposals were concerned, it would be unfortunate if the proposals now before your subcommittee, and embodied in H.R. 6789, which carry out the principal legislative recommendations of the special study, were to become entangled with a protracted review of all the problems anyone saw in section 16. In our judgment such general review, which is essentially extraneous to the recommendations of the special study, might have jeopardized the entire legislative effort at this session.

Legislative review of the *Blau* v. *Lehman* decision is not as simple as it might appear. For example, if broker-dealer partnerships should be subject to section 16(b), it would seem illogical to exclude broker-dealer corporations, which are becoming increasingly significant in the industry. If such corporations were to be subject to section 16(b), it would be necessary to determine what relationship between a director of the issuer and the corporation would give rise to such liability; i.e., would liability arise where a director, an officer, or a stockholder of the corporation, or any combination of these, was a director of the issuer? If broker-dealer partnerships and corporations were to be subjected to section 16(b) it would be necessary to consider whether other types of partnerships and corporations should likewise be brought within that section and, if so, exactly what types of partnerships and corporations and under what circumstances. These are questions of policy and draftsmanship that should be considered in connection with any general revision of section 16.

The foregoing are essentially our reasons for not including in the present legislation recommendations with respect to the *Blau* v. *Lehman* decision. If we can be of any further assistance, please let me know.

Sincerely,

WILLIAM L. CARY, *Chairman.*

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., February 7, 1964.

Hon. WILLIAM L. CARY,
Chairman, Securities and Exchange Commission,
Washington, D.C.

DEAR MR. CHAIRMAN: I acknowledge receipt of your letter of January 30, 1964, replying to my inquiry as to why the Commission had not presented legislative recommendations as suggested by the Supreme Court decision in *Blau* v. *Lehman* covering the matter of short-swing trading profits by a brokerage firm which has a partner on the board of the issuer.

I note that the Commission and the securities industry reached an agreement that the Commission would not present to this committee any legislative recommendations in this field.

Sincerely yours,

HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance.

Mr. STAGGERS. I ask permission that these all be put into the record at this point and, Chairman Cary, you may proceed, at this point, if you will, in your presentation.

STATEMENT OF CHAIRMAN WILLIAM L. CARY; ACCOMPANIED BY COMMISSIONER BYRON D. WOODSIDE; COMMISSIONER MANUEL F. COHEN; COMMISSIONER JACK M. WHITNEY II; ANDREW BARR, CHIEF ACCOUNTANT; PHILIP A. LOOMIS, GENERAL COUNSEL; RALPH S. SAUL, DIRECTOR, DIVISION OF TRADING AND MARKETS; EDMUND H. WORTHY, DIRECTOR, DIVISION OF CORPORATION FINANCE; ARTHUR FLEISCHER, JR., EXECUTIVE ASSISTANT TO THE CHAIRMAN—Resumed

Mr. CARY. Thank you, Mr. Chairman. I appreciate this opportunity to return, particularly with reference to the bill which you have been considering in the last, I think, three separate groups of hearings which you have held.

I wanted to say that I have here at the table beside me members of the Commission and want to introduce them, if I might, and they may, I hope, speak upon occasion and perhaps supplement some of the statements I have to make.

At my very farthest left is my colleague, Commissioner Manuel Cohen. Then beside him is my colleague, Commissioner Byron Woodside. Right beside me on my left is our General Counsel, Philip Loomis. On my immediate right is my executive assistant, Arthur Fleischer, Jr. Beyond him is the director of our division of trading and markets, Ralph Saul, and at the very end is my colleague, Commissioner Jack Whitney.

Mr. Chairman, we are here, as you have already indicated, to testify further on H.R. 6789 and H.R. 6793 and also known as Senate 1642, bills embodying legislative recommendations of the Securities and Exchange Commission. We have already in prior hearings on H.R. 6789

presented to the subcommittee the basic reasons why we consider enactment of this legislation necessary and important. Since that time questions have been raised about various parts of the bill and certain events have occurred which call for comment.

With your permission, Mr. Chairman, I have quite an extended statement here, but it is divided into very definite segments and I thought I wouldn't follow the statement as it is prepared here. I would, however, take up with you at this moment our rebuttal, shall I say, with respect to the stock insurance company problem and the application of the bill to that, and also our statement with respect to what is known as compulsory membership.

It seems to me those are the two major problems that have come up with relation to the bill. It may be at some later date you will want me to speak on, and I have statemens wih respect to, what we call improved controls over broker-dealers and their employees, that is, direct action against the employee as well as against the firm, and also the removal of the exemption from registration for intrastate broker-dealers.

I have two brief statements on those, but I won't speak to those until and unless there are inquiries made.

Finally, I have two, or indeed three, other statements of considerable length, one bearing on the specialist and one bearing on the whole Ira Haupt problem. I thought with your permission that I would focus on the bill first and then when it comes to the questions—for instance, you may choose to start with a question on Ira Haupt—I would like at that time to give you the background and our statement with respect to Ira Haupt. If that is all right as a procedure, I would like to follow it.

Mr. STAGGERS. Mr. Chairman, we will agree with your proposal. You say you have as your two first subjects "insurance" and the "compulsory registration." I believe after you have finished those, at that time if you are willing we would ask you questions and get those two subjects out of the road and proceed to the next questions then.

Mr. CARY. Yes, sir; that would be fine. It is up to you as to how you want to proceed, obviously, but I just merely wanted to say that I thought I would speak to the bill parts first and then have my statements ready on the other areas on which I am sure you will be asking questions, mainly Haupt, and the specialist problem, and the like.

Mr. STAGGERS. We feel that each one of them is very important to our consideration so we don't want you to skip any of them. The last few might be the most important. I am not sure.

Mr. CARY. I simply meant that the last few do not bear on H.R. 6789 and that is why I was going to leave them until the point when you might have asked a question with respect to them.

Mr. STAGGERS. You may proceed with your first two subjects.

Mr. CARY. All right, sir. If I may, therefore, I would like to turn to page 22 of my statement because that is the part which relates to the necessity for including life insurance companies in the general extension of fundamental investor safeguards to the over-the-counter market.

Since we last appeared before your subcommittee on November 20, 1963, a great deal of testimony has been received from representatives of the insurance industry on H.R. 6789. That testimony revealed one

significant new development—the commendable, but woefully inadequate, effort of the National Association of Insurance Commissioners to provide some protection for investors in stock insurance companies in the area of reports to stockholders, proxy solicitations, and insider trading. The testimony also revealed a great many misconceptions, some of them rather startling, as to what H.R. 6789 provides and what it does not provide.

In view of these developments and the importance of the matter, we believe it appropriate to comment on the issues raised and restate our views. On the occasion of our prior appearances before the subcommittee the question of whether or not insurance companies should be subject to H.R. 6789 and whether or not this bill conflicts in any way with State insurance regulation was exhaustively reviewed by the subcommittee.

Indeed, I believe no other single question presented by this legislation has received such careful consideration. Our position was developed at length on November 20, 1963, in response to extended and thoughtful questioning by Chairman Harris and others. Our views were also set forth in a letter dated August 30 to Chairman Harris in response to an inquiry from him, and our position with respect to financial reports and accounting of life insurance companies was further explained in great detail in a letter dated September 18, 1963, to Commissioner Combs of Arkansas, which has been made a part of this record. I will not attempt to repeat that material here. I would like, however, to highlight certain salient considerations as follows:

1. The tenor of some of the discussion before this subcommittee has been such that it might appear that you are presiding over a legislative debate about the acceptability of insurance company financial statements filed with the States and the necessity for clarification in footnotes.

In our view that is not what we are talking about or why we are here. The disclosure and reporting requirements of the Securities Exchange Act of 1934 reflect a well-rounded, well-conceived pattern of Federal regulation which has no counterpart in any other Federal or State statute, duplicates no Federal or State requirement and was enacted to fill a recognized need for the benefit of the securities markets and the investors of this country. The report of the special study has asserted and we are asserting that this pattern of Federal regulation should apply to every major segment of the over-the-counter market, just as it applies to every major segment of the listed market, and the fact that insurance companies happen to be subject to State regulation of their business is completely irrelevant to the problem to which we address ourselves.

That this is so is demonstrated by the consistent congressional policy of applying this pattern of Federal investor protection to regulated industries. The Securities Exchange Act contains no exemptions for industries subject to pervasive Federal regulation, such as banks, railroads, motor carriers, and electric and gas utilities under the jurisdiction of the Federal Power Commission.

State regulation has likewise not given rise to any exemptions, whether for insurance companies or for public utilities. Certain accommodations have been made as to the form and content of financial statements where these are prescribed by regulatory authorities. We

have made comparable accommodations with respect to financial statements for insurance companies. Reliable financial statements are an essential part of the scheme of disclosure, and we do not question the reliability of financial statements filed with the State insurance commissioners. In the total pattern of investor protection differences of opinion concerning footnotes and supporting schedules would seem wholly incidental.

Financial statements are, of course, only one part of the pattern. The Exchange Act affords investor safeguards in the areas of proxy solicitations, company reporting, and securities trading by insiders. The Commission's proxy rules have the effect of placing in the hands of stockholders fundamental business and financial information through requiring the transmission of a report to stockholders, as well as a proxy statement.

They are unique in this respect; there is no other similar State or Federal requirement in existence and never has been. We think the Commission's proxy rules as evolved over the past 30 years reflect one of the major accomplishments flowing from the 1934 act for the benefit of the investing public and the marketplace generally.

The periodic reporting to the Commission of major corporate events and the annual reporting of developments during the year, against a background of reliable financial data, are designed to provide for the benefit of the public and the marketplace timely and reliable information pursuant to uniform and clearly expressed criteria.

Moreover, the statutory scheme reflected in section 16, inhibiting the unfair use of inside information, is well understood and generally accepted as effective and beneficial. It, too, has no counterpart in any Federal or State law.

This pattern is not of direct regulation, such as the States apply to insurance companies and public utilities, but is essentially the mild discipline of required disclosure. It is now applied to the exchange market and, in our judgment, should apply to every major segment of the over-the-counter market, including the insurance industry, which is a major segment of that market.

We have made it abundantly clear that minor variations as between States and as between States and the Federal Government on the matter of financial statements at this day and time are not important and are not an issue. What is important is that no sensible reason can be offered to justify special treatment, special exemptions, if you will, for insurance companies from the point of view of the American investor and the regulation of the securities markets.

2. Stock insurance companies have been fully subject to the Securities Act of 1933 and the Securities Exchange Act of 1934 since the enactment of those statutes. Application of the Federal securities laws to the stock of insurance companies is no "Federal invasion" of the insurance field. Hundreds of insurance companies have registered under the Securities Act of 1933, and approximately 170 insurance companies are now subject to the reporting requirements pursuant to section 15(d) of the Securities Exchange Act.

Moreover, three insurance companies are listed on an exchange and therefore subject to not only the reporting requirements, but to the proxy rules and to the insider trading provisions.

3. The Special Study of Securities Markets—which especially focused on insurance companies—found that the reporting and proxy solicitation practices of the insurance industry were seriously deficient when compared with those required by the Securities Exchange Act of 1934.

For example, 50 percent of the issuers that sent financial material failed to include a profit and loss statement, the key document. This finding is reaffirmed by the recent report of the Financial Analysts Federation, which was transmitted to Chairman Harris on January 17, 1964. The chairman of that federation stated in his letter to Chairman Harris:

> The report clearly demonstrates that the information supplied to stockholders of stock life insurance companies falls far below acceptable standards, although there has been a little improvement since our evaluations in 1959–60.

I might say in 1960 the federation had stated:

> * * * annual reports to stockholders of the life insurance industry are the poorest of any major industry in the United States.

In this connection, if I may just interpolate for a moment, I need not repeat points made about the ballooning of the insurance industry, how it has grown in the past few years, and the promotional nature of many of these developments, of the rise of these insurance companies.

4. In 1934, Congress decided that investors in the stock of insurance companies should have the benefit of the protections afforded by the Securities Exchange Act. There was no conflict with the purpose of policy of State insurance regulation then and there is none now. The primary thrust of State insurance regulation is to insure the solvency of insurance companies for the benefit of policyholders, not to provide disclosure for investors. This distinction was pointed up, although in a slightly different context, in the decision of the Supreme Court in *S.E.C.* v. *Variable Annuity Life Insurance Company of America.*

In contrasting the philosophy and purposes of the disclosure requirements of the Securities Act of 1933 with State insurance regulation, in his concurring opinion Justice Brennan stated with respect to the Securities Act:

> The emphasis is on disclosure; the philosophy of the act is that full disclosure of the details of the enterprise in which the investor is to put his money should be made so that he can intelligently appraise the risks involved.
>
> The regulation of life insurance and annuities by the States proceeded, and still proceeds, on entirely different principles. It seems as paternalistic as the Securities Act of 1933 was keyed to free, informed choice. Prescribed contract clauses are obtained legislatively or administratively. Solvency and the adequacy of reserves to meet the company's obligations are supervised by the establishment of permissible categories of investments and through official examination. The system does not depend on disclosure to the public * * * (359 U.S. 237, 290 (1958)).

And that is the point that we are making.

5. The Commission has no intention of disturbing traditional insurance accounting as evolved by the State securities administrators. Our accounting requirements for insurance companies accept insurance accounting as developed under State regulation, and we do not require that the financial statements filed by insurance companies under the Exchange Act be audited by independent public accountants.

We do require a few explanatory notes—explaining insurance terminology and tax matters, and containing a historical analysis of

surplus—for the benefit of investors unfamiliar with insurance accounting.

These are relatively simple to prepare and involve consequential expense. The information is contained in the insurance company's annual statement (its report to State insurance authorities) or is otherwise readily available, and need not be certified. We are prepared further to coordinate our efforts with the National Association of Insurance Commissioners to the end that we will be in a position to accept substantially or completely the form of financial report filed with the States.

B. CLARIFICATION

The foregoing restates our general position and should dispel, I believe, certain of the many misconceptions which were apparent in the testimony before this subcommittee. While I am sure that none of the witnesses intentionally sought to mislead the subcommittee I think it unfortunate that these gentlemen did not avail themselves of the opportunities available in the record before your subcommittee to ascertain the nature of our proposal before denouncing imaginary evils.

Let us note some of the gross inaccuracies:

1. Several witnesses stated that the cost of complying with the Commission's reporting requirements would be substantial in amount and significant in terms of net income. Practically every estimate was based on the assumption that financial reports would have to be certified.

Accordingly, these estimates must be viewed as totally without foundation. We have stated over and over again—before the Senate Subcommittee on Securities, before this subcommittee, and before the life insurance commissioners, in conversations with representatives of the insurance industry and in our proposed rules—that the Commission does not require certification of financial statements and reserves in connection with annual reports of life insurance companies.

2. It was also urged to the subcommittee that the SEC's accounting requirements would require a change in insurance companies' accounting systems. Here also it has been repeatedly pointed out that, under the Commission's accounting requirements, no change is necessary in an insurance company's accounting system. As just noted, an insurance company can comply, in effect, by filing the report submitted to the States with certain minor explanatory supplements.

3. It was stated to the subcommittee that article 7–A of regulation S–X (the proposed accounting regulation for life insurance companies) had not been discussed with any segment of the industry with which the speaker was acquainted nor had it been discussed with the National Association of Insurance Commissioners (NAIC).

Suffice it to say, in 1960, 2 years before public circularization of the proposal, a draft of the proposed article was sent to the State insurance commissioners of Washington, North Carolina, New Jersey, Oklahoma, North Dakota and Tennessee, all of whom were members of an NAIC committee.

Moreover, the proposed article was publicly circulated in 1962 with a request for comments from any interested parties and copies of the release were sent to over 6,000 persons on the SEC mailing list.

In addition, in our letter to Commissioner Combs, dated September 18, 1963, and I might say in parenthesis, that that was following a meeting I had with him and I believe four or five other insurance commissioners who had come to visit the chairman, we stated that, although the Commission had discussed the article with official representatives of the NAIC, if any of the State commissioners still had problems or reservations, the Commission hoped that it would be advised.

The list is legion. One insurance spokesman commented on the onerousness of preparing quarterly reports. Recognizing the special characteristics of life insurance companies, the Commission long ago exempted insurance companies other than title insurance companies from filing the semiannual reports required generally of commercial and industrial companies and quarterly financial reports are not required at all except for certain real estate companies.

Another stated that under the legislation companies could not merge without Commission approval. Of course, the Commission has no such authority. Certain statements are not worthy of comment, i.e.:

> Its (H.R. 6789) obvious effect, if not its designed effect, is to prevent the development of such financial institutions in areas of the country that need them.

I doubt whether the public will be kept from investing in these companies just by reason of knowing the facts about them.

C. MERGERS

There are a few more major misconceptions about H.R. 6789 I would like to clear up for the subcommittee. A substantial amount of testimony was given about mergers apparently provoked by the reference in my letter to Chairman Harris to mergers as one of the events requiring the filing of a current report with the Commission.

The provisions of H.R. 6789 will apply to mergers of companies subject thereto in the following way. First, if proxies are solicited to vote upon the merger, as is normally the case, the Commission's proxy rules require the furnishing of information necessary to enable the stockholders to appraise the proposed merger as a business and financial matter. These include descriptions of the plan of the merger and pertinent business and financial facts about the companies involved.

Second, if the merger is consummated, this event requires the filing of a current report with the Commission on form 8–K briefly describing the transaction.

It was contended that these provisions need not be applied to insurance companies because of the protections of State regulation. State insurance laws ordinarily provide for mergers of insurance companies by procedures generally similar to those applicable under State corporation law to corporations generally, but with an additional requirement that the merger be approved by the State insurance commissioner.

The statutes of Texas, which are referred to in the testimony as a most comprehensive code for the protection of all concerned, including the stockholders, simply provide that the procedures specified in the State's business corporation law be followed in the case of a merger of insurance companies and that the merger must be approved by the insurance commissioner.

It is further provided that the commissioner must approve unless he finds—

the plan contrary to law or that it would not be in the best interests of the policyholders affected by the plan. (Texas Insurance Code, art. 21.25.)

It will be noted that in this provision nothing whatever is said about the interests of stockholders. This is consistent with the general thrust of State insurance regulation referred to above.

It is true that under the business corporation law of Texas, as is true of most States, stockholders are entitled to vote upon a merger, and a copy of the plan or agreement of merger is furnished to them. This ordinarily is a complex legal document, essentially constituting the charter of the surviving corporation, and does not furnish stockholders with the business and financial facts necessary for an intelligent vote. Since the State law with respect to mergers of insurance companies is essentially the same as the State law with respect to the mergers of other types of corporations, except for the requirement of approval by the insurance commissioner, and since this approval primarily depends on a finding that the merger will be in the best interests of policyholders, it would not appear that stockholders of insurance companies have any significantly greater protections in the area of mergers than do stockholders of other corporations under State corporation law.

A pattern of inadequate disclosure to stockholders concerning insurance company mergers is clearly brought out in an examination by the Commission's Division of Corporation Finance of eight recent proxy statements of insurance companies relating to mergers, consolidations, and acquisitions.

This examination is part of a report by the Division on proxy materials of insurance companies, which I should like to offer for the record.

(The material referred to follows:)

STUDY OF INSURANCE COMPANY PROXY STATEMENTS AND PROXY SOLICITING MATERIAL

The staff of the Division of Corporation Finance recently conducted a study of proxy soliciting material furnished by insurance companies which have filed registration statements under the Securities Act of 1933 and are subject to the reporting requirements under section 15(d) of the Securities Exchange Act of 1934. This study was limited to those companies whose files were immediately available. It should be noted that proxy soliciting material includes proxy statements, forms of proxy, or other soliciting material. Such material is furnished for the information of the Commission in connection with the annual report on form 10–K. This proxy soliciting material is not demed to be "filed" with the Commission or otherwise subject to the liabilities of section 18 of the Securities Exchange Act. Proxy materials for 71 companies were reviewed, of which 39 companies submitted proposals for shareholder action on matters other than the election of directors. Among the proposals to be considered by stockholders of these 39 companies during the last 3 years, there were (1) 17 proposals to increase authorized capital, (2) 10 proposals for the adoption of stock option plans, and (3) 8 proposals related to mergers, consolidations, and acquisitions. Charts detailing the results of this study are attached to this memorandum. Certain salient facts are evident from the study. Among them are:

With respect to the 17 proposals to increase authorized capital, 11 of the solicitations contained no proxy statement, the form of proxy in 10 of the solicitations reviewed did not contain ballot boxes to enable a shareholder to either approve or disapprove the proposed increase (in 3 of the cases reviewed the form of proxy was not available). Six did not even state reasons for the proposed in-

crease, and 14 of the solicitations failed to inform shareholders of the vote necessary for approval.

For the 10 proposals to adopt stock option plans in one-half of those shareholders were not furnished proxy statements, 6 of the solicitations did not have ballots in the form of proxy, and 6 did not indicate the vote needed for approval. With respect to furnishing shareholders a description of the plan, two did not state the number of shares involved, four did not indicate how the option price was to be determined, only five stated when the options would expire, and only one indicated the extent to which the options would be available to officers and directors.

As for the eight companies that submitted proposals to their shareholders concerning mergers, consolidations, and acquisitions (one involved disposition of a significant amount of assets), six of the solicitations did not furnish proxy statements, or indicate whether or not any officers, directors or controlling persons had any interest in the transaction. In three of the cases reviewed the proxy form was not available. Of the five reviewed, three forms of proxy were not presented in ballot form. In four of the seven mergers, the shares of both companies were quoted in the national quotations summary, however, the proxy soliciting material did not disclose the quoted market prices. In only four of the seven was the vote needed for approval indicated. In describing the company to be acquired (and in one instance the assets to be sold) the proxy material of five of the eight companies was materially inadequate. Financial statements, including a balance sheet and a statement of operations, were not included for the surviving or acquiring company in six out of eight cases and such statements were not furnished for the acquired company in five out of seven cases.

The Commission's proxy rules have undergone an evolutionary process since adopted in 1935. It is generally conceded that the rules have had a salutary effect in promoting "corporate democracy." In view of the serious inadequacies detailed above with respect to proxy solicitations by insurance companies and the rudimentary nature of the disclosure to be required by the NAIC as contrasted with the information which is presented to shareholders under the Commission's proxy rules, we can see no reason for exempting insurance companies from the provisions of H.R. 6789, H.R. 6793 and S. 1642.

Mergers, consolidations, and acquisitions (8 proposals)

	Proxy statement [1]	Ballots in form of proxy [2]	Vote needed for approval	Description of company to be acquired [3]	Financial acquiring company	Statements acquired company [3]	Interests of officers and directors	Stock traded in OTC		Market price disclosed
								Acquiring company	Acquired company [3]	
Yes	2	2	5	3	2	2	2	8	4	0
No	6	3	3	5	6	5	6	0	3	8

[1] In determining whether or not a company was considered to have furnished a proxy statement, all information sent the shareholder was reviewed for statements relating to revocability of proxy, by whom the solicitation is made, how it was to be made, who was to bear the cost, record date, and number of shares entitled to vote at the meeting.

[2] With respect to whether or not ballots were provided in the form of proxy under the heading "Mergers, Consolidations and Acquisitions," 3 forms of proxy were not available for review. Similarly, 3 forms of proxy were not available for review under the heading "Increase in Authorized Capital."

[3] 1 proposal involved the disposition of a significant amount of assets of the company, and therefore, there was 1 less company for which market quotations or financial statements were required under the headings "Acquired Company."

Adoption of stock option plan (10 proposals)

	Proxy statement [1]	Ballots in form of proxy	Vote needed for approval	Number of shares	How option prices are determined	Expiration dates	Allocations to officers and directors
Yes	5	4	4	8	6	5	1
No	5	6	6	2	4	5	9

[1] In determining whether or not a company was considered to have furnished a proxy statement, all information sent the shareholder was reviewed for statements relating to revocability of proxy, by whom the solicitation is made, how it was to be made, who was to bear the cost, record date, and number of shares entitled to vote at the meeting.

Increase in authorized capital (17 proposals)

	Proxy statement [1]	Ballots in form of proxy [2]	Vote needed for approval	Reasons stated for increase
Yes	6	4	3	11
No	11	10	14	6

[1] In determining whether or not a company was considered to have furnished a proxy statement, all information sent the shareholder was reviewed for statements relating to: revocability of proxy, by whom the solicitation is made, how it was to be made, who was to bear the cost, record date, and number of shares entitled to vote at the meeting.

[2] With respect to whether or not ballots were provided in the form of proxy under the heading "Mergers, Consolidations, and Acquisitions," 3 forms of proxy were not available for review. Similarly, 3 forms of proxy were not available for review under the heading "Increase in Authorized Capital."

Mergers, consolidations, and acquisitions

Company	Proxy statement	Ballots in form of proxy	Vote needed for approval	Description of company to be acquired	Financial statements		Interests of officers and directors	Stock traded in OTC		Market price disclosed
					Acquiring company	Acquired company		Acquiring company	Acquired company	
1	Yes	(1)	Yes	Yes	No	No	Yes	Yes	Yes	No.
2	No	No	No	No	No	No	No	Yes	Yes	No.
3	No	No	Yes	No	No	(2)	No	Yes	-------	No.
4	No	(1)	Yes	No	Yes	Yes	Yes	Yes	No	No.
5	No	No	Yes	No	Yes	Yes	No	Yes	No	No.
6	Yes	Yes	Yes	No	No	No	No	Yes	Yes	No.
7	No	Yes	No	Yes	No	No	No	Yes	No	No.
8	No	(1)	No	Yes	No	No	No	Yes	Yes	No.

[1] Not available.
[2] Not required.

Adoption of stock option plans

Company	Proxy statement	Ballots in form of proxy	Vote needed for approval	Number of shares	How option prices are determined	Expiration dates	Allocations to officers and directors
1	No	No	No	No	No	No	No.
2	No	No	Yes	Yes	Yes	Yes	No.
3	Yes	Yes	No	Yes	Yes	Yes	No.
4	No	No	Yes	Yes	Yes	Yes	No.
5	Yes	Yes	Yes	Yes	Yes	Yes	No.
6 [1]	Yes	No	No	Yes	Yes	No	No.
6 [1]	Yes	No	Yes	Yes	No	No	Yes.
7	No	Yes	No	Yes	Yes	Yes	No.
8	Yes	No	No	Yes	No	No	No.
9	No	Yes	No	No	No	No	No.

1 company had 2 plans for which the proxy material was examined.

Increase in authorized capital

Company	Proxy statement	Ballots in form of proxy	Vote needed for approval	Reasons stated for increase
1	Yes	Yes	Yes	Yes.
2	No	No	No	No.
3	No	No	No	Yes.
4	Yes	No	No	No.
5	No	No	No	Yes.
6	No	No	No	No.
7	No	No	No	Yes.
8	No	(1)	No	Yes.
9	No	No	No	Yes.
10	No	(1)	No	Yes.
11	Yes	Yes	Yes	Yes.
12	No	Yes	No	Yes.
13	Yes	No	No	No.
14	No	No	No	No.
15	No	(1)	No	No.
16	Yes	No	No	Yes.
17	Yes	Yes	Yes	Yes.

[1] Not available.

Mr. CARY. I would note that these proxy statements are not required to be filed with the Commission and, of course, have not been reviewed by it. The Division's report indicates that financial statements were not included for the acquiring company in six out of eight cases.

Moreover, such statements were not furnished for the acquired company in five out of seven instances. Six of the cases did not indicate whether any officers, directors, or controlling persons had any interest in the transaction.

D. FINANCIAL INSTITUTIONS

It was also stated at the hearings that insurance companies are the only financial group subject to H.R. 6789. This is, of course, incorrect. Special provision is made in the bill for banks and savings and loan associations.

Aside from these, all financial corporations such as finance companies, loan companies, et cetera, are subject to H.R. 6789 in the same manner as all other corporations. Banks are fully subject but, as to

them, H.R. 6789 will be administered by the Federal bank regulatory agencies.

With respect to savings and loan associations, an effort is made to treat them in essentially the same manner as insurance companies are treated, that is, mutual savings and loan associations will be exempt, just as mutual insurance companies are.

In the case of stock savings and loan associations, the stock, if purchased and traded as an equity investment, is subject to H.R. 6789 just as is stock of insurance companies.

On the other hand, savings accounts in savings and loan associations are not subject to the bill, just as insurance policies are not covered. Because of the fact that most savings and loan associations issue so-called shares, which in fact merely evidence the existence of a savings account, special provision had to be made in proposed section 12(g) (2) (C) of the bill to exempt that type of "share."

E. PROPOSAL OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Turning now to the proposal of the National Association of Insurance Commissioners to provide additional protection for stockholders, I would first like to say that we regard this as a commendable development, but woefully inadequate.

It was apparently designed as a substitute for the proxy and insider trading provisions, which are extended to signify over-the-counter companies by H.R. 6789.

To appreciate its inadequacies, both the plan of the insurances commissioners and the requirements of sections 14 and 16 of the Securities Exchange Act should be considered.

The plan of the insurance commissioners essentially involves adding a four-page questionnaire referred to as a "stockholders information supplement" to the annual statement filed by insurance companies with the State insurance commissioner.

This questionnaire will inquire whether the insurance company sent an annual report to stockholders during its last fiscal year, whether it proposes to do so during its current fiscal year, and whether any such report contained certain specified financial statements.

It will also inquire as to whether the insurance company furnished to its stockholders, in connection with the solicitation of proxies, certain prescribed information concerning the management and directors, including their occupation, years of service as directors, stock ownership, and remuneration.

This prescribed information would be included in the questionnaire furnished to the State insurance commissioner.

Finally, the "stockholders information supplement" requires a statement by directors, officers, and holders of more than 10 percent of the stock concerning their ownership of shares of the insurance company and shares acquired and disposed of during the year.

I will now briefly describe the pertinent provisions of the Securities Exchange Act. Section 14 prohibits companies subject thereto from soliciting proxies in contravention of the rules and regulations of the Commission.

Under this section the Commission has evolved a scheme of disclosure to stockholders in connection with the solicitation of proxies

which has been described as "very likely the most effective disclosure device in the SEC scheme of things." (L. Loss, Securities Regulation, p. 1027.)

Stockholders are required to be furnished with a proxy statement which contains pertinent information concerning any and all matters which are to be voted upon, together with descriptions of the voting rights of the stockholders themselves and the identity of the persons soliciting proxies.

An annual report—this is one of the most fundamental things—to stockholders must accompany or precede the proxy statement for the annual meeting. The form of proxy must give stockholders an opportunity to specify by ballot a choice between approval or disapproval of any matter to be voted on, instead of leaving this up to the discretion of the persons who receive the proxy, as is the usual practice under State law.

Stockholders are given an opportunity to submit proposals in the proxy statement for consideration by their fellow stockholders; the use of false or misleading information is prohibited; and provision is made for review of the proxy material by the staff of the Commission to make sure that it conforms to the rules.

Where a proxy contest for control of a corporation occurs, special provisions come into play which are designed to inform stockholders fully concerning the identity and interests of the participants in the contest, and to protect them against misrepresentations which unfortunately can occur in the heat of a proxy contest.

For the purpose of preventing the misuse of inside information, section 16(a) of our act requires that reports of all changes in insider's holdings of equity securities of the issuer be filed within 10 days after the close of the month in which such changes occurred, and section 16(b) provides that all profits of insiders derived from short-swing trading in such securities shall inure to and be recoverable by the issuer. Short-swing trading is defined as sales and purchases or purchases and sales within any 6-months period. Short selling by insiders is prohibited.

Comparison of the "stockholders information supplement of the NAIC" with the foregoing provisions of the Securities Exchange Act indicates that the proposal of the State insurance commissioners is by no means an adequate substitute.

In the first place, the "stockholders information supplement" is merely a questionnaire filed with the State insurance commissioners. It does not require or guarantee that any information will be furnished to any stockholder.

We understand that it is anticipated that insurance companies will furnish the information specified to stockholders because it would be embarrassing for them to give a negative answer on the questionnaire filed with the insurance commissioners.

In many instances this will probably be so. On the other hand, there is no assurance of this as to all 50 States and for the indefinite future. If any State insurance commissioner should let it become known that he did not particularly care whether the questionnaire was answered in the affirmative or in the negative, the disclosure scheme would probably collapse in that State. In this connection, it should be remembered that, prior to the introduction of this bill,

State insurance commissioners generally did not seem to be much interested in disclosure to stockholders.

In the second place, there is no control whatsoever over the form and content of the reports or proxy soliciting material, aside from the particular items enumerated in the questionnaire. There is also no provision for the review of any of this material by the State insurance commissioner to determine whether or not the information supplied is complete and not misleading.

Insofar as proxy solicitation is concerned, the only topic as to which any information is called for is with respect to the management, their securities holdings, remunerations, et cetera. Other matters which may be voted upon at stockholders' meetings are not covered at all.

Moreover, because the State insurance commissioners will apparently have no control over nonmanagement proxy material, the protections against unscrupulous corporate raiders provided by the Commission's proxy rules will be absent.

In the third place, there is no provision for the timely reporting of material events, such as a sale or acquisition of assets. Moreover, the provisions made with respect to insider trading are exceedingly ineffective when compared with section 16 of the Securities Exchange Act of 1934.

Not only is there no provision for the recovery of profits by insiders from short-swing trading, but the reports of their transactions are filed only once a year, some months after the close of the fiscal year. It would seem that this information would be so stale by the time it reached the stockholders as to be practically useless.

In this connection, it may be noted that many investment analysts regard information concerning the transactions of insiders as significant for purposes of investment analyses since it may indicate the insider's own appraisal as to the prospects of the company and the investment merit of its securities.

Finally the provisions of the insurance commissioners, unlike those of the Exchange Act, do not prohibit short selling by insiders, which historically has been an area of abuse.

In summary, we believe that no adequate basis has been shown to reverse the decision made by Congress in 1934 that investors in the stock of insurance companies are entitled to the same protections under the Securities Exchange Act as investors in the stock or other companies, and that the efforts of the insurance commissioners to encourage insurance companies to furnish some information to stockholders are a totally inadequate substitute for the carefully developed scheme of investor disclosure and protection which Congress has provided in the Securities Exchange Act of 1934.

Mr. Chairman, that concludes my statement, solely with respect to the stock insurance company problem. I don't know whether you would like to move on to the other segment of the bill that I believe from the inquiries that have been made in the past seem to be most subject to question—that would be the compulsory membership—or whether you would like me to stop here.

Mr. STAGGERS. I believe, since you had stated to start with that you intended to give these two together, that you might as well proceed with the next statement.

Mr. CARY. I will proceed to page 43. The subject matter that I would like to now discuss is the required membership for broker-dealers in a registered securities association.

Section 6(a) of H.R. 6789 would require all over-the-counter broker-dealers to become members of a registered securities association. These associations were specifically authorized by Congress in 1938 as a medium for self-regulation in the over-the-counter market. At present the National Association of Securities Dealers, Inc. (NASD), is the only registered association. We repeatedly noted, however—and this is something I do want to emphasize—that any group of dealers meeting the standards enumerated in the Exchange Act may form and register an association. Objections have been voiced as to the need and desirability for compulsory membership; its cost to the small broker; and its constitutionality. The Commission has no doubts on these points.

Let me first place the problem in context. This amendment would affect only a limited number, but significant group, of broker-dealers. Thus, on February 28, 1962, of the broker-dealer firms registered with the Commission and that devoted a substantial portion of their time to over-the-counter transactions in conventional securities, including mutual fund shares, about 95 percent were members of the NASD. This overwhelming proportion is not surprising since—as an inducement to membership—Congress specifically permitted an association to prohibit a member from joining with a nonmember in the distribution of securities or from giving discounts from retail prices to nonmembers.

It is significant to point out that the Association of Mutual Fund Plan Sponsors, Inc., which includes among members an important segment of those broker-dealers that are not members of the NASD, supported the extension of self-regulation to all members of their industry in a letter dated June 26, 1963, to the Senate Subcommittee on Securities. Moreover, Mr. John C. Williamson, director of governmental relations, National Association of Real Estate Boards, testified before the Senate subcommittee that his association, consisting of 74,000 realtors, endorsed the compulsory membership section of the bill. Sellers of real estate securities also represent an important element in the securities markets not uniformly affected by self-regulation.

Why does the Commission believe that broker-dealers should belong to a self-regulatory agency? Essentially because self-regulation has been most effective in raising and maintaining standards in the industry, in many cases above those required by law. It has acted in areas where the Government could not operate or could not have operated as effectively or efficiently. The special study, which intensively focussed on self-regulation in its examination of the markets, concluded:

> * * * it is appropriate to emphasize * * * that the basic statutory design of substantial reliance on industry self-regulation appears to have stood the test of time and to have worked effectively in most areas.

The special study further stated: "The NASD has many important accomplishments to its credit." For example, the NASD's markup policy and its enforcement has been of aid in preventing unreasonable markups in trading transactions with customers. Moreover, the

NASD has in recent years undertaken a review of underwriting fees charged by member firms with a view to preventing unreasonable fees. The NASD has taken steps in the area, including examinations for salesmen; H.R. 6789 would authorize and direct significant improvements. Finally, the association's program of examination of member firms—which covers, among other things, compliance with the Commissions's net capital rules—has assisted in obtaining and maintaining compliance with the various Federal securities acts and Commission's rules, as well as those of the NASD.

In this connection, it would appear that the activities of the NASD have proven effective in reducing the number of the most serious legal offenses—those that lead to revocation of registration with the Commission. During the 12-year period 1940–51, on the basis of the average number of broker-dealer registrants that were members and nonmembers of the NASD, the percentage of non-NASD members whose registration was revoked by the Commission was about nine times as high as the percentage of NASD members having their registration revoked. During the period July 1, 1961, to July 1, 1962, the percentage of non NASD members whose registration was revoked was about 3.8 times as high as the percentage of NASD members having their registration revoked.

In summary, the operations of the NASD have increased protection for investors, often in areas where the Commission is not authorized to act, such as underwriting compensation. Considerable savings to the taxpayers have resulted; for example, if the NASD had not spent over $2.5 million in 1963, the Commission would have had to increase its budget to cover the work otherwise performed by the NASD. It is contemplated, moreover, that the activities of the NASD, as those of the other self-regulatory agencies, will be expanded and become more vigorous, under somewhat more intensive Commission supervision.

I would strongly emphasize that the highly important provisions of H.R. 6789 requiring registered securities associations to estabilsh appropriate higher standards of training, experience, and other qualifications will have the necessary industrywide impact only if membership is required. If membership is not required, increased governmental regulation over the nonmembers will be necessary to prevent an undesirable gap between standards applicable to members and nonbers. Otherwise, all NASD members would have to meet requirements of competence and training, whereas nonmembers would not. This makes little sense.

We would strongly prefer compulsory self-regulation to the alternative of increased governmental regulation. In many areas, Commission regulation may not be as sensitive or effective as regulation by a registered securities association, especially where ethical standards, as opposed to legal standards, are involved. In certain fields, such as qualifications, regulation has traditionally been done by the self-regulatory agencies. Moreover, it would be anomalous and inefficient for the Commission to do a job in respect of some broker-dealers that the self-regulatory agencies do for the vast majority. The Commission's main responsibilities are, and should continue to be, oversight over the self-regulatory organizations and concentration on major policy questions and serious fraudulent conduct. Our efforts should

be diverted. The extension of the existing framework of self-regulation would, for these reasons, be the more sensible solution. On the other hand, if membership is not required, financial equity would dictate that there should be statutory authorization for the Commission to assess fees against nonmembers to defray the costs of the added regulation occasioned by their nonmembership.

If I may deviate from my statement for one moment just to reemphasize this point, for example you would feel that compulsory membership should not be adopted, it seems to me it forces, as I said in this statement, the Commission to undertake the regulation of, shall we say, that 5-percent group. My own view is that the Commission really ought not to be encroaching into that area of that kind of regulation. We shouldn't be extending ourselves in areas where it isn't getting to the main issues, where it isn't the oversight over the self-regulatory institutions. I think from the questions undoubtedly that you will raise on special issues and others, our job, it seems to me, one of oversight and more concentration on that area, oversight of self-regulatory institutions and major fraud matters, and not get diverted into these other areas. I think philosophically it is important as well as practical, so I would urge this point for further consideration.

Going on with my statement, questions have also been raised about the costs of joining and remaining a member of a self-regulatory association. In its letter of January 14, 1964, to Chairman Staggers, which was also sent to each member of the subcommittee and to Chairman Harris, the Commission detailed these costs for a NASD firm. We there showed that they are modest for the large majority of firms. For example, during the fiscal year ended September 30, 1963, about 77 percent (3,740) of the NASD's members paid annual dues of $100 to $199.

Let me make two additional points. First, the Commission has a distinct responsibility in this area. The exchange Act requires that the dues and fees levied by a registered securities association be equitably allocated and requires the Commission to disapprove any dues and fee structure that does not meet the test. Second, the costs of membership are for regulation that would have to be performed by the Commission if membership is not required. The costs of the alternative Commission regulation would either be borne by the taxpayers or, as fairness would seem to dictate, by nonmembers through Commission fees. Thus, these costs would be incurred even if membership is not required.

Finally, I would turn to the issue of constitutionality—which was also extensively discussed in our letter to Chairman Staggers. The Commission strongly maintains there is no real question as to constitutionality, which in the main relates to the "delegation of powers" doctrine. The extensive Commission oversight, and the judicial review of that oversight where specific action is taken against a firm or an employee, assure that associations are organized and operated fairly and in the public interest. For example, the Commission has the power to disapprove any rule change of an association or abrogate any existing rule; it must review any disciplinary action by the association or denial of membership, where requested by a aggrieved party. This governmental oversight meets any constitutional ques-

tion. That was the holding of the Court of Appeals for the Second Circuit with respect to the present statute and the fact of compulsory membership should not change the result.

In summary, in view of the favorable record of self-regulation and the future advances it is expected to make, its discipline and standards should be applicable to all firms.

Mr. Chairman, that brings us up to two others which I was not planning at this point to discuss. They are very brief. I think each of them is about a page and a half. They relate to two other matters on which some question was raised in connection with the bill.

One was what we call in our heading IV at page 50 of my statement "Improved Controls Over Broker-Dealers and Their Employees." The bill authorizes us to proceed against a firm and the individual as distinguished from just the firm alone.

Questions about this authority have been raised and I would like to have our statement on it made a part of the record. I didn't think it necessary to read the statement unless the questions are raised and inquiries are made today.

The second brief statement is our heading V at page 51 of my statement, about two and half pages long, which deals with the removal of the exemption from registration for intrastate broker-dealers. If there is any question in that connection, any inquiry today, I would like to ask the privilege at that particular time to read that statement.

That, however, completes what I had planned as a prepared statement with respect to the major questions which seem to me to be left open after the hearing on the bill.

(The material mentioned above follows:)

IV. IMPROVED CONTROLS OVER BROKER-DEALERS AND THEIR EMPLOYEES

Several provisions of H.R. 6789 are designed, as recommended by the special study, to give the Commission increased flexibility and choice in assessing administrative sanctions against firms and their personnel according to the relative culpability of the parties involved in violations. One part of that program would be the new intermediate sanctions with respect to a firm: suspension of its registration with the Commission for up to 12 months or censure, if revocation of registration is not warranted. Another aspect relates to individuals. The Commission would be authorized to impose specific, flexible sanctions—censure, suspensions—on individual violators as it could do in the case of firms. Moreover, the Commission could move solely against offending individuals.

Concern has been expressed that the effect of these provisions will be that individual salesmen will be disciplined, while their firms go undisturbed. Let me assure this subcommittee that this bill is not intended to, and in no way will, relieve firms of their legal or moral responsibility for the conduct of their personnel or replace Commission discipline of firms with discipline of individuals only. Indeed, the bill expressly codifies the Commission view that a failure to supervise is a basis for proceeding against a firm. In nearly all cases, action will be taken against both firms and individuals. Only in the relatively unusual case where it is clear that no administrative sanction against the firm is warranted will action be taken solely against individuals, e.g., (1) where a salesman, despite proper safeguards and controls, embezzles money or other property from his firm, and (2) where a salesman commits a private securities fraud related to his firm's business.

To summarize, section 6(b), allowing the Commission to focus on individual conduct, is part of the program to give the Commission increased flexibility and choice in taking action against firms and their employees. The section will in no way relieve a firm from its responsibilities for the conduct of its employees.

V. REMOVAL OF THE EXEMPTION FROM REGISTRATION FOR INTRASTATE BROKER-DEALERS

Broker-dealers whose business is "exclusively intrastate" are presently exempt from registration with the Commission. Section 6(a) of H.R. 6789 would remove that exemption. Questions have been raised as to whether there is a Federal interest in the activities of these brokers. These questions apparently rest on the mistaken assumption that intrastate brokers are presently outside the scope of Federal regulation. This is not at all the case.

In section 15(c) of the Securities Exchange Act of 1934, Congress has imposed obligations upon intrastate brokers in the important substantive areas of fraud and capital. I would quite agree that H.R. 6789 gives the Commission new powers over these brokers—but powers in large measure to meet already existing responsibilities.

The Commission presently spends a significant amount of time and effort in discharging its duties with respect to intrastate broker-dealers. Since these broker-dealers are not required to register, the Commission does not learn of their existence until there are complaints. Also, they are not subject to the record-keeping and reporting rules that are applicable to registered broker-dealers. The lack of these two important enforcement tools has made Commission fraud investigations in respect of intrastate broker-dealers more difficult and has resulted in time spent that is disproportionate to their numbers and importance. The proposed repeal will enable the Commission to discharge more effectively and efficiently its responsibility to see that these broker-dealers, who are often ignorant of their responsibilities under Federal law, conform to the standards of conduct which Congress has required of them.

Other important purposes to be served by this amendment would be to subject these broker-dealers to the self-regulatory standards prevailing in the securities industry. This will further the establishment of uniform minimum standards. Moreover, repeal of the exemption will also preclude broker-dealers from evading the impact of disciplinary action by the Commission by temporary retreating to an intrastate business.

Removal of the intrastate exemption will not result in Federal preemption. State regulation of intrastate broker-dealers would be invalidated only where there is a conflict and this only where a State authority attempted to relieve broker-dealers registered with it from the duty to comply with Federal law. No State has ever attempted to do so. States can require and have required broker-dealers subject to Federal requirements to employ with their requirements, and this they have done for 30 years. Since State regulation and Federal regulation are aimed at common goals, the prevention of fraud and the protection of investors, it is rare when there is even a possibility of a conflict. The Commission cooperates with State securities administrators, and State regulation and the Commission's regulation supplement each other. The States primarily regulate brokers and dealers through licensing rules, which are in no way affected or impaired by Federal regulation; and the Commission's regulation supplements State regulation in providing surveillance over the conduct of brokers and dealers.

Although there is the theoretical possibility of a conflict between State and Federal regulation, the Commission has had concurrent jurisdiction with the States for 30 years in the regulation of both registered and unregistered broker-dealers and, to the Commission's knowledge, there has been no instance of conflict.

Mr. STAGGERS. Mr. Cary, we certainly want to thank you for this, in my opinion, very strong and good statement that you have made. There are some questions I am sure that the committee wants to ask you and at this time we will start that questioning.

Mr. Dingell, any questions?

Mr. DINGELL. Mr. Cary, you indicate in your statement on page 51, referring to section 6(b).

The section will in no way relieve a firm from its responsibilities for the conduct of its employees.

I assume this means that where there is a serious action by a firm or a member of a firm which adversely affects the interest of investors the Commission will give very serious thought and I assume in a num-

ber of instances, if not most, proceed against the firm as well as against the employee because of the failure by the firm to properly supervise the employee.

Am I correct in that?

Mr. CARY. That is absolutely correct. In other words, the assurance that we wanted to give you, and that is the main thrust of this brief statement at pages 50 and 51 is that this is not going to mean that we will take action only against individuals. It merely means that in some cases we would want to take action against an individual as well as the firm.

Mr. DINGELL. Mr. Cary, I noticed all through your statement, for example, at page 39 and at page 25, you speak of section 16 of the act.

Mr. CARY. Yes, sir.

Mr. DINGELL. Prescribing unfair use of insider information and also prescribing short-swing trading by insiders, I assume that is a section which the Commission intends to continue supporting with enthusiasm. Am I correct?

Mr. CARY. Indeed it is.

Mr. DINGELL. Mr. Cary, that is a very good point because that brings up something that has concerned me greatly with regard to the bill. That is simply this. I notice that the bill provides for a very serious weakening with regard to market makers in section 16. Am I correct?

Mr. CARY. I would say there is a definite provision making this inapplicable to market makers.

Mr. DINGELL. That is on page 36 of the bill, line 5 on down to line 21 inclusive.

Mr. CARY. I believe that is correct; yes, sir.

Mr. DINGELL. I noticed that the report of the special study which cost the taxpayers something on the order of a million dollars as referred to in release No. 24 by the Securities and Exchange Commission, dated April 3, 1964, includes this language:

> The report also concludes that there is no need for a general and broad exemption from section 16(b) which provides for corporate recovery of short-swing trading profits of insiders in respect of broker-dealers making markets in securities of issuers on whose board of directors they are represented.

Am I correct?

Mr. CARY. That is correct. That is a statement from the report.

Mr. DINGELL. You remember very well, Mr. Cary, at the time that you were here last you and I had a discussion about whether or not this was the Commission's report, whether or not the Commission endorsed the report, or whether or not the Commission merely forwarded the report to this committee.

You indicated, I believe, in the record at that time that you felt that the Commission endorsed the report. I assume that the language of the bill which you folks down there at the Commission sent up to us, H.R. 6793, embodies generally the language of the report and the recommendations of the special study commission.

Am I correct?

Mr. CARY. In a broad sense, that is correct.

Mr. DINGELL. Then it is rather surprising to me, in view of the report, to find the language appearing at page 36, line 5 and following, that I referred to. How do you justify this, Mr. Cary?

Mr. CARY. Yes, sir; our original view would have been to carry out in a general way with respect to the application of 1(b) the theory that it should apply to all persons equally.

Mr. DINGELL. Why should it not apply to a market maker then.

Mr. CARY. We have had very substantial discussions with the industry on that.

Mr. DINGELL. That is the next point that I want to come around to, because I notice here in a letter to the Honorable Harley Staggers—this is your letter on the letterhead of the Commission, dated January 30, 1964—on page 2 about the middle of it under paragraph 2 it reads as follows:

I would point out that, when the Commission subsequently met with the securities industry and its representatives on the present legislative program—

Then there is some other language and it comes down and says:

* * * it was agreed that proposals for the section's amended would not be included in the legislative program now pending before your subcommittee.

Mr. CARY. Yes, sir.

Mr. DINGELL (continuing):

It would, of course, have been inconsistent with this determination to include legislative proposals in the limited but important area represented by *Blau* v. *Lehman*.

This is the Supreme Court case.

Mr. CARY. Yes, sir.

Mr. DINGELL. In other words, what you did was you held meetings with the industry and you simply agreed with the industry that you would afford industry exemption from the insider trading provisions of section (b) which we have already referred to as being particularly important and which are therefore embodied in the language of H.R. 6793. Am I correct?

Mr. CARY. I think, in general, I agree with everything you said.

Mr. DINGELL. In other words, you simply agreed with the industry that you would disregard the recommendations of the special study with regard to section 16(b).

Mr. CARY. Let me say this in respect to market makers.

Mr. DINGELL. In respect to market makers, the special study specifically deals with the problem of market makers and insider information, short-swing trading, does it not?

Mr. CARY. That is correct.

Mr. DINGELL. And in effect you have completely disregarded the recommendations of the special study with regard to this particular point. Am I correct?

Mr. CARY. We pursued in general the theory that the——

Mr. DINGELL. You are not answering my question.

Mr. CARY. I will generally agree with you; yes, sir. I would like to make an explanatory statement at some point, but I agree with you. I think your criticism is perfectly appropriate, although I would have some explanation to give.

Mr. DINGELL. As I have said before, Mr. Cary, I have a very high regard for you. I think you are a dedicated and a fine public servant, but on this particular matter and I have some very substantial disagreement, because we spent over a million dollars of taxpayers' money to come up with a special study which I assume was carefully conducted by competent people, was it not?

Mr. CARY. Yes, sir; which I am very proud of.

Mr. DINGELL. You appointed them and you picked the most competent people you could lay your hands on, did you not?

Mr. CARY. Yes, sir.

Mr. DINGELL. And one of their recommendations was directly in opposition to the provisions of subsection (b), line 5, page 36 of the bill, was it not?

Mr. CARY. Yes, sir; generally.

Mr. DINGELL. And what happened was that you met with the industry and you decided, as you indicated in your response to Chairman Staggers of this subcommittee, that you would let them have a loophole more broad in the law than was already there.

Am I correct?

Mr. CARY. We gave, rather than the word "loophole," what I would regard as a limited exemption to market makers.

Mr. DINGELL. You can call it whatever you want, but the fact of the matter is it says that market makers in the future are going to be able to derive benefits of insider information which they have not previously been allowed to derive.

Isn't that a fact.

Mr. CARY. I will ask Mr. Loomis to speak to that.

Mr. LOOMIS. Commissioner Cohen also will speak to it. I would just say briefly that over-the-counter market makers are not now subject to the bill of course.

Mr DINGELL. We are not discussing over-the-counter market makers. I think maybe we ought to take a look at them, but, as a matter of fact, other market makers are bound by the provisions of 16(b) and you are exempting them from that provision, are you not, under this bill?

Mr. LOOMIS. As it was written here it might be subject to that interpretation, but as it was changed in the Senate it applies only to over-the-counter market makers, and we think that is desirable.

Mr. DINGELL. I don't happen to think it is desirable. It should apply to any market maker, but the fact of the matter is you have permitted this legislation to go directly opposite the recommendations of the special study group and you have permitted market makers to utilize inside information under this bill for their private benefit and under this bill you would permit them to engage in short-swing trading. You would permit them to utilize insider information under this bill for their personal and for their private gain, something which was not previously permitted by law.

Mr. CARY. Mr. Cairman, of course this law has not previously been applicable to over-the-counter securities. Therefore, 16(b) has not been applicable to them before. You are quite right that, if 16(b) in its general form had been made applicable to these particular securities, it would be applicable without any exemption and we have applied a limited exemption. If I may, I would like to give you some of the background and reasons for it.

There has been traditionally in the over-the-counter market, and now if this bill would go through it would apply to securities in the over-the-counter market——

Mr. DINGELL. It would also apply to the market generally, would it not?

Mr. CARY. No, sir. This only applies to securities in the over-the-counter market. This limited exemption would only apply to over-the-counter marketmakers, the point that Mr. Loomis made. They are a special group that I wanted to describe, if I may.

Mr. DINGELL. Let's concede that it is just a limited exemption. Here I am going to read to you from the language of *Blau* v. *Lehman*, reading to you from the opinion of Justice Douglas with whom the Chief Justice concurs. They were quoting from a report of the 73d Congress, 2d session, and they said as follows:

> Among the most vicious practices unearthed at the hearing before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control in the destinies of their companies to enable them to acquire and profit by information not available to others.

This language would be fully applicable to marketmakers, would it not?

Mr. CARY. That language is generally applicable to all directors and it would include marketmaker directors; yes, sir.

Mr. DINGELL. It would actually include marketmaker directors.

Mr. CARY. That is correct; as a general appropriation this is——

Mr. DINGELL. So in the original law this was a matter of grave concern to the Congress and this is long settled policy with regard to marketmakers and marketmaker directors, and here yet, Mr. Cary, and I want you to know that I am personally very ciritical of this, frankly I don't believe you can come forward with any adequate justification for the exemption that you have put into this legislation.

As a matter of fact, Mr. Cary, I don't believe that there is anything you can say to this committee this morning which would make it plain that this particular exemption which we are now discussing is not going to authorize a rather peculiar, dangerous, and highly profitable form of rascality on the part of insiders.

Mr. CARY. Mr. Chairman, I would like to explain now, if I may, the reason for the limited exemption that is being given here.

First of all, your general statement, Mr. Dingell, that you read from *Blau* v. *Lehman* is, as you say, applicable to directors of companies whose securities are subject to 16(b) generally. At the moment up until this bill is enacted that would only include listed companies.

Now it is going to be extended, if the bill is enacted, to unlisted companies of substantial size with a large public interest. Those are over-the-counter companies in which traditionally there has been frequently a person who sponsored securities, quite often the underwriter, who took the responsibility of making a market in those securities. He also, usually, because he was the one who sponsored it, who was sort of behind the company initially in its financing to the public, was a director of the company.

It is quite true that our Special Study Report indicated they didn't think there should be any general exemption with respect to that group of over-the-counter marketmakers who are also directors. At the same time we had assurances from some of the most responsible leaders in the industry, and I can think of several who spoke on this

very point in a meeting which we held with them, that they thought a lack of an exemption would have a very substantial and appreciable effect on the market.

Under those circumstances, we provided a very limited exemption. We have the power under this law to specify the terms and conditions for the exemption; moreover, we have authority over broker-dealers—and by definition these are broker-dealers because they are market-makers who are directors—and therefore we still have antifraud authority over those broker-dealers even though this exemption is given.

Mr. DINGELL. You would have that authority under another section?

Mr. CARY. That is correct.

Mr. DINGELL. This would not be under section 16(b). You would have to proceed under another section.

Mr. CARY. Under section 15 generally, I suppose, would be the principal one and 10(b)(5), as you have indicated, of the Securities Exchange Act.

Mr. DINGELL. In other words, you are repealing a specific statute dealing with a specific problem and you are then going to proceed under a general section. Am I correct?

Mr. CARY. We are providing a limited exemption for market-makers.

Mr. DINGELL. You didn't answer my question. I said you were repealing a specific prohibition and you are then going to operate under a general provision of the statute. Isn't that correct?

Mr. CARY. In respect to marketmakers, but I will ask Mr. Cohen to speak to this too.

Mr. DINGELL. I want to get a simple answer to this because I want to proceed to another point. This is, in effect, what you are doing. You are repealing a specific prohibition and you are going to then try in the future to attack this under a general proviso. Am I correct?

Mr. CARY. I would like to have Mr. Cohen speak to this.

Mr. DINGELL. I wish you would give me a simple answer now, Mr. Cohen.

Mr. COHEN. The answer is no, but I need to explain it, if I may.

Mr. DINGELL. Ten (b)(5) is the general section, is it not?

Mr. COHEN. General antifraud section, yes, sir.

Mr. DINGELL. Section 15 is also a general section.

Mr. COHEN. Yes.

Mr. DINGELL. And section 16(b) is a specific section; is it not?

Mr. COHEN. Yes, sir.

Mr. DINGELL. Then, gentlemen, we have the answer to my question. I want to go to this. I would like to have this Mr. Cary answer this question.

Mr. COHEN. May I add a word, Mr. Dingell?

Mr. DINGELL. I don't think it is necessary. I would be happy to have you do it; but I am already over my time, over the 5-minute limit. My problem, gentlemen, is just simply this. You are seeking to repeal a specific provision.

Now there is an ancient doctrine of interpretation that is applied by the courts that the expression of one thing excludes other things. Am I correct?

Mr. CARY. Yes, sir; I know that legal doctrine.

Mr. DINGELL. I believe the Latin is "expressio unius est exclusio alterius," or something of that type.

Mr. CARY. Yes, sir.

Mr. DINGELL. When we have gotten down into this aren't you effectively then creating an ambiguity whereby you may not then proceed under section 10(b)(5) or under the other section 15 that you referred to? Isn't there a possibility that you are creating a vagueness or an ambiguity?

Mr. CARY. No, sir.

Mr. DINGELL. You repeal the specific section and you go then to general sections.

Mr. CARY. I think no. I think the answer to that is "No."

Mr. DINGELL. Really the answer is you hope that is so.

Mr. CARY. This statement before this committee will, I think, further support the fact that there is no ambiguity in this. There is no, shall we say, freedom from the application of either 10 or 15 in the case of a marketmaker direction.

Mr. DINGELL. My chairman is getting very concerned about the time. I just want to read one other thing which I have here and that is a memorandum from the Securities and Exchange Commission with respect to changes in H.R. 6789 between its submission to the industry liaison committee and its introduction to the Congress.

Now, as I remember, you consulted rather liberally with members of the industry before you presented this legislation to the Congress, and I think it is appropriate that you did and I certainly am not critical of it.

Mr. CARY. Yes, sir.

Mr. DINGELL. But in this on page 7 I note the following language:

> The proposal submitted to the industry liaison committee would have authorized the Commission to grant exemptions from the provisions of section 16(b) of the act which provide for the recovery of short-swing profits of insiders, but do not provide a specific exemption for broker-dealers who maintain an over-the-counter market in securities of a particular issuer and are at the same time represented on the board of directors of that issuer. Some members of the industry liaison committee urged strongly that such exemption should be of general application and provided legally in the statute. Subsequently, there was submitted to the Commission an alternative draft which would achieve that result. This alternative draft would vest authority in the Commission to specify terms and conditions for the exemption. Upon further consideration the Commission concluded that the alternative put forward should be accepted.

Mr. CARY. Yes, sir.

Mr. DINGELL. So this is really the industry proposal that we have here. It is not the Commission proposal. It is not the proposal that was put forward by the special study. Would you agree with me on this last thought?

Mr. CARY. I would agree with you that the limited exemption is based on an industry committee recommendation; yes, sir.

Mr. DINGELL. And I think we would have to agree, with the language of the Congress which originally set forward this prohibition way back in the 73d Congress, that it was set forward to prevent rascality. It was put forward and enacted into law to prevent unscrupulous utilization of insider information, and we are effectively repealing this statute as to a large number of individuals in the industry who have a particular form of insider information which can be extremely profitable to

them and which could be utilized by them for their private profit to the disadvantage of large numbers of investors.

Am I correct?

Mr. CARY. Mr. Chairman, we think this: That this group is a group who primarily are engaged in making the market for these securities, these over-the-counter securities. With respect to that particular group, we will still have to secure reports under section 16(a). Second, we will have other powers over them through our antitrust powers. The opportunity for abuse will be sufficiently limited and at the same time it will dispel the industry worry that this might dry up the existence of markets for certain securities.

Mr. DINGELL. You tell me one reason, if you will please, why a marketmaker should be permitted to use inside information for his private profit?

Mr. CARY. It is not that, sir.

Mr. DINGELL. If you will give me one reason why he should have this right I will look again to my opposition to this section. Name me one reason, if you will please.

Mr. CARY. The general reason is that marketmakers as a whole in order to maintain a market, in other words, to be a marketmaker, have to be in and out selling and buying the stock.

Therefore, by their very definition, they would be purchasing and selling within a 6-month period and subject to 16(b). If you don't want those marketmakers to exist, then you wouldn't give this limited exemption.

Mr. DINGELL. That is really not a justification because there is no reason why an individual member under *Blau* v. *Lehman* should be permitted to do this when his firm already can profit from insider information that he happens to have.

Am I correct?

Mr. CARY. Blau against Lehman is another problem, sir, which would require an addition to the application of 16(b).

Mr. DINGELL. But you have still not told me one reason why an insider should be permitted, whether he be a marketmaker or anyone else, to utilize insider information to his personal and private advantage and why he should be permitted thereby to engage in short-swing trading for his own advantage.

Mr. CARY. I would like to ask Mr. Cohen to speak to this.

Mr. DINGELL. I would like to have you speak to it.

Mr. CARY. All right. I would like to say this. We are not authorizing them to use inside information. What we are authorizing them is to be marketmakers, which they are, and in the process of being marketmakers they are going to be subject to the short-swing trading provisions unless there is this limited exemption.

Mr. DINGELL. You tell me this. If this limited exemption is so desirable in the case of over-the-counter why is it not desirable in the case of marketmakers who deal on regular exchanges where you will have more control over the individual marketmaker.

Mr. CARY. Mr. Chairman, there really can't be said to be "marketmakers" on listed securities.

With regard to listed securities which are on exchanges, you are dealing with an auction market—primarily transactions between public buyers and sellers—in which the transactions, the purchase and sale

transactions, are recorded. In the over-the-counter market you are primarily dealing only through marketmakers—who are willing to take positions and develop a market in a stock. Also many over-the-counter companies are new companies that need their underwriter both as a director and as a marketmaker. It is a different group. It is a different market.

Mr. DINGELL. In other words, Mr. Cary, you are saying that we should not give the right on an auction market where the information is generally available to the public. Am I correct?

Mr. CARY. There is no need for it, that is right.

Mr. DINGELL. But you are saying, where there is no or a much more limited amount of information available to the public, that we should give marketmakers, who thereby have a greater advantage, the opportunity to use their private information, information achieved through their position for their private benefit, and this I disagree with.

Mr. CARY. Of course, the bill itself provides for more information so that the point that you have made is not totally accurate in that there will be information being given at the same time pursuant to this bill with respect to the securities involved.

Mr. DINGELL. Thank you, Mr. Chairman.

Mr. STAGGERS. Mr. Dingell, I think you have raised a very important point with respect to the memorandum that was submitted about the committee and also with respect to the bill and I think it is something we have to take into consideration in executive session. Mr. Glenn?

Mr. GLENN. Mr. Cary, while we are on that subject, and while I must admit I do not quite understand the portent of the discussion of the legal authority by my colleague, Mr. Dingell, I am willing to give some of my time to you, and particularly to Mr. Cohen, if it helps to clarify what has gone on.

Mr. CARY. Maybe Mr. Cohen can now give another objective interpretation.

Mr. COHEN. I just want to make a few points. First of all, section 16(b) does not now apply to marketmakers in the over-the-counter market and has never applied to them, so that the exemption written into the statute would preserve the present situation as to marketmakers.

No. 2, the exemption, even as written in, does not condone, sanction, or endorse in any way the use, misuse, or abuse of inside information. The antifraud provisions are designed to deal with that situation and there would be prohibition against such abuses whether or not 16(b) is in the statute and applies to marketmakers; 16(b) is a section which merely provides a civil remedy on behalf of the company to recover, irrespective to use or misuse of inside information, profits realized by certain directors and officers in connection with short-run transactions.

The third point I want to make is that the exemption does not provide any exemption at all, even as to over-the-counter companies, with respect to officers, directors, or principal stockholders, other than this limited group of marketmakers.

The fourth point I want to make is that the special study report did not recommend flatly against any exemption. It urged rather that there was no justification for a general exemption, but urged further that there be authority in the Commission to grant exemption on an ad hoc or case-by-case basis.

As the chairman has pointed out, the leaders of the industry suggested that in the over-the-counter market you were dealing with many smaller companies, companies that, in many cases, were substantially different than the companies that enjoy trading on the stock exchange, that the element of sponsorship was very important to the distribution of securities, particularly securities of smaller or medium-sized companies in this country, and in order to obtain the services needed by such medium-sized companies and smaller companies, of investment bankers, it was desirable, if not necessary, in many situations, as the study recognized itself, in some situations——

Mr. DINGELL. Mr. Cohen, if you will yield, the study made no mention of that point and as a matter of fact, the study, just to keep the record straight, specifically recommended against giving that authority, and specifically—and I read from the study—recommended against giving an exemption from insider trading prohibitions under the very matters we are discussing today.

Mr. COHEN. I didn't say to the contrary, and if it sounded that way I am sorry. What I did say was that the study recommended that there not be this general exemption, but did suggest that the Commission have authority to grant exemption in certain situations, situations of the characer hat I have now described.

I think it was in the context of this entire discussion and with these various considerations in mind that the Commission determined to recommend legislation in the form that is now before you. I really want to emphasize as my last point, the point that Mr. Loomis made, that this provision is limited solely to transactions in the over-the-counter market.

Mr. GLENN. Mr. Cary, going back to the subject which you covered first on the life insurance companies making reports to the SEC, as you know, we had considerable testimony from the companies and also from the National Association of Insurance Commissions that they have for years given great protection to policyholders, and they did also show that they have started within the past few years giving some protection to stockholders.

I gather from what you say here today, and you clarified considerable of the testimony which we had from them, that even though this may be so, you still feel that what they are doing is not sufficient for the protection of the general public in their requirements which they propose to have for the stockholders.

Is that right?

Mr. CARY. Yes, sir. I would say that we have never said that they are not giving adequate protection to the policyholders. Indeed, that is just the point. They have been giving protection to policyholders and really no others. This questionnaire is the first sort of effort in

the direction of thinking about shareholders that has come up since our own bill has been proposed. I did say that I really think it is halfhearted. I think it is woefully inadequate. It isn't compulsory. It doesn't have review by the Commissioner itself. It is really just sending out a questionnaire: Did you send these things? It doesn't say you must send it. It doesn't have any application, for example, to the point that Mr. Dingell has been bringing up, the application basically of an insider trading rule.

Naturally under this you may, or you must I suppose, supply information if you are a director, an officer, or a 10-percent shareholder on an annual basis of any trade you made in a security, but giving it on an annual basis and then having a few months lag after that is really giving stale information. Furthermore, the whole point, the whole philosophy, that we have adopted of having an annual report go out with a proxy statement, proxy material—this disclosure of the type of information that the investor would like—all of that is absent in their questionnaire.

Mr. GLENN. One last question. I was amazed at the summation which you gave on page 48 of the report as to the nominal cost of the dues of being a member of the self-regulatory associations. We were led to believe in the testimony submitted that this would be a large factor, but you say it would be between $100 and $199 as to about 77 percent of the membership. What would be the result of joining an association as to the other 23 percent which you have not included. Would it be greater or less?

Mr. CARY. I assume they would be greater, sir, and it would all depend on the number of registered representatives that the particular firm has. In other words, as it moves up in number I am sure that they would be subject to a higher fee, and, as Mr. Woodside mentions, the kind of business that they do, underwriting or otherwise, because there is a substantial charge, as I recall, based on their underwriting activities.

Mr. GLENN. Would it be very much greater, or would you say, just in comparison with this figure, a nominal figure?

Mr. CARY. I think Mr. Saul could give you more or less the exact charges in this area. I might ask him to speak to that point.

Mr. SAUL. Mr. Glenn, I don't have the precise charges in front of me, but there is a maximum and I believe that the maximum charge that is incurred by any firm in the NASD is somewhere in the neighborhood of about $12,000, but most of the members, as pointed out in the chairman's statement, do pay these minimal fees, primarily because they have few branch offices and few salesmen. I just don't know what the impact would be though on the other 23 percent.

Mr. GLENN. Could you prepare some sort of a chart that would show this and have it made a part of the record?

Mr. CARY. We would be glad to do so, sir, very definitely.

(The statement referred to follows:)

National Association of Securities Dealers, Inc., assessments, year ended Sept. 30, 1963 [1]

Rate of assessment	1963	
	Members	Amount
$100 to $199 [2]	3,740	$450,811
$200 to $299	404	96,080
$300 to $399	175	60,477
$400 to $499	93	41,475
$500 to $599	62	33,553
$600 to $699	51	32,813
$700 to $799	27	19,955
$800 to $899	27	22,887
$900 to $999	24	22,697
$1,000 to $1,499	70	84,125
$1,500 to $1,999	39	67,141
$2,000 to $2,999	36	88,746
$3,000 to $3,999	11	37,101
$4,000 to $4,999	18	80,282
$5,000 to $5,999	10	56,724
$6,000 to $6,999	5	32,768
$7,000 to $7,999	7	53,401
$8,000 to $9,999	23	116,201
$10,000	11	110,000
Total	4,823	1,507,237

[1] The basis for the computation of firms' annual dues is discussed on the following page.
[2] Some members actually paid less than $100 because they were not members for all of the year. Those members are nevertheless put in the $100 to $199 category.

BASIS OF COMPUTATION OF ANNUAL DUES (ASSESSMENTS) FOR NASD'S FISCAL YEAR ENDED SEPTEMBER 30, 1963

In summary, for the NASD's fiscal year ended September 30, 1963, the annual dues for a member consisted of the total of the following three elements:

(*a*) A basic membership fee of $100.

(*b*) A "head tax" of $5 per person within the organization devoting time to the investment banking or securities business.

(*c*) Members participating in underwriting were assessed 0.003 percent on the principal amount thereof, with the exception of investment company underwriters or sponsors, who were assessed 0.006 percent of gross sales of investment company shares for which they acted as sponsor or underwriter.

A $7,500 limit was applicable to item (*b*), a $7,500 limit was applicable to item (*c*), and the aggregate annual dues were subject to an overall $10,000 limit.

The various elements of the NASD's annual dues structure for the NASD's current fiscal year, which began on October 1, 1963, are 33⅓ to 50 percent higher than the elements of the dues structure for the year ended September 30, 1963. The annual dues structure for the current fiscal year and the other fees that the NASD imposes are discussed in the accompanying memorandum.

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION ON COSTS OF MEMBERSHIP IN THE NASD

This memorandum deals with the costs of membership in the NASD. Although the proposal in H.R. 6789 is one of membership in a registered securities association and therefore would not necessarily require membership in the NASD, perhaps the most concrete idea of the costs of membership in a registered securities association can be gained from an examination of the NASD fee structure.

Three points should be noted at the outset. First, the costs incurred by broker-dealers for membership in a registered securities association are costs incurred for essential regulation that directly benefits investors. The NASD is not organized or operated for profit. NASD dues and fees are designed solely

to offset the costs of its regulatory activities such as inspection of member firms and development and administration of examinations to test the knowledge of personnel new to the securities business.

Second, the costs of membership are costs incurred for regulation that would otherwise be provided by the Government. The cost of the alternative governmental regulation would either be borne by the Government, meaning the taxpayers, or, as the Commission believes would be more equitable, through fees collected by the Commission from nonmember broker-dealers to defray the costs of the added regulation. For example, if membership is not required, the Commission believes that it should be empowered to prescribe and administer examinations testing the knowledge of nonmember broker-dealers and their personnel. The costs of any such examinations should be borne by the nonmembers rather than the taxpayers, since members of the NASD themselves bear the cost of NASD examinations. Thus, the costs of membership in a registered securities association are not additional costs that would be incurred solely because of a requirement of membership. If membership is not required and if, as the Commission believes would be equitable, the Commission is empowered to levy fees upon nonmembers to defray the costs of the additional governmental regulation occasioned by their nonmembership, the absence of a requirement of membership would result in no savings to the nonmembers.

Third, the Commission is charged by statute with the responsibility of reviewing the dues structure of a registered securities association to assure that it is equitable.

Attached is a copy of the portion of the NASD's bylaws that sets forth the NASD fee structure for its current fiscal year, which began on October 1, 1963. The fee structure consists of two separate elements: "annual dues," and what can conveniently be referred to as "other fees."

In summary, the annual dues for a member consist of the total of the following three elements:

(*a*) A basic membership fee of $150.

(*b*) A "head tax" of $7 per person within the organization devoting time to the investment banking or securities business.

(*c*) Members participating in underwriting are assessed 0.004 percent on the principal amount thereof, with the exception of investment company underwriters or sponsors, who are assessed 0.008 percent of gross sales of investment company shares for which they acted as sponsor or underwriter.

A $10,000 limit is placed on item (*b*), a $10,000 limit is placed on item (*c*), and the aggregate annual dues are subject to an overall $12,500 limit.

The other fees that the NASD assesses are:

(*a*) A $30 fee for each branch office open any time during the year.

(*b*) A $25 fee for each application by one of the firm's personnel for status as "registered representative." Generally speaking, a sole proprietor, partner, officer, supervisor, or salesman of a member firm would be required to register as a registered representative. This is in addition to any fees under (*c*) or (*d*) below.

(*c*) A $20 fee for each examination administered in connection with registration of one of the firm's personnel (other than a principal) as a registered representative.

(*d*) A $25 fee for each examination administered in connection with the application of one of the firm's principals as a registered representative. In general, a principal is an officer, partner, or sole proprietor.

(*e*) A $150 fee for an application by a firm for membership.

These other fees are in addition to the annual dues and are not subject to any of the limits applicable in computing annual dues. The fees set forth in (*b*), (*c*), and (*d*) are not periodic fees and are incurred only upon a change in personnel. The examination fees set forth in (*c*) and (*d*) would be incurred only where the applicant for registered representative status has less than 1 year's experience in the business; no examination is required of applicants with experience of 1 year or more. The fee set forth in (*e*) is strictly a one-time cost.

For the overwhelming majority of firms that are members of the NASD, the annual costs of membership are modest. A breakdown of the annual dues paid by the 4,823 NASD members during the NASD's fiscal year ended September 30, 1963, shows that during that fiscal year about 77 percent (3,740) of the NASD members paid annual dues of $100 to $199:[3] about 16 percent paid annual dues of

[3] Some members actually paid less than $100 because they were members for less than the full year. Such members are, however, placed in the $100 to $199 category.

$200 to $699; about 4 percent paid $700 to $1,999; about 1.4 percent paid $2,000 to $4,999; and the remaining members (46 in number) paid $5,000 to $10,000. None paid over $10,000 (the overall maximum for that fiscal year).

No breakdown in annual dues is available for the current fiscal year, which began on October 1, 1963. The various elements of the annual dues schedule for the current fiscal year are 33 to 50 percent higher than those in the annual dues schedule for the fiscal year ended September 30, 1963. Extrapolating from the figures for the fiscal year ended September 30, 1963, it would appear that during the current fiscal year about 77 percent of the NASD's members would pay annual dues of $150 to $299 and that the annual dues of most of the remaining 23 percent of the NASD's members would increase by 33 to 50 percent over fiscal 1963. During the NASD's current fiscal year no firm will pay annual dues of more than $12,500, the overall maximum on annual dues.

The above figures relate to the annual dues paid by NASD members. The remaining membership expenses consist of the other fees—the fees for securing registration of registered representatives and for examinations and the branch office fee. As noted, the examination and registration fees vary with turnover of personnel. Some firms pass on to the salesman a portion or all of the fees for registering him and for his examination, if required. However, the discussion herein assumes that the firms themselves bear such fees.

A breakdown of the other fees paid by firms or classes of firms is not available, but the NASD estimates that during the current fiscal year, the total other fees collected by it will be about 60 percent of the total annual dues collected by it. Thus, taking the broad average, it is estimated that the total of the annual dues and the other fees collected by the NASD during the current fiscal year will be about 1.6 times as large as the annual dues alone.

It must be noted, however, that other fees incurred by a firm can, depending on the circumstances, either be only a small percentage of the firm's annual dues or, on the other hand, can be much larger than the firm's annual dues. For example, a small firm with no turnover and no branch offices would pay no other fees, while a large firm with heavy turnover could incur other fees larger than its annual dues.

At the hearings on H.R. 6789, one witness stated that the cost of membership in the NASD could run as high as $75,000 per year. That figure would be paid only by a mammoth firm hiring during a year 1,500 to 2,000 salesmen, with about half of them being new to the business, and the bulk of the costs would be for registration and examination fees, as the NASD's annual dues are subject to a $12,500 limit. While $75,000 is a sizable amount, it would for such a firm be only a small fraction of salaries and commissions. The examination fees would merely defray NASD expenses in assuring that the firm's salesmen that are new to the business have a minimum degree of knowledge about the intricate merchandise they propose to sell before they begin to deal with customers in a fiduciary capacity and give them advice about investments and securities. Moreover, the registration of salesmen and other securities personnel by the NASD is an indispensable first step in its enforcement of its rules and the Federal securities laws with respect to them and in keeping out of the securities business those persons who, because of past misconduct in the securities business, are precluded by statute and the NASD's rules from being associated with a member without the consent or direction of the commission.

A firm that would have to pay $75,000 per year for membership expenses in the NASD would be a firm with 3,000 to 4,000 salesmen, with a high turnover rate, and with a high percentage of its new personnel having less than 1 year's experience in the business. NASD regulation of that type of firm is in the public interest, and salesmen who are beginners in the securities business clearly need to be subjected to the NASD's examination requirements. For example, the special study of securities markets showed that the large mutual fund firms that are not members of the NASD generally give their salesmen training programs that are inferior to those given by NASD members. A price tag averaging around $25 per salesman is a reasonable price for the protections afforded to investors by NASD membership. Moreover, when a firm with a high turnover rate is required to join the NASD or some other registered securities association, the registration and examination fees may have the salutary effect of causing the firm to find ways to reduce its turnover rate.

At this point it should be reemphasized that these costs—annual dues and other fees such as fees for examinations for and registration of personnel—are costs incurred for regulation that would otherwise be provided by the Govern-

ment and are not costs that would be incurred only because of a requirement of membership in a registered securities association. If membership is not required and if, as the Commission believes would be equitable, the Commission is empowered to levy fees upon nonmembers to defray the costs of the additional governmental regulation occasioned by their nonmembership, the fees levied by the Commission would probably be about as high as the NASD's annual dues and other fees, and the absence of a requirement of membership would result in no substantial savings to the nonmembers. Moreover, as the Commission has pointed out in prior submissions on this point, the alternative to required membership—giving the Commission greater powers over nonmembers—is not as desirable as required membership. In many areas—such as unethical, as opposed to illegal, conduct—the Commission could not do the job as easily or effectively since the Commission must work in a somewhat circumscribed and legalistic framework. Also, members of the affected business can bring to bear on some problems of regulation a greater degree of expertness and expedition than can the Commission, which is necessarily somewhat more remote. In addition, it would seem anomalous and inefficient for the Commission to perform tasks such as administration of examinations for a relatively small group of nonmembers, while the self-regulatory agencies do so for the vast majority.

At the present time the overwhelming majority of all firms doing an over-the-counter business, including both large and small firms, are members of the NASD and therefore have not found the dues and fees imposed by the association to be prohibitive or exorbitant. It is also significant that Investors Diversified Services, Inc., a large firm with about 3,000 salesmen, and which is not at present a member of the NASD, expressly noted in a letter to the Senate committee dated June 8, 1963, that it has no objection to the proposed required membership in a registered securities association. The Association of Mutual Fund Plan Sponsors, Inc., which includes among its membership an important segment of those dealers which are not members of the NASD, supported the provision in a letter to the Senate committee dated June 26, 1963.

COSTS OF JOINING THE NASD

The foregoing discussion has dealt with the costs of being a member of the NASD. There are additional costs for joining the NASD, but these are one-time costs and are usually modest. The membership application fee is $150. The only additional costs of joining are the registration fees for registered representatives and examination fees, where required. Using a two-man partnership with three salesmen-employees as an example, the fees for registering the five registered representatives would be $125; assuming two of the salesmen had less than 1 year's experience and were required to take the examination, an additional $40 would be incurred. For such a firm, the total costs of joining the NASD would be $315 ($150+$125+$40). A firm in this category would appear to be typical. Commission figures indicate that as of June 30, 1962, of the NASD members who were not members of either the New York Stock Exchange or the American Stock Exchange, about 62 percent had one to five registered representatives. Non-NASD members, as a group, would probably not have a smaller percentage of their component firms in the one to five registered representatives category.

A large firm with thousands of salesmen would incur significant admission expenses for registration and examinations. However, as discussed above, these expenses would be only a small fraction of items such as salaries and commissions and would only defray NASD expenses in providing much needed regulatory activities. Of course, once a salesman or principal is registered and has passed the examination, if one is required, no further fees with respect to him are imposed so long as he stays with the firm, except that the "head tax" element of the annual dues (currently $7 per year) is applicable. And it should be remembered that the costs a firm incurs upon joining the NASD (principally for registering its personnel and for examinations for its personnel with less than 1 year's experience) are roughly equal to the costs that have been incurred over the years by a similarly situated member firm of comparable size in registering its personnel and in paying for examination fees for beginners in the business.

[Excerpt from NASD bylaws]

SCHEDULE "A"

The classification of the membership for dues assessment purposes, as provided in section 1 of article III of the bylaws of the corporation, shall be determined on the basis of the following formula:

1. All members of the association shall be assessed an annual basic membership fee of $150 plus an additional assessment of $7 for each individual in the member's organization who devotes any time to the "investment banking or securities business" (as defined in article 1, section 3(c) of the bylaws). The term "individual" includes a partner, corporate officer, or individual proprietor as well as other personnel. In addition, all members participating in underwritings[1] (as defined) shall be assessed 0.004 percent of the principal amount of such underwritings, with the exception of investment company underwriters and sponsors who shall be assessed 0.008 percent of gross sales of shares of investment companies for which they acted as underwriter or sponsor, including sales of shares repurchased and resold. In no case shall any member's assessment exceed $10,000 for personnel and $10,000 for underwritings and gross sales of shares of investment companies. However, in no case shall the aggregate assessment exceed $12,500 per member.

2. Each member shall be assessed a fee of $30 for each registered branch office, as defined in the bylaws, open during any part of the association's fiscal year.

3. Each member shall be assessed a fee of $25 for each application for registration as a registered representative of a member firm.

4. There shall be an examination fee of $20 assessed as to each individual who is required to take an examination in accordance with the appropriate provisions of the bylaws. This fee is in addition to the registration fee described in item 3 above.

5. There shall be an examination fee of $25 assessed as to each individual who is required to take any special examination which may be in effect for principals (officers, partners, and sole proprietors) in accordance with the appropriate provisions of the bylaws. Members will be advised as to the effective date of this examination. This fee is in addition to the registration fee described in item 3 above.

6. Each applicant for membership shall be assessed $150 in connection with the filing of an application for membership, in addition to any dues or fees otherwise payable.

7. Items 2, 3, 4, 5, and 6 above shall not be included in the limit of assessments set forth in item 1.

Effective October 1, 1963.

[1] The term "underwritings" means any purchase from an issuer or a person or persons other than an issuer with a view to, or any sale or sales for an issuer or anyone other than an issuer in connection with, the distribution of any security (other than United States, State, county, and municipal issues), or a direct or indirect participation in any such undertaking, or a participation in the direct or indirect underwriting of any such undertaking; *but such term shall not include a participation where the interest is limited to a commission, and/or a concession, from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission and/or concession.* The term "underwritings" as defined herein shall include securities placed privately without a public offering. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

Mr. GLENN. Thank you, Mr. Cary. Thank you, Mr. Chairman.

Mr. STAGGERS. Mr. Long?

Mr. LONG. No questions, Mr. Chairman.

Mr. STAGGERS. Mr. Keith?

Mr. KEITH. Thank you, Mr. Chairman. I would like to preface my questions with a commendation for the way in which Mr. Cary, backed up by Mr. Cohen, has responded to the points raised by my colleague from Michigan. Mr. Cary, the special study group made a number of recommendations which, as I scan your testimony of today and as I remember your testimony on other occasions, haven't been adequately commented on.

If my survey of either today's or past testimony is inadequate, I would appreciate your advising me of it. The study group concluded that, if the NASD was to fulfill its role as a self-regulatory body, its structure had to be basically modified and strengthened, my questions pertain to their recommendations.

It was recommended that the professional staff of the association be increased in size and given increased responsibility. Has this been done?

Mr. CARY. Yes, sir. I think to some limited extent I reported on that in my earlier presentation when I covered the implementation of the special study thus far, but I think I can report additional progress. The facts of the matter are that the NASD has just very recently met, I think in the last month, and is reorganizing itself. It now for the first time has a president. It has a new man who is coming in to hold that position. It is increasing its budget. It is having new bylaws and, as I understand it, a new charter, and as a consequence they are making steps definitely in the direction of the special study recommendations.

Mr. KEITH. Without much elaboration, are they, as far as you know, paying particular attention to the recommendations with reference to increasing the responsibility of the president or executive board?

Mr. CARY. That is correct, yes, sir.

Mr. KEITH. Has there been established or is there contemplated an executive committee which could meet at more frequent intervals than the board of governors?

Mr. CARY. Mr. Saul informs me they are contemplating an executive committee. I might say the president they have chosen was their chairman and they induced him to leave his firm, which, as I recall, was in Milwaukee, and to come now as a full paid president on a long-term basis.

Mr. KEITH. What is the ratio of the New York Stock Exchange Members to nonmembers of the board of governors? Do you happen to know? I think it has been 18 out of 21.

Mr. CARY. I will ask Mr. Saul to speak to that. I don't have the exact figures myself.

Mr. SAUL. I believe, Mr. Keith, the present ratio is 17 to 21. There are 21 members on the board of governors and I believe there are 17 members of the board who are connected with New York Stock Exchange member firms.

Mr. KEITH. Thank you.

Mr. CARY. Then, of course, there is a division between the floor members, the people representing the floor, and those representing firms dealing with the public.

I think the question was the New York Stock Exchange, was it not, sir?

Mr. KEITH. Yes.

Mr. CARY. I am sorry.

Mr. LOOMIS. I believe Mr. Keith was referring to persons connected with members of the New York Stock Exchange who are members of the board of governors of the NASD.

Mr. KEITH. That is correct.

Mr. LOOMIS. None of these persons are floor members.

Mr. CARY. I made a total misinterpretation. I hope you will correct that with Mr. Loomis' remarks.

Mr. KEITH. I have no further questions at this time, Mr. Chairman.

Mr. STAGGERS. Mr. Dingell has another question he would like to ask.

Mr. DINGELL. Mr. Chairman, I noticed here you were quoting at some length from Professor Loss.

Mr. CARY. Yes, Louis Loss.

Mr. DINGELL. He had some comments on this with regard to section 16(b) in which he said, and I quote:

> I do not know whether it would be a good idea or whether the price would be too high for getting through something like the Fulbright bill if there were an exemption from section 16(b).

It would appear that there is substantial opposition among intelligent and informed scholars of the securities market with regard to this repeal of section 16(b), this exemption from section 16(b), afforded by legislation before the committee.

Mr. CARY. Wasn't he referring to a total nonapplication of 16(b) in the whole context, rather than to the market maker in the over-the-counter market. I think that that was in a broader context.

Mr. DINGELL. I would have to let the good professor speak for himself, but it occurs to me that his statement is rather clear with regard to exemption from section 16(b). Certainly it is my position that if the exemption is bad to give to the New York Stock Exchange or to the American Stock Exchange, we can from that infer that it is probably equally bad to give to the over-the-counter market, since you will agree at least insofar as the past is concerned that the level of regulations and the general manner in which the over-the-counter market has been conducted has been in a less carefully regulated manner in most instances. Am I correct?

Mr. CARY. That is generally correct, yes, sir, up to this time.

Mr. DINGELL. And also that generally it was conducted under circumstances which were considerably more fraught with peril for investors than were the more carefully regulated markets and the more carefully organized markets of the American and the New York Stock Exchanges.

Am I correct?

Mr. CARY. We are now bringing the level up under this bill.

Mr. DINGELL. You are bringing the level up, but you are not bringing it up to the same level that you will bring it up to the New York Stock Exchange or the American Stock Exchange. Am I correct?

Mr. CARY. Insofar as market makers are concerned. My colleague, Mr. Woodside, I think would like to speak briefly on this general subject.

Mr. DINGELL. I would be delighted to hear from Mr. Woodside, but I am operating under very carefully limited time. So we have the problem that we are going to afford an exemption to the less well regulated portion of the market from the insider trading information under the bill that we have before us, do we not?

Mr. CARY. We are giving a limited exemption, that is correct, to market makers for a particular reason.

Mr. DINGELL. That is right.

Mr. CARY. In the over-the-counter market.

Mr. DINGELL. In the less well regulated segment of the market. Am I correct?

Mr. CARY. Before this bill. Now it will be regulated in very much the same way.

Mr. DINGELL. Still less regulated, though, than the others.

Mr. CARY. Certainly probably than exchange-regulated securities, that is correct.

Mr. DINGELL. I thank the chairman and I am very grateful to my good colleague from Maine.

Mr. STAGGERS. The committee will stand adjourned because there is one bill on the floor that requires some of us to be there. We will stand adjourned until tomorrow at 10 o'clock.

(Whereupon, at 12 noon, the committee adjourned to reconvene at 10 a.m., February 19, 1964.)

INVESTOR PROTECTION

WEDNESDAY, FEBRUARY 19, 1964

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE OF THE
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to recess, in room 1334, Longworth Building, Hon. Harley O. Staggers (chairman of the subcommittee) presiding.

Mr. STAGGERS. The committee will come to order.

We will resume the hearings where we left off yesterday when Chairman Cary was our witness on H.R. 6789 and H.R. 6793.

Mr. Cary, again the subcommittee is pleased to have you with us and we certainly will try to bear with you in trying to keep your engagement at noontime, and we will recess in time. We will proceed from here with the understanding that you will come back this afternoon, if needed.

STATEMENT OF CHAIRMAN WILLIAM L. CARY, ACCOMPANIED BY COMMISSIONER BYRON D. WOODSIDE; COMMISSIONER MANUEL F. COHEN; COMMISSIONER JACK M. WHITNEY II; ANDREW BARR, CHIEF ACCOUNTANT; PHILIP A. LOOMIS, GENERAL COUNSEL; RALPH S. SAUL, DIRECTOR, DIVISION OF TRADING AND MARKETS; EDMUND H. WORTHY, DIRECTOR, DIVISION OF CORPORATION FINANCE; AND ARTHUR FLEISCHER, JR., EXECUTIVE ASSISTANT TO THE CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION—Resumed

Mr. CARY. Yes, sir.

Mr. STAGGERS. About what time?

Mr. CARY. I could be back at 3 o'clock for sure.

Mr. STAGGERS. If we do not finish this morning we will set the hearings again to resume at 3 o'clock.

Mr. CARY. Thank you, sir, very much.

Mr. STAGGERS. Of course, that depends upon the procedures on the House floor as to whether we can, and if we cannot we will get word to you and the committee as to what takes place. We may be voting or we may be in the amendment stage or something and then we cannot sit at that time.

At this time I believe that we will forgo any further questioning by any member of the committee until you have presented your statement in full that you intend to present to the committee and then we will resume questioning.

You may proceed, if you will.

Mr. CARY. Yes, sir. In that case, as you may recall, yesterday I said I had two additional statements to make, one on the *Haupt* case and the other on specialists. I had not known exactly how you wanted to proceed. I thought of going to the specialists first, but in view of the fact that I take it you want me to read both of those other statements perhaps I might just as well proceed in the normal page way in which the statement is prepared. That would bring me, therefore, really to page 2 of my statement which bears on the *Ira Haupt* case.

Mr. STAGGERS. Page 2.

Mr. CARY. Page 2. As you may recall, Mr. Chairman, I started really at page 22 yesterday.

First of all, with respect to the *Haupt* case, an event of major significance since the prior hearings on H.R. 6789 has been the insolvency of Ira Haupt & Co. By way of background, on November 20, 1963, Ira Haupt & Co. and J. R. Williston & Beane, Inc., members of the New York Stock Exchange, were suspended by the exchange for failure to comply with the exchange's minimum net capital rule. These firms were in serious financial difficulties arising out of their relationship as broker and creditor for a single commodities customer.

Currently Haupt is undergoing liquidation pursuant to an agreement among the general partners of the firm, the New York Stock Exchange and various creditors of the firm under which the exchange has made available $12 million for payment to the firm's securities customers. This commendable action permitted investors to secure their funds and securities without undue delay and saved them from suffering losses which might otherwise have been insured.

J. R. Williston & Beane, Inc., after being reinstated by the exchange, was absorbed by another exchange member firm and I understand that its customers suffered no losses as a result of the firm's financial difficulties.

The Commission has been investigating the facts of the Haupt affair and the regulatory problems which it raises within the jurisdiction of the Commission. The New York Stock Exchange has also been active and we have kept in contact with the exchange.

The Haupt situation is a matter of importance to us for several reasons. First, the funds and securities which customers of Haupt left with the firm were placed in jeopardy. Second, the insolvency of a brokerage firm carries with it the risk of affecting the general confidence of investors. Third, the combination of securities and commodities business, although apparently limited primarily to New York Stock Exchange member firms, occurs with some frequency in those firms.

Thus, many important New York Stock Exchange firms are also members of the major commodities exchanges. Commodity income of some of these firms is quite substantial. In 1962, for example, of a reporting group of almost 346 exchange firms, 26 had gross commodity commissions of over $100,000 and 12 had commodity commissions of over $1 million.

We have not completed our analysis nor has the New York Stock Exchange submitted their views on the problems arising from the

Haupt case. However, I can outline the conclusions we have so far reached, which are presented in more detail subsequently:

1. Additional safeguards for securities customers must be adpoted by firms also engaged in the commodity business. These firms appear to be primarily New York Stock Exchange members.

2. Although our examination reveals certain deficiencies in the rules and procedures of the New York Stock Exchange and the practice of its member firms respecting commodity activities and the safekeeping of customers' securities, we fully expect these deficiencies will be remedied and we shall continue to rely on the efforts of the exchange in this area, although under more intensive Commission oversight.

3. In addition the commodities question, the *Haupt* case has accelerated our consideration of the recommendations of the report of the special study relating to the protection of customers' funds and securities—also problems which appear to concern primarily members of the New York Stock Exchange. The thrust of several of these recommendations is that the rules of the various self-regulatory agencies should be amended to afford financial responsibility protections similar to those which the New York Stock Exchange's rules are presently designed to provide.

4. With the exception of certain amendments to the Bankruptcy Act, the recommendations of the special study report relating to the protection of customers' funds and securities can be implemented by the self-regulatory agencies under existing authority. We have written these agencies about the problems disclosed by the *Haupt* case and discussed in the special study report. If they do not adopt rules adequate to meet the revealed shortcomings, we shall operate under our own rulemaking powers or ask Congress for legislation, where needed.

5. We hope to submit to the Congress amendments to the Bankruptcy Act following further analysis of the complex problems presented by the bankruptcy of securities firms.

I would now like to give a brief and somewhat simplified factual description of the *Ira Haupt* case.

In May 1963, Ira Haupt & Co., opened a commodities account for Allied Crude Vegetable Oil Refining Corp., a large processor and dealer in cottonseed and soybean oils. As a condition for opening the Allied account at Haupt, DeAngelis, the principal of Allied, required that Haupt arrange for a $2.5 million financing of Allied's commercial operations.

Pursuant to the terms of a written agreement, Allied received the loan of $2.5 million, collateralized by warehouse receipts and forward sales contracts for cottonseed and soybean oils. Haupt in term pledged the warehouse receipts with a bank and borrowed the $2.5 million. During the ensuing months, the loans by Haupt to Allied increased in amount until, by November 1963, totaled $10 million; Haupt in turn was indebted to various banks for the same amount.

In the autumn of 1963, Allied began purchasing, through the Haupt firm, a very large number of contracts for future delivery of cottonseed and soybean oil. By November, Allied held 15,000 contracts and thereby exposed Haupt to a risk whose dimensions must be understood in light of the rules applicable to trading in futures contracts.

First, the broker is liable for any drop in the market to the clearing

association which clears transactions for the particular commodities exchange. If the broker's customer cannot meet a daily margin call (which is equal to the decline in the market multiplied by the number of futures contracts held), the broker must tender immediate payment to the clearing association. The clearing association looks to the broker and the broker looks to the customer. If the customer holds a substantial number of contracts, even a slight decline can seriously tax a broker's resources.

Just going out of the statement for a moment, I figured if there are 60,000 pounds per contract and if the market dropped a cent a a pound that would mean $600 per contract, and if there were 1,500 contracts it would mean roughly $9 million, so you can see the magnitude of a drop of a cent a pound with that many contracts held.

Second, because of the low initial margins which apply to the purchase of futures contracts, a customer of a brokerage firm can, with a relatively small cash outlay, purchase a very sizable number of contracts and thus create significant exposure for the firm. The difference between the margin put up by the customer and the price of the contract is the total exposure of a firm in the event that the customer cannot pay for and take delivery of the commodity called for by the contracts perhaps months later.

It should be pointed out that, although the customer may liquidate the contract at some point prior to delivery day, thereby relieving the broker of its obligation, liquidation could drive the price down because of the selling pressure. This could require the broker to meet additional margin requirements and thus absorb, on a current basis, the full impact of a market decline in commodity prices.

The New York Produce Exchange Clearing Association rules did not require that Allied, Haupt's customer, put up any margin upon the purchase of cottonseed futures contracts. Haupt, as the broker, however, was required to put up $400 with the Clearing Association, or approximately 5 percent of the cost of a contract.

In the beginning, Haupt required for its own protection that Allied pay it the $400 of initial margin in cash; after October 1963, Haupt began to accept warehouse receipts, instead of cash, for a portion of the $400 payment—many of these receipts later apparently turned out to be forged or worthless.

By the middle of November, Haupt had loaned Allied $3.1 million collateralized by warehouse receipts, which was used to finance the initial margin payments. Haupt also pledged these warehouse receipts with banks. This $3.1 million was in addition to the $10 million in loans to Allied referred to above.

On November 15, 1963, after a month's prior notice, the New York Produce Exchange required an increase in the initial margin which had to be deposited by members on cottonseed oil contracts. The combination of this margin increase, which applied retroactively to existing contracts, and a drop in prices for both cottonseed and soybean oils resulted in a call by Haupt upon Allied for $51 million. When Allied failed to put up the money, Haupt was immediately liable to the Clearing Association for the full amount and paid it.

On November 18, the next trading day, an additional $9 million in margin was called for from Allied because of a substantial market decline. Once again Allied did not meet its call from Haupt. Once

again Haupt made payment to the Clearing Association, this time by borrowing money from several banks in so-called day loans. These loans are on an unsecured basis and are payable at the close of business on the same day. These day loans were then discharged by overnight loans of $13.5 million, which in some cases were secured by customers' securities in violation of New York Stock Exchanges rules.

On the next day, Tuesday, November 19, Haupt borrowed another $29 million in day loans from four banks, repaid the overnight loans, and received back the securities which had been pledged the night before.

Of the balance of the day loans, over $11 million was paid out with respect to Allied's commodity account, as there were further declines and margin calls in both cottonseed and soybean oil contracts which Allied did not meet.

Later that day, Allied filed a voluntary petition in bankruptcy. As a result of the foregoing, Haupt ended up with liabilities to the banks in the amount of $13.1 million collateralized by warehouse receipts, many apparently worthless and over $23 million in unsecured indebtedness, most of which was incurred on November 18 and 19, immediately before Haupt's suspension. As you know, Mr. DeAngelis has recently been indicted by a Federal grand jury in New Jersey for violations of the National Stolen Property Act.

I would now like to turn to the regulatory problems raised by the *Haupt* case. We can divide these into two parts. The first revolves around the risks arising from a broker-dealer's activities in commodities. The special study made no attempt in its report to discuss problems arising in connection with commodity accounts, because no case of consequence to securities regulation has arisen out of commodities activities.

The second concerns itself with the general question of the financial responsibility of broker-dealers and the protection of customers' funds and securities. This latter issue was examined by the study and recommendations were made in the report.

Even before the insolvency of the Haupt firm, the Commission was working on the implementation of certain of these. For example, the Commission had been engaged in an extensive revision of its net capital rule. Nevertheless, I would be less than candid if I did not state that the Haupt situation has altered the priority position which we had given to financial responsibility problems in our implementation program.

In addition, we have had to reexamine the issues, since the special study did not have the *Haupt* case as an example before it.

We expect to resolve certain of the problems disclosed by the *Haupt* case and the special study report through issuance of Commission rules. At the same time the self-regulatory agencies have an initial responsibility with respect to many of those problems. We have told those agencies that they should vigorously pursue the recommendations of the report relating to the protection of customers' funds and securities and we have suggested to the New York Stock Exchange a series of measures designed to deal with the Haupt problem—certain of which we understand the exchange had been already considering. We are keeping in contact with the self-regulatory institutions on these questions. We believe that they will take appropriate action

promptly. If they do not, we shall exercise our own rulemaking powers or, if necessary, come back to this subcommittee for legislation.

The New York Stock Exchange has traditionally had a highly significant role in the area of financial responsibility. This is necessarily so since its members hold most of the customers' securities and free credit balances, as well as apparently handling most of the commodities business transacted by brokerage firms. Member firms of the New York Stock Exchange are exempt from the Commission's net capital rule because that exchange's rules and settled practices impose requirements more comprehensive than the requirements of the Commission's net capital ratio rule.

Moreover, as we informed Chairman Harris in our letter of December 14, 1963, the Commission's program of routine inspection of broker-dealer firms generally excludes member firms of the New York Stock Exchange. That exclusion has been based upon the apparent adequacy of the exchange's examination of its own members, including commodities activities, as well as the workload and budgetary considerations involved in a Commission program of inspection of such firms. Those member firms doing a general business with the public are required to file three financial questionnaires annually, one of which must be prepared by an independent public accountant following a surprise audit of the firm's books.

Moreover, there is a review, on approximately an annual basis, of the firm's accounting records by an exchange examiner.

Member firms have in fact had a very good solvency record. The *Haupt* case was only the second insolvency of a New York Stock Exchange member firm in the last 25 years. I might add that, in its evaluation of the New York Stock Exchange as a self-regulatory institution, the report of the special study of securities markets noted that the—

> enforcement by the exchange of its net capital rule should be the standard by which other aspects of its regulatory pattern is judged. The staff vigorously seeks out violations and they are processed swiftly and fairly.

To be sure, our investigation of the Ira Haupt matter has brought out certain shortcomings in exchange rules and member firm practices which must be remedied—to these I shall turn in a moment. These deficiencies do not mean, however, that the Commission should not continue to rely to an important extent on the exchange in the area of financial responsibility. We anticipate that the exchange will take appropriate steps to meet the problems revealed.

At the same time, in the light of the *Haupt* case, we have placed increased emphasis upon the financial responsibility area in our program of oversight with respect to the self-regulatory agencies. As part of our plan of regular inspections of these agencies, we are conducting examinations of their procedures in the enforcement of rules relating to minimum net capital, segregation, hypothecation and lending of customer's securities; and handling of free credit balances.

These examinations include visits to firms in order to ascertain their pertinent procedures, inspection of agency files, and discussions with staff personnel. Deficiencies found in rules or procedures will be brought to the attention of the agency and remedies will be actively pursued.

I would like now to discuss several of the problems evident in the Haupt situation. Basically, Haupt may be viewed as a case in which assets of securities customers were exposed to risks arising from the employment by the firm of its capital and credit to finance the commercial operations and speculative trading in commodity futures of a customer.

The rules of the Commission and of the New York Stock Exchange are designed to insure the financial responsibility of a broker-dealer no matter what activities he pursues. Thus, an exchange rule requires that, if a customer does not have an equity in his commodities account equal to the margin required on the commodity future contracts carried in that account, the deficiency is a total charge against the firm's net capital.

While this and other provisions are designed to provide significant protections, it is clear from the facts and circumstances surrounding the insolvency of Ira Haupt & Co. that present rules do not adequately take into account the risks of the commodities business.

The most complete protection could be provided the assets of securities customers by having a brokerage firm conduct its commodities activities through a separate corporation. In our opinion, it is premature at this time to embrace the ultimate remedy of divorcing the commodities business from the securities business. It appears that the commodity problems identified in our examination of the *Haupt* case can be dealt with effectively by alternative means. We have suggested to the New York Stock Exchange that the following improvements in the exchange's rules and in the procedures of member firms should be considered:

1. The establishment of initial and maintenance margin requirements for commodities futures transactions by customers of member firms, with appropriate restrictions on the financing of such margin by member firms. At the present time, the Commodity Exchange Act does not give the Department of Agriculture authority to regulate margins on commodity purchases. The only such requirements, imposed by the commodity exchanges, have been nominal. In the Haupt case, the absence of significant margin levels exposed the firm to serious risks; this exposure was compounded by the fact that Haupt lent Allied considerable sums to meet the initial margin requirements in effect.

2. Adjusting the charges in effect taken against net capital when a brokerage firm handles commodities transactions. At the present time commodities activities can result in various deductions from a firm's net worth in computing its net capital.

For example, under the New York Stock Exchange capital rule, a firm must deduct from net worth one-half of 1 percent of the total long or short future contracts in each commodity, whichever is greater, carried for all customers. The adjustments in these deductions would in large measure depend on the amount of the margin requirements, if any, imposed on commodity purchases, discussed in 1. above.

3. Limitations on the financing by member firms of activities unrelated to the brokerage business. At present, the exchange has rules limiting in certain respects the nonbrokerage activities of member firms; these might well be expanded to restrict "nonpurpose" loans, particularly where these loans, as in Haupt, expose securities customers to significant risks.

4. Limitations on the size of commodity positions held by a firm or for the account of a single customer. This type of regulation will limit a firm's total exposure and the risks it takes in extensively financing one customer, including that of a customer's insolvency or of his fraudulent activity.

5. Improving the recording systems, i.e., the books and records, of member firms to the end that these systems adequately disclose on a continuing and immediate basis the extent and type of potential risk resulting from commodities positions. It appears that on several occasions the principals of Ira Haupt & Co. were not aware of the size and nature of its commodities accounts.

6. Strengthening present supervisory procedures of member firms relating to the handling of commodity accounts and to the borrowing and lending of funds, including consideration of a requirement that at least one partner approve any loan of a specified amount made by a firm. There were several occasions in the *Haupt* case in which supervision exercised may not have been adequate.

For example, no partner approved any of the sizable loans from Haupt to Allied or the indebtedness of Haupt to the banks, except for the initial $2½ million loan.

In his testimony before this subcommittee, Mr. Funston stated that an exchange committee was considering a number of suggestions, including limitations on the amount of commodities positions carried by a firm—which would be related to proposals 2 and 4 above—qualification requirements for those handling commodities accounts, and restrictions on loans against warehouse receipts. All of these proposals will be reviewed. A necessary keystone is an adjustment in the net capital rule to take into account the risks attendant upon commodities business. The Commission is now considering amendments of its own capital rule to this end.

The general problems of broker-dealer financial responsibility arise from the fact that many brokerage firms perform banking and custodial functions in the course of which they have custody of, and use, customers' cash and securities. These assets are exposed in varying degrees to the risks of a firm's business.

The Report of the Special Study addressed itself in some detail to these issues; I have already indicated that the *Haupt* case has accelerated our consideration of the report's recommendations.

With respect to protection of customers' securities, the report recommended that rules be adopted requiring that: (1) fully paid and "excess margin" securities (the amount of securities in a margin account not thought necessary to secure a customer's indebtedness) be segregated and marked in a manner that protects the interest of each individual customers; (2) there be a "reasonable relationship" between the amount of each customer's securities that can be hypothecated or lent by a broker and the amount of indebtedness of such customer; and (3) the specific written consent of a customer be secured before lending his fully paid or excess margin securities.

The general purposes of these requirements are to prevent the misuse of customers' securities, to inform customers that their securities are being used by their broker and to make it possible for customers to reclaim the securities in the event of insolvency. The New York Stock Exchange presently has rules seeking to provide

these protections and most of the other self-regulatory agencies have adopted various of them.

It should be kept in mind that the problems relating to the custody of customers' securities by brokerage firms appear to concern primarily members of the New York Stock Exchange. The Special Study Report pointed out that many small over-the-counter dealers do not hold customers' securities regularly nor do they hold securities in safekeeping for as large a proportion of their customers as do exchange firms.

Moreover, over-the-counter dealers do not normally hypothecate or lend customers' securities. This is true because, generally speaking, brokers may hypothecate customers' securities only to secure bank loans for the purpose of financing customers' purchases on margin, and brokers lend customers' securities primarily for delivery on short sales.

Over-the-counter securities cannot be purchased on margin, and the borrowing of securities to deliver against short sales in the over-the-counter market is very limited. Despite the more limited nature of these problems in the over-the-counter market, and in certain of the exchanges, it is highly desirable that financial responsibility protections similar to those which the New York Stock Exchange rules are designed to provide, be afforded to all investors—the declared purpose of the pertinent recommendations of the Report of the Special Study.

We have written the various self-regulatory agencies suggesting that they adopt the recommendations of the Special Study Report in this area. If these institutions are willing to act promptly and expand their own rules, there may be no necessity for Commission action.

Thus, the NASD has recently replied and indicated its intention to adopt a rule requiring segregation of securities. Should there be a reluctance to act, we shall either issue our own rules or, where necessary, ask the Congress for power to do so.

The Haupt situation itself raises certain questions respecting the protection of customers' securities beyond those discussed in the Special Study Report. For example, it appears that Haupt had not adequately segregated customers' securities.

It further appears that Haupt pledged securities to secure bank loans in violation of exchange rules. The difficulty of fully protecting customers' securities when they remain with a firm, especially in moments of great stress, has led the Commission to propose that careful consideration be given to the establishment of a central depository for customers' fully paid and excess margin securities.

This suggestion would not only have the advantage of providing additional safeguards for customers' securities but would also reduce the number of physical transfers and would resolve back-office custodial and recordkeeping problems.

The New York Stock Exchange has recently informed us that they are developing a plan to centralize the transfer of ownership and the delivery of securities which they hope to have in operation by the latter part of next year. They have agreed to reexamine this system in the light of the Haupt situation to see how it can be utilized to give additional protection to customers' securities.

The other major area of financial responsibility relates to protection of customers' free credit balances—those amounts of cash owed by brokers to customers which the customers have an immediate unrestricted right to withdraw. These balances are not required to be segregated and very large amounts of customers' funds are used by brokerage firms in their businesses. Use of these fund accounts for important additions to the income of many firms and reduces interest costs on money that might otherwise have to be borrowed. As previously pointed out, the net capital rule is intended as a general safeguard.

The Report of the Special Study concluded:

> On the basis of prior loss experience * * * there does not appear to be a need to require complete segregation at this time.

The report stated that losses of customers' free credit balances had been small in comparison to the great volume of transactions taking place and the number of customers in the market. The need for protection, and the added benefits that would be afforded, must be balanced against the added costs which might have to be absorbed by customers because of the segregation of free credit balances.

The study report did recommend that broker-dealers be required to maintain a reserve in cash or Government securities equal to a given percentage of free credit balances and to provide customers having free credit balances with notice on a regular basis. We have recently circulated a rule proposal among the self-regulatory agencies containing this latter recommendation. Its purpose is to require periodic disclosure to a customer that his funds may be used by a firm in its business and thereby to place the customer in possession of information which allows him to protect himself.

As for the other study report recommendation, we are considering an amendment to our net capital rule which would require firms to maintain a specified percentage of their customer's free credit balances in cash or Government securities. A recent study by our Division of Trading and Markets has indicated that a significant percentage of broker-dealers presently keep on hand cash or Government securities in an amount equal to 50 percent or more of the free credit balances.

The primary purpose of this amendment is to provide a certain amount of liquidity in the event that customers wish to withdraw these balances. Moreover, by in effect restricting the investment of free credit balances, it can also serve to limit the risks a firm might otherwise incur.

The study, or course, did not have the *Haupt* case before it in reaching its judgment on the free credit balance issue. We believe the primary problems of that case can be resolved through additional restrictions on brokerage firms engaged in the commodities business and assume that this will be done.

In addition, we have noted the report's characterization of the solvency record of the brokerage community as "quite good." Under the circumstances, the Commission is of the view that complete segregation of free credit balances should be adopted only as a last resort.

At the same time, we believe—and have so advised the self-regulatory agencies—that the report's recommendations relating to free credit balances should be vigorously pursued. As just noted, one of

these is the subject of a proposed Commission rule which has been distributed to the self-regulatory agencies, while the other has been included as part of an extensive revision of the capital rule and is presently being analyzed by the Commission.

There is one final point that I would like to discuss in connection with the Ira Haupt matter. The purpose of requirements concerning the treatment of customers' funds and securities is not only to prevent their misappropriation by an unscrupulous broker or his employees, but also to provide that, in the event of bankruptcy, customers will have preference over general creditors of the firm.

The Special Study Report recommended that the provisions of the Bankruptcy Act dealing with insolvency in brokerage firms be strengthened and clarified in several respects—including those sections relating to the kind of segregation of cash and securities which will insure a preference. These recommendations present very complex problems; after further examination, we hope to propose amendments to the Bankruptcy Act, which appear to be necessary to provide more adequate protection to customers in the event of a broker's insolvency.

In view of the time that it will take to consult with the National Bankruptcy Conference and prepare such technical and complex legislation, the Commission strongly believes that this should not hold up enactment of H.R. 6789, which is unrelated to the Bankruptcy Act problems.

Mr. Chairman, that completes the statement on Ira Haupt. As you indicated, I also have one other statement on the question of the specialist and, as you indicated further, I would move to that and that would finish our statement.

Mr. STAGGERS. Very well, you may proceed.

Mr. CARY. Moving on to what is page 54 of my statement, the role of the specialist and the market break of November 22, 1963, pursuant to a request from you, Chairman Staggers, the Commission transmitted to the subcommittee a study of specialists' and floor traders' activities in 25 stocks on November 22 and 26, 1963. November 22, of course, was the date of the tragic assassination of the late President; after 1:40 p.m., when the news concerning the assassination became generally known, the market, as measured by the Dow-Jones Industrial Average, declined 24 points in a period of less than a half hour. The volume during this period was almost 2½ million shares.

The next trading day, November 26, was also one of extraordinary volume and price change; over 9 million shares were traded and the market was up 32 points. Our study of the activity of those 2 days has focused attention on the role of the specialist, the Special Study Report's recommendations relating to specialists, and our progress with respect to the recommendations.

This subcommittee has had the benefit of extended explanation by officials of the New York Stock Exchange on the role of the specialist. At the same time a brief description of their operations; that is, of specialists' operations, may be helpful.

The specialist performs two basic functions with respect to the issues in which he specializes. First, as a broker's broker he holds and executes orders entrusted to him by other brokers on behalf of the latter's customers. These are generally "limited price" orders speci-

rying a price above which the customer will not buy or below which he will not sell; the price of the order is above or below the prevailing market when submitted or the order would not be left with the specialist. The specialist acts as a central repository for such orders. These orders comprise the "book," which is actually a small book that they carry.

The second important function of the specialist is to purchase and sell securities for his own account in order to maintain a fair and orderly market. In this capacity, the specialist will buy securities from the public when there is no other public purchasing power available at a price reasonably related to the last transaction and will sell securities to the public under the same circumstances. The Securities Exchange Act and the rules of the exchanges are designed to limit the buying and selling by specialists to these situations.

The Special Study made an extensive examination of the specialist system on the New York Stock Exchange. The report concluded that:

> In its present form (the specialist system) appears to be an essential mechanism for maintaining continuous auction markets and, in broad terms, appears to be serving its purposes satisfactorily. There is a need, not for any broad and drastic change in the system, but for a number of important, specific improvements in specialist practices and in regulatory concepts and methods. * * *

The conclusions and recommendations of the Special Study are based on an examination and analysis of a depth and detail not previously available to the Commission. I would like to outline certain of the problems discussed by the study, with particular emphasis upon those which were also evident in our recent examination of specialists' trading on November 22.

A fundamental difficulty is the uneven performance of different specialist units. This is apparent in several respects. Some specialists are unwilling to inject themselves in the market at times of crisis; this conclusion was dramatically demonstrated by our recent study which showed certain specialists did not take adequate positions in the rapidly declining market.

In contrast to this underparticipation, our analysis pointed up the problems arising from overparticipation on the sell side as illustrated by the unregulated liquidation of positions.

Thus, the specialists in American Photocopy sold 12,400 shares of which 4,800 shares were sold short, and made no purchases at all. This is a slight revision from the original figures we furnished to you, but they have been furnished to us in turn by the New York Stock Exchange and accentuated the problem a little more.

I would note that on February 6, the New York Stock Exchange disciplined these specialists by taking this stock away from them. Mr. Funston has informed the Commission that American Photocopy accounted for almost three-quarters of the income of these specialists. We also understand that the exchange is reviewing the activities of other specialists on November 22.

As an example of another problem, the Special Study Report commented upon the inadequacies of the present tests used to measure specialists' performance. The New York Stock Exchange's analysis of the November 22 market, which employed aggregate data, illustrates some of these difficulties. This is an area in which aggregate data are neither useful nor meaningful.

The exchange stated that the 25 specialists studied purchased some 104,000 shares on balance during the period between 1:41 (when news of the late President's assassination apparently reached the floor) and the close. However, approximately 80 percent of the purchase balance was accumulated after the stocks had declined more than 50 percent of the total decline. The exchange's analysis also indicated that the specialists in the 26 stocks assumed additional commitments valued at $5.2 million during the period from 1:41 to 2:07. It appears that the specialists in five stocks took on an additional commitment of $4.2 million or 82 percent of the total capital commitment. Aggregated data must be supplemented by portraits of specialists' trading in individual stocks on a chronological basis as the Commission did in its study of November 22.

A question of continuing concern since the enactment of the Securities Exchange Act, and a subject of several studies—including an exhaustive one by the Special Study—is whether the broker and dealer functions of specialists should be segregated. This subcommittee has manifested an interest in this problem during the hearings.

The study concluded, and the Commission agrees, that any such drastic change as segregating the functions of specialists should be based on a clear preponderance of the evidence and this preponderance does not now exist.

Essentially this conclusion was reached before of the following considerations. First, specialists' brokerage income, which is substantial, provides a continuous source of funds to cover the risks which the rules oblige specialists to assume in their dealer capacity. Moreover, since investors tend to trade in stocks with narrow markets, the possibility of increased brokerage income serves as an incentive to a specialist in the performance of his dealer activities. Furthermore, without knowledge of the "book" it is not clear that a specialist could or would perform as effectively. I shall conclude by saying, in the words of the report—

> that expectations of investors, credit arrangements which depend on liquidity, and the very organization of the exchanges, to one extent or another, revolve around the technical market functions of the specialist.

If the specialist did not continue in his combined role, the auction market as we know it today might well take on a different form and the benefits of continuity and liquidity might well be diminished. It should be noted that specialists are involved as dealer in about 25 percent of exchange transactions and as broker in about 30 percent.

Although not recommending segregation of functions, the study's proposals are designed to minimize and alleviate the conflict of interest problems in a more comprehensive manner than existing regulation. For example, present rules do limit the specialist's opportunity to deal at unfair prices with the brokerage orders he holds. The study's proposals would strengthen these restrictions. In addition, they include limitations on the handling of public customers' accounts by specialists, restrictions against tax-motivated trading, prohibitions against a specialist handling certain types of brokerage orders, and a general improvement of surveillance and enforcement. I might add that segregating functions would not have re-

solved the major problems that were apparent in the November 22 activities.

I should now like to discuss our progress in implementing the study's report recommendations relating to specialists. Our staff has had numerous conferences with both the New York and American Exchanges on these problems. April 1 of this year has been set as the date for the exchanges to submit their definitive positions on each of the recommendations of the study in this area. These recommendations can be divided into the following categories:

1. Clarification and strengthening of the regulatory structure affecting specialists with emphasis upon refining the obligation of specialists to maintain a fair and orderly market. A proposed Commission rule to this end—which I shall discuss later—has been distributed to the New York and American Stock Exchanges.

2. A substantial increase in specialist capital requirements. Agreement in principle has been reached on this point with the New York Stock Exchange; I understand that Mr. Funston so indicated to this subcommittee. Other proposals relating to financial responsibility, including the development of procedures to improve the capacity of specialists to handle large blocks of stock, are being pursued by the exchanges and will be taken up at our April meeting.

3. Limitations on dealer transactions by specialists, including appropriate restrictions on the right of liquidation of inventories.

4. Minimizing and controlling the conflicts in the mingled function of broker and dealer through prohibiting a specialist from executing certain tax-motivated transactions, restricting the type of brokerage orders he can handle, and forbidding him for servicing the accounts of his own public customers in stocks in which he is registered.

5. Improvement in surveillance and enforcement practices to bring deficient specialists up to acceptable levels of performance. This proposal is closely connected with the need for modern automated procedures, a subject of continuous and intense discussion between us and the exchanges.

We regard as a key step in our implementation program the proposed rule we have recently sent to the New York and American Stock Exchanges for their comment. The rule sets forth the basic obligation of specialists to maintain a fair and orderly market and restricts their dealer activities to a course of dealing reasonably necessary to accomplish that purpose.

The rule would prohibit those dealer transactions that ordinarily have a detrimental effect upon the market or involve a direct conflict between the specialist's broker and dealer functions. For example, the rule would restrict sales below the last price because of their destabilizing effect on the market. On occasion transactions of this type may be an essential part of a proper course of dealing in the maintenance of fair and orderly markets. However, a determination to that effect can be made adequately only in the context of a comprehensive regulatory and surveillance system which defines standards and provides for their enforcement.

In recognition of these facts, the proposal would permit otherwise prohibited dealer transactions for those exchanges which have a comprehensive plan enabling them to exercise a fully informed vigi-

lance and discrimination in evaluating specialist performance in particular situations. In this connection, I would point out that in the development of a plan by an exchange, various problems noted in the Special Study Report would receive treatment. Thus, a plan would deal with many of the recommendations outlined above, including minimum capital, dealer participation, acceptance and execution of brokerage orders, and surveillance procedures.

I would like to focus special attention on this last subject—surveillance procedures. We believe that the more sophisticated and complete a program of surveillance and enforcement the less the necessity for outright prohibition of particular types of specialist activities or inflexible and detailed rules governing those activities. Our letter to ths subcommittee on January 21, 1964, and the Special Study Report emphasized the great difficulty of reconstructing markets under present procedures. These methods are mainly manual and time consuming in nature; the resulting data are often inaccurate and incomplete.

We believe that the use of modern automated procedures can bring dramatic improvement in the ability of the Commission and of the exchanges to fulfill their regulatory responsibilities. Because of the vital importance of this subject, we have hired outside consultants to secure additional technical assistance. We are insisting that the New York and American Stock Exchanges develop programs to assure that automated surveillance techniques are used to the maximum extent feasible. I would like to offer for the record a letter from the Commission to the New York Stock Exchange, dated December 10, 1963, stating our views on this subject.

(The statement referred to follows:)

EXHIBIT A

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., December 10, 1963.

Mr. G. KEITH FUNSTON,
President, New York Stock Exchange,
New York, N.Y.

DEAR MR. FUNSTON: On October 31, members of our staff met with representatives of the exchange concerning the NYSE's projected system of automation.

The purpose of the meeting was to express the Commission's interest in obtaining transaction data which might be accumulated within the capacity of the exchange's program and equipment. However, it would appear that the present plans of the exchange for automation do not now provide for the input of such data. As a result, the following important market data with respect to each transaction are apparently not to be obtained:

(*a*) Identity of underlying brokers on both sides (that is, those whose phone clerks received the orders at the edge of the floor);
(*b*) Whether the sale was long, short, or short exempt;
(*c*) Whether the specialist acted as agent; and
(*d*) Whether the principal was a specialist, floor trader, odd-lot dealer, or member off floor.

Other desirable data not to be obtained are:

(*e*) Executing brokers (if different from underlying);
(*f*) Covering purchases; and
(*g*) Type of order.

One point emphasized at the October 31 conference was the likelihood that an automated system which accumulated reliable and current market data about each transaction would ease the reporting burden on members. At present there are a number of reports being filed by members on a periodic basis with the exchange for surveillance and informational purposes. In addi-

tion to the fact that many of these reports must be laboriously compiled and processed by hand, they suffer from serious inadequacies. There may be a considerable timelag between the filing and availability of data even for the particular end use for which the report is designed. Moreover, since these reports have been developed for a specific end use and each is analyzed for a single purpose, it requires long and painstaking effort to reconstruct the whole market at a particular point in time. The final result, even after integrating the data from these reports, may still not be a comprehensive or fully reliable market picture.

An automated system which accumulated some or all of the market data outlined above at the point of execution would serve to cure these defects. It would therefore assist in important surveillance purposes, perhaps obviating or mitigating some of the trading problems which have traditionally occupied the energies of the exchange and the Commission. Such a system could furnish immediately, for particular stocks, reliable and vital data as to prices, volume, and market participants. Development of such a system affords a possibility for less restrictive rules than might otherwise be necessary.

We are sure that you also appreciate the contribution which automated equipment can make to the fulfillment of our mutual regulatory responsibilities. It is difficult to find any significant reason for not utilizing this equipment to take full advantage of its potential for these purposes.

In view of the statutory responsibilities of both the exchange and the Commission, we urge you to take steps to facilitate obtaining the first four items listed above and, if practical, the last three as well. We believe that time is an important factor in the program and, as requested at the meeting on October 31, we would appreciate your specific advice on each of these items at the earliest possible date.

Sincerely yours,

RALPH S. SAUL, *Director.*

Mr. CARY. Up to this time, the New York Stock Exchange has not been receptive to our proposals. However, our staff did meet with them the day before yesterday and I understand some progress has now been made, but we still have a long way to go, Mr. Chairman.

In brief, what are the advantages of automation? By capturing in automated form comprehensive information on each transaction and performing by computer the tedious clerical and analytical procedures of market reconstruction, now requiring days and weeks of human labor, the efficacy of surveillance efforts could be improved in a number of ways:

1. Surveillance could be carried out on a comprehensive, rather than on a sample or partial, basis. Exchange review of each specialist's performance could be continuous, instead of only for 8 weeks of the year as at present. The need for this type of supervision was underscored by both Mr. Funston and Mr. Frank, of the New York Stock Exchange in recent testimony before this subcommittee, that the prime check on any specialist conflict of interest must be tight policing and continuous review of his transactions.

2. The timeliness of surveillance could be greatly improved. Several kinds of rule violations could be detected almost immediately after they occur on the floor. The prolonged delays now confronting the exchange were recently brought to this subcommittee's attention. Mr. Funston explained that the 2½-month interim between the November 22 market break and the first disciplinary proceeding was due to the difficult and complicated nature of properly reconstructing the market and the relevant circumstances under present surveillance procedures.

3. The quality of surveillance would be significantly enhanced through the availability of more accurate and complete information.

For example, evaluation of a specialist's performance could be based not only upon his dealer transactions, as at present, but also in the context of the agency orders which he executes for others.

Moving over, Mr. Chairman, from the specialists as such to the floor trader, our study of November 22, 1963, shed little new light on floor traders' activities. Floor traders are members of exchanges who trade for their own account and initiate their transactions while personally present on the floor of the exchange. Unlike specialists, floor traders have no affirmative market responsibilities, although there are certain restrictions under exchange rules upon their trading.

The reports filed with the Commission and the exchange indicate that on November 22 there was floor trader activity in only nine of the stocks studied and some of this was not in great volume.

However, many of the floor traders' sales came immediately after the news of the late President's assassination but before the public had an adequate time to react. Although this trading may have been in negligible quantities, it illustrates the floor traders' ability to react more swiftly to news than the public. Other floor trading took the form of purchases after there had been substantial price declines.

In the case of Sperry Rand, one floor trading firm, which has carried a significant position in this stock for some time, seems to have provided almost as much support to the market as the specialist. Its purchases accounted for 87 percent of the floor trader purchase balance of 30,000 shares for that day.

The report of the special study recommended the gradual abolition of floor trading. The Commission agreed that a rule to this effect should be developed, unless the exchanges demonstrate that the continuance of floor trading would be in the public interest.

The exchange's response is expected in approximately 2 weeks. I should also like to point out that the Special Study Report recommended a class of auxiliary specialists be developed; in effect these members would be allowed to floor trade but pursuant to regulations assuring their financial responsibility and limiting their market participation in a manner similar to specialists. This approach would permit the continued operation of those few floor traders who do on occasion help the market through the acquisition of large blocks.

Mr. Chairman, that completes all my prepared statement. I did have one more that I am just going to ask to submit for the record which is really giving a general status report of our implementation of the recommendations of the Report of the Special Study up to the present date. I have it here and it is a separate statement. It is not numbered consecutively and it is about 6½ pages long, and I would like to submit that for the record.

Mr. STAGGERS. I was wondering if you could summarize that, because I think that is important to this committee, as to what you intend to do there, what you have done, and so forth, if you would do that.

Mr. CARY. Yes, sir. I would be very glad to. May I say one of the reasons I didn't want to is some of it is repetition of statements made in the earlier hearing I had, but I can summarize it very swiftly and I don't think it will take more than 5 or 10 minutes of your time.

Mr. STAGGERS. All right, if you will do that by headings.

Mr. CARY. Yes, sir. I do want to make one sort of preliminary statement. In view of the broad scope of this program, of the Special

Study itself, it has raised some basic problems about the regulatory scheme and certain of its recommendations propose significant alternatives in established ways of doing business. For that reason we have been proceeding through presenting the study's recommendations to the industry, getting their views, and then setting deadlines for their reports and reactions before we finally act under our rulemaking power.

I do have this statement and I will just cover it very briefly. For instance, at page 2, the first phase you might say of our Special Study, as you recall, was the American Stock Exchange investigation, which, of course, has already been discussed before this committee.

In addition, I would say that the self-regulatory agencies themselves have been rather active. The New York Stock Exchange, for example, has materially strengthened its rules with respect to market letters along the lines of the report's recommendations and the procedures for exchange review of these materials has been quite substantially improved.

In qualifications standards as well, written examinations are now required of individuals desiring to become allied members, floor members, specialists, or odd-lot brokers. In addition, requirements have been adopted for the registration of salesmen.

Moreover, new and more stringent standards for approval of branch offices and branch office managers have been adopted. Branch offices are being inspected for the first time to review selling activities. On the floor the exchange has agreed to assume jurisdiction of the odd-lot problem, the odd-lot differential, and at least the first step it has taken is to require specialists to report transactions by their public customers.

Moving over to the NASD side of the fence for the moment, as I mentioned, perhaps yesterday, in response I believe to a question raised by Congressman Keith, the board of governors of the NASD has been considering very recently proposals for modification and strengthening of the organization of the association. They will have a new president taking office in April. He has been appointed. The board also at that time considered a significant revision of its rules relating to market letters and to those concerning selling practices. I think when adopted these will carry out several key recommendations of the report.

As to what is going to transpire in the near future, the New York Stock Exchanges' report on floor trading I mentioned a moment ago should be submitted to the Commission within 2 or 3 weeks. The exchanges are scheduled to give their definitive responses to the specialist recommendations by April 1. That is the deadline set on that. The cost study of the odd-lot differential proposed by the study report is now underway. This should require extensive work and will probably not be available until September 1.

Another major part of the work that we have done obviously is what I have been referring to today—H.R. 6789. The bill has been one of the major features of our work. I won't discuss it, but I just wanted to emphasize it again.

In addition, our Commission has this rulemaking authority, and we have pretty broad rulemaking authority, and that is the reason we are not coming to Congress for any broader legislation in the two major

areas that we have discussed here. A vital reform has already taken place in the reorganization of our own Division of Trading and Markets and that division is now engaged in inspecting the exchanges themselves and the NASD on a regular and thorough basis. We have had people up there at the exchange looking at what they are doing and will continue to do so. We have two rule proposals outstanding and they have been exposed for public comment. One is known as 14(a)(3) relating to financial statements in annual reports, and then we have 17(a)(8) which has been referred to earlier in these hearings, the exchange filings of proposed rules with the Commission.

Other Commission rule proposals have been circulated among the self-regulatory agencies and these cover the following topics: Specialists, identification of wholesale quotations in the over-the-counter market, notice to customers with respect to their free credit balances, and controls over selling practices through classification of orders. Other important rule proposals will be circulated in the near future. We are considering an extensive revision of our net capital rule which would set minimum capital standards for broker-dealers generally, would require reserves in cash or Government bonds of a specific amount of customers' free credit balances held by a firm, and would establish certain charges against net capital for those firms also engaged in the commodities business. We will also be considering a series of amendments to our proxy rules, designed both to clarify and to strengthen our disclosure requirements.

Various other rulemaking proposals, and I would just like a few final comments, are in different stages of completion. One of them deals with the so-called third market. That is the off-board trading in listed stocks. The staff has met with the major market makers of listed securities to discuss the reports' recommendations and expects shortly to have proposed rules and report forms ready for comment. The staff is also drafting a rule to deal with riskless transactions in the over-the-counter market.

Mr. STAGGERS. Would you state that again?

Mr. CARY. I said the staff, sir, is drafting a rule to deal with riskless transactions in the over-the-counter market. That is over-the-counter transaction in which the broker-dealer only buys a stock after receiving an order for it from his customer. As a consequence he is really acting in an agency capacity; these are deemed to be riskless transactions in which he is undergoing no risk and yet in respect of which he may be taking a higher commission than ordinarily taken in an agency transaction.

Maybe I better just make sure that I have stated that as clearly as possible. I might just turn to Mr. Saul and see. Is that an adequate statement?

Mr. SAUL. Yes.

Mr. STAGGERS. May I interrupt you right there?

Mr. CARY. Yes, sir.

Mr. STAGGERS. In that connection, you say you are going into this; what are you doing?

Mr. CARY. Yes, sir; we are drafting a rule right now on this question, proposing a rule.

Mr. STAGGERS. I want to come back to it a little bit later because I think it has to do with quotations on the over-the-counter market.

Mr. CARY. Yes, sir. That really completes my statement. I was going to emphasize this automated surveillance but I have already discussed it and that is another thing which we are getting into a great deal at this time.

However, it has already been discussed in my material on specialists and I don't think I need to repeat it. That covers in general, Mr. Chairman, in a very brief way where we have gone thus far and what our immediate plans and programs are.

(Statement referred to follows:)

STATEMENT OF WILLIAM L. CARY, CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION, ON IMPLEMENTATION OF THE RECOMMENDATIONS OF THE REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS

At the time of my appearance before this subcommittee on November 19 of last year. I reported in detail on our plans for the implementation of the recommendations of the Report of the Special Study of Securities Markets and results achieved at that time. We are happy for this opportunity once more to present an overall review of our activities.

The report has presented us with an ambitious program. We appreciate that it represents the first thorough examination of the securities markets in 30 years. The report raises basic questions about the regulatory scheme and certain of its recommendations propose significant alternatives in established ways of doing business. Many of them are directed to the self-regulatory agencies; under the statutory framework these agencies have the initial responsibility to remedy shortcomings in business practices of their members and abuses in their markets. They requested and were entitled to a reasonable period to appraise and analyze the proposals. Deadlines on many issues are now approaching. We have repeatedly urged the self-regulatory agencies to expedite their examination and we know that intensive work is in progress. Because of all these circumstances, we know well this is not a program to be written swiftly and then enacted by fiat.

A. By any measure progress has been significant. A raising of standards throughout the securities industry has been evident since the inception of the Special Study. This subcommittee is well aware of the major constitutional and organizational reform which has taken place on the American Stock Exchange since the release of the Commission staff report on that exchange early in 1962. This reform has been manifested in the strengthening of its staff, the adoption of many new rules, and several disciplinary actions by the exchange against the persons cited in the Commission staff study.

The self-regulatory agencies have been generally active. Around 60 recommendations in the report are specifically directed to those agencies; satisfactory progress has been made with respect to about one-half of them. Let us highlight a few areas. The New York Stock Exchange has materially strengthened its rules with respect to market letters along the lines of the report's recommendations and the procedures for exchange review of these materials have been improved. In the vital field of qualification standards, written examinations are now required of individuals desiring to become allied members, floor members, specialists or odd-lot brokers, and additional requirements have been adopted for the registration of salesmen. Moreover, new and more stringent standards for approval of branch offices and branch office managers have been adopted. For the first time these offices are being inspected to review selling activities and the adequacy of supervision.

In the floor area, the exchange has assumed jurisdiction over the odd-lot differential. Moreover, it is now requiring specialists to report transactions by their public customers.

The Special Study Report pointed out various fundamental problems in the organization and operation of the National Association of Securities Dealers, Inc., and made several recommendations for improvement. At its January meeting I understand that the board of governors of the NASD considered proposals for modification and strengthening of the organization of the association. The Commission is to receive these proposals in the near future. The board also considered at that time a significant revision to the rules relating to market letters and to those concerning selling practices. When adopted by the NASD, these will implement several key recommendations of the report.

Much action by the self-regulatory agencies is due in the near future. The New York Stock Exchange's report on floor trading should be submitted to the Commission within 3 weeks. The exchanges are scheduled to give their definitive responses to all of the specialist recommendations by April 1. The extensive cost-study of the odd-lot differential proposed by the study report is now underway and the New York Stock Exchange expects to submit the results to us by September 1.

B. A most important product of the study report is H.R. 6789, the bill now pending before this subcommittee. I have previously indicated that enactment of this legislation would implement in whole or in part, or directly aid the implementation of, 33 recommendations of the report. These numbers are not the key. This bill encompasses the most significant reform of the securities laws since the enactment of the Investment Company Act of 1940. I appreciate that one aspect of H.R. 6789 has been before the Congress on previous occasions—that part extending fundamental investor safeguards to companies whose securities are traded in the over-the-counter market. But I do not believe that fact in any way minimizes the necessity for passage now of the bill. The report's examination graphically demonstrates the spectacular growth of the over-the-counter market; should investors in that market continue to be denied basic protections? Furthermore, H.R. 6789 has another vital aspect that cannot be overlooked; namely, its provisions extending self-regulation and requiring higher standards of qualification for persons in the securities industry. One point is emphatically clear from the Special Study Report; minimum criteria of competence, training, experience, and financial responsibility are an absolute keystone to raising standards in the securities industry. H.R. 6789 would authorize and direct their establishment. The bill would also extend the discipline and standards of self-regulation to those firms in the industry not now subject to them. This is a logical development from the congressional decision reached in 1938 to make self-regulation an integral part of the pattern of Federal securities regulation.

C. This Commission, of course, has extensive rulemaking powers where it can act without legislation. Of the approximately 70 recommendations in the report directing the Commission to act in some specific manner, over 40 either have been entirely implemented or significant first steps completed. A most vital reform has been the reorganization of the Division of Trading and Markets which is now inspecting the exchanges and the NASD on a regular and thorough basis. Two rule proposals have been exposed for public comment relating to financial statements in annual reports and exchange filings of proposed rules with the Commission. Other Commission rule proposals have been circulated among the self-regulatory agencies and other interested industry groups. These cover the following topics: specialists; identification of wholesale quotations in the over-the-counter market; notice to customers with respect to their free credit balances; and controls over selling practices through the classification of orders. Other important rule proposals will be circulated in the near future. We are considering an extensive revision of our net capital rule which would set minimum capital standards for broker-dealers generally, would require a reserve in cash or Government bonds of a specific amount of customers' free credit balances held by a firm, and would establish certain charges against net capital for those firms also engaged in the commodities business. We will also soon be considering a series of amendments to our proxy rules, designed both to clarify and strengthen our disclosure requirements.

Various other rule proposals are in different stages of completion. A topic which has elicited some comment at these hearings is the off-board market for listed stocks, or the "third market." The staff has met with the major market-makers of listed securities to discuss the report's recommendations and experts shortly to have proposed rules and report forms ready for comment. The staff is also drafting a rule to deal with riskless transactions in the over-the-counter market.

D. I have already reported to this subcommittee the immense importance of automated surveillance techniques. We shall continue to insist that the exchanges develop programs to assure that these techniques are used to the maximum extent feasible. Furthermore, we have discussed with the odd-lot firms the use of electronic data-processing equipment in odd-lot trading and plans are being formulated for what appears to be an effective program.

In summary, I believe that substantial progress has been made. The Commission is fully dedicated to the task of making the Special Study Report fully meaningful. We shall continue our efforts and in the months to come I am con-

fident there will be further tangible evidence of progress in the form of important new rules both by the Commission and the self-regulatory agencies, and as reflected in improvements in practices throughout the securities markets.

Mr. STAGGERS. I think this last statement of yours is the most vital of all that you have made here. Did you submit that to the committee?

Mr. CARY. I did. I have it here and I think we submitted it yesterday. This is a separately appended statement entitled my statement before your committee on implementation of the recommendations of the report of the special study of securities markets, dated February 18, dated yesterday. It is a seven-page statement, Mr. Chairman.

Mr. STAGGERS. I wanted to pursue it a little bit further because I think it is very, very important. I think there are many things in there that we ought to go over that may be the crux of this whole thing if they are fully discussed. I believe if they are taken care of we certainly are getting to a lot of things.

I wonder if you have made any suggestions for additional legislation in connection with this bill.

Mr. CARY. No, sir, we have not.

Mr. STAGGERS. I am not going to pursue any questions at this present time because I have assured one or two members they would be first, but later I want to ask you with respect to some of these proposals, would you say that if you need them you will come back to Congress?

Mr. CARY. Right.

Mr. STAGGERS. Wouldn't that be too late sometimes, maybe like the Ira Haupt case or the dealings of the specialists. Wouldn't it possibly be better to do them ahead of time so you would have them?

I think the committee in its wisdom will probably take this up and we might give you some additional legislation in anticipating something of this nature.

Mr. GARY. Yes, sir. In answer to that, you are referring, for instance, Mr. Chairman, to the *Ira Haupt* case.

Mr. STAGGERS. I think it takes in several phases, too.

Mr. CARY. Just to illustrate a point of view that I was going to indicate, for example, I suppose the most obvious thing that one would come up with if you just wanted a clean-cut situation would be to divorce the commodities business entirely from the securities business by requiring, let us say, brokerage firms to have a separate corporation through which they do the commodities business.

Now, in a sense we can achieve that obliquely, but not directly, through existing powers of requiring what we call a haircut; in other words, saying that their net capital has to be very much strengthened if they go in this commodities business. Every commodities contract would reduce their net capital under the net capital rule by blank dollars, so in a sense we have oblique power.

Now, we are not proposing to go so far as to recommend the divorcement, as I indicated. We do propose, for example, and we have the power to require an extensive margin, let's say, in the event that a firm that is in the securities business also is in the commodities business. We also would expect to strengthen our net capital rule if they are in the commodities business.

What I had in mind, therefore, and that is just an illustration, since you brought it up, is saying that we are genuinely proposing to strengthen our financial responsibility requirements in the light of the Ira Haupt case through our rulemaking power. If we had to come in for an actual divorcement and your committee, for example, didn't feel that we should do it obliquely through our net capital rule, then we might have to come back to you. But we do feel that we have quite a substantial amount of power and at least our thought would be to exercise that first and if, for any reasons, we now find it won't work, then we would come back to you.

That is just an illustration of the point I was trying to make.

Mr. STAGGERS. I appreciate the explanation. I would like to say briefly that I believe it is the disposition of this committee to be entirely fair and to recognize that the Commission is doing the very best it can, and the exchanges are doing the very best they can and we are assuming that all of the dealings in the commodities are open and above board, with the exception of one man who I think was trying to do a job but he got caught. He thought that maybe he had done some of these things before and had gotten by with it. I think in the deliberations of the subcommittee and the full committee, if we feel that perhaps you need something additional, we may so provide, because if you have to come back to Congress to ask for the law and the power, it might take a long time in order to do this.

Mr. CARY. I appreciate your point, yes, sir.

Mr. STAGGERS. I believe this is the first complete revision we have had of the SEC laws and if there is a reasonable chance of these things, they ought to be included in this bill.

For instance, when members of the stock exchange were here we asked a dealer who deals directly with commodities what his capital requirements were. They didn't know amongst themselves and they never reached a definite decision, even though we had one of the dealers, and I believe one of them was directly connected with commodities. I believe that Congress ought to perhaps set up some sort of a definitive standard to proceed by.

I have many questions, but I will forego them and turn now, because of a definite promise, to my colleague from Pennsylvania, Mr. Curtin, and he may proceed with the questioning now. He didn't have the opportunity yesterday.

Mr. CARY. Thank you.

Mr. CURTIN. Thank you, Mr. Chairman. Mr. Cary, I want to congratulate you on a very fine marshaling of the facts and presentation of the problems in this particular field and how you think these problems can be solved. However, this proposed legislation is so important to the securities section of our economic life that I think it is necessary that we carefully look into all proposals of the bill.

Incidentally, before going into the provisions of the bill itself, I would like some clarification on a series of articles that recently appeared in a trade journal. A series of three articles appeared in Barron's Weekly, starting February 3, giving a story on the Commission's activities both in private investigation and in a stop-order proceeding against the Atlantic Research Corp. under the 1933 act, and a certain suspension of trading of the stock of this corporation until the corporation stipulated certain matters under the 1933 act. These

articles contain some pretty startling allegations and it seems to me, in view of the tenor of this story, you may wish to comment about it.

Mr. CARY. Yes, sir. I would like to start with that and then I might ask my colleague, Commissioner Woodside, to speak to it perhaps more definitively than I shall. May I say, Mr. Chairman, perhaps I should make almost a record of our opinion in the Atlantic Research case which was issued on December 6, 1963, authorizing a stop order with respect to securities proposed to be issued by that corporation.

Now, it was not only by that corporation, but, as I recall, it was also a secondary offering of other persons. In that connection may I sort of summarize some of the conclusions which we reached in that opinion with respect to it. It is perhaps best summarized in about three headnotes that we have here with respect to how the management was operating the Atlantic Research Corp.

We pointed out here that, where the registrant, that is, the company, directed and completely dominated the management policies and activities of other companies which had no business activities of their own, not related to the registrant and were operated together with registrant as one unit, the failure to disclose these facts and these relationships, and the fact that they were subsidiaries, and to consolidate the financial statements of these companies with those of registrant so as to eliminate the effect of this intercompany arrangement, was materially misleading.

That is one of the conclusions which we reached with respect to the use by that company of a series of organizations as to which they may not technically have held the stock, but which they totally dominated by organizing it, financing it, instructing it when to act, and so forth. That was a first point, and may I say that was an important point because of the fact that if the firm had published its own earnings it would show a very substantial profit, but if it published the earnings of the parent and the subsidiary corporations it would show a net loss, and that would therefore have a tremendous affect on market values.

A second point in the opinion is—now I am reading these headnotes in order to give you some background with respect to it—where the chief executive officer, who was a dominant stockholder, caused the company to advance funds to these undisclosed companies to make large-scale purchases of the registrant's stock on the open market and caused the company to present misleading financial statements, it was held that the failure to disclose these policies and activities, having a potential and actual affect of supporting the market prices of registrant's stock, renders the registration statement and the references to market prices materially deficient.

If I may explain that headnote a little more carefully, it was in this nature: That we found that the chief executive officer of that corporation, who had a very large holding in the company, and in fact I suppose this is a rather typical example of a highly successful company which is dominated by one or two people then going public—we found that he had a very large number of shares in this corporation and engaged in other transactions and other investments so that he had pledged a great deal of it to the bank.

Therefore, the value of that stock was important—to keep that value up while the stock is being pledged with the bank. We found

in this case, and the opinion so evidences, that there were loans by the corporation itself to subsidiary companies, and the proceeds of those loans in turn were used to make purchases of the stock, which in turn of course would have an effect on keeping the market value up.

Mr. Woodside is far more familiar with it than I and I really would like to have him just develop the point a little further.

Mr. CURTIN. Before we get to that, what you are telling us is the background as a result of which you felt this investigation was necessary. May I say at this point that I know nothing about this company except that I understand it was and is rather prominent in the missile field.

Mr. CARY. Yes, sir.

Mr. CURTAIN. However, it is not the background of this company—which may have made the investigation necessary—which comes under criticism in these articles, but it is your procedure in handling the investigation which is criticized. It is stated in the articles, among other things, that you told the company that if the officers would sign a statement saying that they confessed to all the charges that they could then go ahead with your blessing.

Mr. CARY. Mr. Curtin, we were willing to go right ahead and have a public stop-order proceeding in this case.

Mr. CURTIN. Could you answer that question? Is that about what happened?

Mr. CARY. We offered them that.

Mr. CURTIN. Is that the usual way stop orders are handled?

Mr. CARY. We normally would proceed in that manner.

Mr. CURTIN. Normally you say, "you have been bad boys, admit you have been bad, and then go ahead with our blessing"?

Mr. CARY. No, sir. What we would normally do is have an investigation, which would be private in nature, on the basis of which we would determine that there was a basis for a stop-order proceeding. Then a stop-order proceeding would be instituted and it would be public in nature. In this case the complaint, the statement, had been prepared, the order for the stop-order proceeding had been prepared, and they were aware of the fact of our knowledge of all the facts and it was shown to them, and we were ready to go ahead with a stop-order proceeding.

There was another fact in this picture. I think maybe if I might, in view of the complexity of this case I would like to ask Mr. Woodside to continue at this point.

Mr. CURTIN. That will be satisfactory, but before we get to that I would like to quote a few paragraphs in these articles.

As I have said, I know nothing about this matter except these articles and I am after clarification.

Mr. CARY. Yes, sir.

Mr. CURTIN. Quoting from Barron's—

The Commission, indicated the chairman, also wanted the trading ban lifted without delay, but it was going to dictate the terms. He told the delegation that a statement of matters (to be considered in a hearing under section 8(d) of the 1933 Securities Act) had been prepared by the SEC staff, including all the detail that the Commission felt was necessary. He said that the company would have to sign a stipulation comprising "every fact that is contained in this statement of matters." It also would have to (1) consent to the institution of a so-called stop-order proceeding, (2) agree that the record so far taken

in the investigation could be made public at the option of the SEC, and, (3) "since the investigation is really not finished," agree that it be continued and later, if the Commissioner decided, also made public.

Finally, Mr. Cary told the group that Atlantic Research must sign the stipulation by the end of the day or:

We will put out our statement of matters ourselves.

Then if the company would do that—

the Commissioner made a general pledge that cooperation and not obstruction henceforth would rule relations between the SEC and the beleaguered company, and agreed to lift the suspension order if the company accepted the terms.

Is that what happened?

Mr. CARY. I was going to discuss that suspension order, but I think Mr. Woodside is more keenly familiar with it.

Mr. CURTIN. Is that what happened?

Mr. CARY. In general it is true. It is given a certain coloration. That is the reason I would like to have him speak to it.

Mr. CURTIN. All right. I will be glad to hear from Mr. Woodside.

Mr. WOODSIDE. Mr. Curtin, Atlantic Research had filed a registration statement under the Securities Act in the spring or midpart of 1962. That registration statement was under examination. It related to a proposed offering by several major stockholders. It did not represent company financing. In the course of the review of that registration statement we discovered that the financial information and the story presented in that statement was not correct.

In other words, it was materially wrong and misleading. We considered it sufficiently serious that we felt that there should be a suspension of trading in the stock on the exchange until certain basic facts were made available to the public so that the American public would have some understanding of the situation in the company as a basis for trading.

It also was apparent that major revisions in the registration statement would have to be made. When we brought this whole matter to the attention of the company they were of course upset, No. 1, at the notion that trading in this stock should continue suspended for any length of time, and, No. 2, they were anxious to avoid any public proceeding.

Under the Securities Act if you are going to have a stop-order proceeding the only way you can do it under the act is to have a public proceeding. There is no such thing as a private stop order.

Mr. CURTIN. Didn't you, in substance, issue a private stop order by your call from Washington to suspend trading in that stock?

Mr. WOODSIDE. We don't think so.

Mr. CURTIN. What do you call that?

Mr. WOODSIDE. What happened was that the statement of matters for our public proceeding was prepared in such a way as to indicate the general nature of the deficiencies in the registration statement and in the annual reports that had been filed under the 1934 act. The company conceded that these charges were correct and joined in a public release of the information.

Upon that occurring the Commission lifted the suspension order. In other words, trading was resumed.

Mr. CURTIN. Before we get beyond that, you say you are not permitted to put out private stop orders and I am quite curious as to

just what type of stop order you call the one that originated by your call from Washington when you said trading must be suspended in this stock. Wasn't that a private stop order?

Mr. WOODSIDE. These are two different things.

Mr. CURTIN. What is the distinction?

Mr. WOODSIDE. This stock was listed on the American Stock Exchange and the Commission has authority to suspend trading in a security for a 10-day period if the Commission considers that it is in the public interest to do so.

Mr. CURTIN. Isn't that in the nature of a private stop order?

Mr. WOODSIDE. No, sir; that is a power that we have under the 1934 act. It is an emergency sort of thing. There is no need under the statute to have any hearing. We can act out of hand. A stop-order proceeding under the Securities Act is a very different thing and it challenges the correctness of the contents of a registration statement under the 1933 act, a document on file with us, and the two are completely unconnected really.

It so happened here that Atlantic Research was a listed company. It had filed reports with the Commission and the exchange which were not accurate and honest reports. We felt that they had to be at least preliminarily clarified before trading in its stock should be resumed, and that was done through the means of the statement of matters and the consent signed by the company which was distributed to its stockholders at the time.

We went forward with our proceeding under the Securities Act and we did exactly what the company wanted us to do. They did not want the publicity. They conceded the incorrectness of the registration statement. They indicated complete willingness to amend. They also conceded that they did not, themselves, know what the complete facts were and they understood that we would proceed to make certain that we had the complete facts. They were quite anxious that there not be publicity, and we proceeded on a private basis with their knowledge and consent.

Now, it is true that the three articles published by Barron's were critical of our procedure.

Mr. CURTIN. Highly critical. I would refer to another section of Barron's articles which says——

Mr. WOODSIDE. All I would say is that is exactly the procedure they asked.

Mr. CURTIN. The article says:

> The SEC is supposed to protect investors. In the case of Atlantic Research Corp., however, it succeeded only in damaging the company, management, and shareholders alike. Thereby, in the name of the public interest, it also has struck a blow against the national security.

So I would say the articles are highly critical.

Mr. WOODSIDE. I will say one thing, Mr. Curtin, which needs to be said, I think. The purpose of the Securities Act is to require a company to publish a registration statement, prospectus, that tells an honest story and its basic purpose is to prevent fraud in the sale of securities. The registration statement, as we have found in our stop-order proceeding, was a fraudulent document and we think that in stopping the sale of that stock on the basis of that document that we prevented the perpetration of a major fraud on the American public.

We have not been critical of what the company did or how the company has been managed. We have been critical only of the failure of the company to tell the story properly and honestly in the documents required to be filed with us for the benefit of the public.

If Barron's is in favor of fraudulent sale of securities by Atlantic Research that is all right with me. Our job is to stop that and we think we did.

Mr. CARY. Mr. Chairman, may I just add one point to that.

Mr. CURTIN. Yes, sir.

Mr. CARY. That article, which you say is highly critical——

Mr. CURTIN. Three articles.

Mr. CARY. Three articles which are highly critical, it seems to me, blend two things that are really unrelated. One is the management from a technical standpoint, and the management from a financial standpoint, and it may well be that a man who has considerable scientific ability, for example, suddenly regards himself as a financier, and then he begins to move off in areas and to conduct practices which may well affect the value of the stock.

That doesn't mean that it is still not technically an excellent company, so we were relating ourselves to the registration statement with respect to the stock itself, with respect to values of that stock, and the facts concerning that stock.

Mr. CURTIN. Then I presume you feel these articles were unfair to your Commission?

Mr. CARY. Indeed we do.

Mr. CURTIN. Now, Mr. Cary, getting back to the bill. One of the features of it provides for registration with NASD. I notice in the bill that there is provision for exemption of persons from registering with NASD, at your discretion. I think in the Senate report it says that, "such membership would, accordingly, be required subject to a power in the Commission to grant such exemptions as it deems necessary and appropriate."

Why do you think you should have that exemption right?

Mr. CARY. Mr. Curtin, that is a question I think I would like to ask Mr. Whitney to speak to. That is a field in which he is most familiar.

Mr. WHITNEY. Mr. Curtin, I think you will find possibly in our prior testimony here, and certainly I think it is in the Senate side report already, in discussing the number of firms which are not now members of the NASD we stated that we had found that some of those firms are technically broker-dealers. They fit the definition, but actually their business conduct and their business practice is, say, primarily in the insurance business, or primarily in the real estate business, and it is only because of the way the definition of broker-dealer is worded that they would be caught, so that we wouldn't have to require them to register or to belong to the NASD for a purely formal piece of paper. We wouldn't be accomplishing anything, so we wanted to preserve what made good sense to us, the right to exempt those people from complying with the requirement that didn't fit the real facts, even thought it fit the technical language.

Mr. CURTIN. But the act doesn't say that there are conditions under which you can exempt persons from membership in NASD.

Mr. WHITNEY. No, sir; it is worded in broader terms; you are correct.

Mr. CURTIN. Under the terms of this proposed act you are not restricted in any way from exempting people from membership; are you?

Mr. WHITNEY. No. You are quite right. The policy that underlies the language is as I have stated it. The exact statutory language is broader.

Mr. CURTIN. So that under this proposed act the Commission can exempt anybody that in it, in its absolute discretion, thinks should be exempted?

Mr. WHITNEY. We have a standard.

Mr. CURTIN. Isn't that correct?

Mr. LOOMIS. There is a general standard for exempting anyone. The Commission must deem it necessary or appropriate in the public interest or for the protection for investors, which is the traditional standard.

Mr. CURTIN. That is just a general standard? That is not in the law?

Mr. LOOMIS. That is in the law.

Mr. CURTIN. In this proposed act?

Mr. LOOMIS. That is the language that is in this law, in this provision.

Mr. CURTIN. Whereabouts?

Mr. LOOMIS. It is in the provision that grants the exemption which is found on page 14 of the bill at lines 9 and 10.

Mr. CURTIN. That wording is:

> The Commission may by such rules and regulations or orders as it deems necessary or appropriate in the public interest or for the protection of investors, either unconditionally or upon specified terms and conditions or for specified periods, exempt from clauses (A) or (B) * * *

That doesn't say what companies, or dealers, you can exempt and which you cannot. It is just "in the public interest."

Mr. LOOMIS. That is right.

Mr. CURTIN. Where do you then find the authority for your statement?

Mr. LOOMIS. I believe, as Commissioner Whitney said, it is in the legislative history that this was intended to take care of people who don't really fit as a matter of business substance into the definition. Then there are other considerations. For example, the Commission might give some people an extension of time in which to qualify for membership in the NASD and so hence there is a provision for temporary exemptions and matters of that kind.

Mr. CURTIN. Don't you think it would be better if you wrote into this law a classification of under what conditions, and what classifications of business, persons, would be exempt from compulsory membership in NASD, rather than letting the Commission decide it solely on the ground of public interest, which is a pretty elastic term?

Mr. LOOMIS. It would be rather difficult to cover all the possibilities because they are legion.

Mr. WHITNEY. I would only add I believe, if Mr. Loomis didn't state it, that this general standard, the language which you just read of the public interest and the need for the protection of investors, is

the standard which you find throughout the acts whenever this Commission has been given the power to exempt somebody. It has been couched in those broad terms rather than with the greater specificity that you are now suggesting. It may be that we could classify more carefully as a matter of statute, but in writing this provision, as we have some of the others, we have used the same standard that has been on the boks since 1933 and 1934.

Mr. CURTIN. The regulations and bylaws of NASD provide, I presume, for its own officers and its own regulatory and disciplinary board, and, if the appropriate board feels it is justified that it can expel any number from the association; can it not?

Mr. CARY. Subject to Commission review; yes, sir.

Mr. CURTIN. Right. If that happens, if a member of the association is removed from membership, that puts that particular member out of business; doesn't it?

Mr. CARY. No, sir. If he chooses to appeal to us it will be reviewed by us before he is put out of business.

Mr. CURTIN. Don't you see any fundamental danger in letting competitors sit in judgment on a member?

Mr. CARY. Well, sir, if we didn't have this supervision and oversight and review, indeed, by the Commission there would certainly be a problem, but I think with that protection it seems to us to be adequate, Mr. Curtin.

Mr. WHITNEY. Mr. Curtin, this is also not a new provision.

Mr. CURTIN. I am sorry, I didn't hear you.

Mr. WHITNEY. This is not a new provision.

Mr. CURTIN. What is not a new provision?

Mr. WHITNEY. Membership in a voluntary association. The compulsory membership is new, but if you will bear in mind that better than 90 percent of the broker-dealers in this country are now members of that association——

Mr. CURTIN. Voluntarily.

Mr. WHITNEY. Voluntarily—then if they are disciplined by that association, to us your phrase, by their competitors, and they are expelled, they have the right to appeal to us, so that the protection afforded is through the Commission review.

Mr. CURTIN. Using that argument then, is there any reason why that proposal should not apply in other fields; the Government say to all railroads, that they must belong to the National Association of Railroads, or say to the trucking companies that they must belong to the National Association of Railroads because it deals with transportation; or say to all the people in communications—television or radio—that they belong to a national association; or say to all lawyers that they must belong to the American Bar Association? What is the distinction?

Mr. WHITNEY. Actually the bar association analogy is rather close, because in some States I think you will recall a lawyer is required and the bar association is used by the judges of the judicial system as a discipling device.

Mr. CURTIN. I am an attorney and in my State of Pennsylvania there is no such requirement. In some States there are, but not in all.

Mr. WHITNEY. It is not a compulsory body in all States.

Mr. CARY. Mr. Curtin, further in answer to your point, using the railroads and all the other industries that you are referring to, I would say that we do have a rather unique system here of a self-regulatory device with a substantial amount of authority in regulating standards in the National Association of Securities Dealers.

Now, on that premise, and unless you want all of that authority exercised by the Federal Government at our level directly and initially, it seems to us that this is a good vehicle in order to have, shall we say, the preliminary standards setting and the preliminary action taken by the self-regulatory institution and then have it all reviewable by us, including the standards they set as well as what they do.

It is a system, I agree with you, that is a little different from other industries, but it is a system that seems to me that sort of goes right along with the philosophy of Congress in enacting the Securities Exchange Act of 1934. Mr. Loomis would like to add another point.

Mr. LOOMIS. There is one thing I wanted to say. You suggested earlier that the board of governors of the association could decide more or less in their discretion who they were going to let in and who they were going to kick out.

Mr. CURTIN. I didn't say who they were going to let in. I said who they were going to suspend from membership.

Mr. LOOMIS. And they have to let them in?

Mr. CURTIN. That is correct, they have to let them in.

Mr. LOOMIS. Yes, sir; so if they expell somebody, the Commission, in order to sustain that action of expulsion, must find that this member did violate their rules or the laws because those are the grounds upon which they can expell somebody. They can't expell them because they don't like them. They have to find that he violated a requirement and the Commission has to find that that finding is supported by the evidence.

I would also like to suggest that this isn't a trade association like the Association of American Railroads. This association is created by Congress to engage in self-regulation. That is all it is there for.

Mr. CURTIN. Of course, just as an aside, it seems to me that if some company has been expelled and appeals to the Commission and the Commission reinstates them, they are going to be awfully unpopular members of that particular association, which henceforth is going to watch such member, or members, very closely.

Mr. LOOMIS. If within an appropriate time they have filed an application for review, they are not literally expelled until after we have passed upon it.

Mr. CURTIN. I guess I didn't make my statement clear. I said assuming you have such a situation and after such consideration you say to the association, "You cannot expel this member," and he goes back or stays in, he is not going to be the most popular member of the association, and I would think that there would be a possibility that the governing body of the association would be looking for a chance to take retaliatory action in the future.

Mr. LOOMIS. The Commission has done this several times and apparently they get along. This is not a social organization.

Mr. CURTIN. I understand that.

Mr. HARRIS. Mr. Chairman, may I interrupt the gentleman?

Mr. CURTIN. Of course.

Mr. HARRIS. This is off the record.

(Discussion off the record.)

Mr. STAGGERS. Mr. Cary, the rest of the committee and I have listened with keen interest to your statement of just what you are doing now in connection with the protection of customers accounts with members of the exchanges and with members of the securities dealers association and what you are doing in connection with the activities of the specialists on the exchanges.

You have answered the requests to comment on these two subjects in sufficient detail that I believe I have no particular questions I wish to address to you in this field at this time.

This subcommittee certaintly is pleased that your Commission is taking active steps now to protect investors in these important areas. For many years this committee has been concerned about these areas and about the need to do something to provide the protection which the investors, I believe, were justified in feeling that they were receiving under the exchange act.

Eleven years ago next week, on February 25, 1953, Commissioner Richard B. McEntire appeared before the Committee on Interstate and Foreign Commerce to discuss the topic of the adequacy of the protection to customers of broker-dealers; audits; capital requirements; treatment of cash and securities balances; and a duplication or absence of policing by the Commission. At that time Commissioner McEntire stated, and I think his words were sufficiently significant that they should here be quoted:

> We believe that nothing that the committee might do could be of more importance in connection with our work, than to study carefully the situation which we are facing, and either to work out a solution or at least to direct the attention of the investing public to the fact that adequate protection is not really being offered to them in the form of the Commission's watchfulness over broker-dealers' conduct and financial affairs.

I think that the work of this subcommittee the last few years clearly has pointed up the fact to the investment public that adequate protection has not really been offered them in the form of the Commission's watchfulness over broker-dealers' conduct in financial affairs. I am gratified, and I am sure the rest of the committee is, that from what you have told us this morning the Commission now is very definitely trying to do something in this field.

I think that your statement this morning was very definite along those lines. We are hopeful they will be carried out and you certainly have started a constructive program, and again I want to repeat that if this subcommittee in its wisdom thinks that the Commission should have additional laws, we intend to make them.

Thank you very kindly. I will ask permission of the House that we may sit this afternoon. As I say, that depends upon the activity of the House as to whether we can actually meet.

Mr. CARY. Mr. Chairman, may I say one thing: That we are intensely grateful to the committee for really in a sense asking some of these questions and pushing because it seems to me that you have encouraged us in positions we are taking pursuant to the Special Study, on the one hand, and you are stimulating us in areas where I don't think we probably would have gone ahead as fast if you had not asked these questions. I think, therefore, it has been exceedingly

beneficial to us and perhaps a slight goad that we might need on some occasions that I think we will recognize and profit by. Thank you.

Mr. STAGGERS. That is a very generous statement and I might say that we are both working toward the same end, so we are accomplishing something as well.

We will recess until 3 o'clock.

(Whereupon, at 11:50 a.m., the subcommittee recessed to reconvene at 3 p.m., the same day.)

AFTERNOON SESSION

Mr. STAGGERS. The committee will come to order.

We are glad to have you back again, Chairman Cary. We hope that we will be able to finish by this evening and we will not have to come back later. We are hoping to get through. We will take up where we left off, with questioning by Mr. Curtin.

Mr. CURTIN. Thank you, Mr. Chairman.

Mr. Cary, going to another feature of the bill. In this proposed legislation, do you people draw any distinction between life insurance companies and fire and casualty insurance companies?

Mr. CARY. No, sir; we do not. We did address ourselves primarily to the life insurance companies, as you know, because they were the ones who, I think, raised the most question with us and they are the ones who came to my office and discussed it primarily, although we have had visits also from fire and casualty. The general position we take is applicable both to fire and casualty and to life. There are a few distinctions in accounting but, by and large, our general position is the same.

Mr. CURTIN. Now, as I understand it, in all of the 50 States today there is a uniform form of statement that the various companies—fire, casualty, and life—all file with the insurance commissioners of their respective States; am I correct in that?

Mr. CARY. That is correct. I believe there may be some distinction in the material filed by fire and casualty on the one hand and life on the other. May I check that with two people? Andrew Barr, chief accountant, I think would know best on that point.

Mr. CURTIN. Is there any distinction between fire and casualty and life?

Mr. BARR. There are differences in accounting because of the difference of the nature of the business performed. Otherwise, the general character and the plans are the same.

Mr. CURTIN. Are these statements that are filed with the State commissioners generally acceptable? Are they generally all inclusive?

Mr. CARY. When you say acceptable, Mr. Curtin, are you thinking are they acceptable to us?

Mr. CURTIN. Yes; acceptable in that they give full disclosure of the pertinent facts relating to the management and the capitalization of the company involved.

Mr. CARY. Mr. Curtin, I would say not wholly acceptable. The material that is there is perfectly correct; I mean we have no question there. For instance, the periodic information that we required, the annual report that the proxy rules require, and even some additional

supplemental information on the surplus and so forth, which would be useful to investors as distinguished from policyholders is not there.

Mr. CURTIN. You say in your statement, Mr. Cary, on page 29, that—

> The Commission has no intention of disturbing traditional insurance accounting as evolved by the State securities administrators—

and then, as I understand your statement, you go on to say that—

> the additional information that you want is relatively simple to prepare and involves inconsequential expense. The information is largely contained in the insurance companies' annual statement.

If it is contained in the annual statement, why do you propose a different form of statement?

Mr. CARY. In general, sir, we would be willing to accept the bulk of the material which is contained in that which is filed with the insurance commissioners. We would only ask that certain minimal supplemental information be available.

Now, may I say I am talking exclusively on the financial information; I am not talking about nonfinancial information. We will stick to the financial. We request, for example, a historical analysis of surplus which might not have been of any interest to a policyholder; he does not care about the surplus they have.

Mr. CURTIN. Now, during these hearings I have heard frequent reference to the fact that one of your main complaints is that you do not have these State reports filed with you.

Mr. CARY. That is correct. Well, they are not filed with us, that is correct, and they are not publicly available, really.

Mr. CURTIN. Right.

Now, if that is your main cause for concern in this field, would it not be satisfactory and meet all of your requirements if the law merely stated that the insurance companies would be required to file with you copies of the statements they file with the State insurance commissioners?

Mr. CARY. Mr. Curtin, if we could have that plus a statement that they would file certain limited additional information that I just referred to, then I think we would be satisfied with that as financial information. I am limiting myself to the financial information.

Mr. CURTIN. When you say "limited additional information," I am curious to know what you mean by that.

Mr. CARY. I would not think in terms of more than two or three pages, frankly.

Mr. CURTIN. Would you be willing to file with this committee a statement of what you would be satisfied to have in addition to the statements filed with the insurance commissioners to make you agreeable to merely filing with you of the statement by the insurance companies, which they now file with their respective State, plus a short supplemental with this limited additional information to meet all the requirements that you desire?

Mr. CARY. We have largely already filed that but we would be very glad to make it explicitly clear what we have in mind and do so; yes, sir.

Mr. CURTIN. Over and above what they presently file in their annual report to their State insurance department.

Mr. CARY. That is right. We have described it in our statement here as primarily—and Mr. Barr, I think, can speak to that technically because he has dealt with the insurance industry on the securities exchange side and the Securities Act side for many years. It largely would be a translation of terms which would be understood by the investor, this historical analysis of earned surplus that I have referred to and the tax status of those companies. Those are the three things, I think, that Mr. Barr brought to your attention.

Is that correct?

He confirms that.

(The information requested follows:)

MEMORANDUM PREPARED BY THE OFFICE OF THE CHIEF ACCOUNTANT, SECURITIES AND EXCHANGE COMMISSION, IN RESPONSE TO REQUEST CONCERNING INSURANCE COMPANIES OF THE SUBCOMMITTEE ON COMMERCE AND FINANCE OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, HOUSE OF REPRESENTATIVES, ON H.R. 6789 AND H.R. 6793

At pages 1233 and 1234 of the stenographic report of proceedings of the Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce on February 19, 1964, Hon. Willard A. Curtin made the following request of Chairman Cary: "Would you be willing to file with this committee a statement of what you would be satisfied to have in addition to the statements filed with the insurance commissioners to make you agreeable to merely filing with you of the statement by the insurance companies, which they now file with their respective State, plus a short supplemental with this limited additional information, to meet all the requirements that you desire?" and "Over and above what they presently file in their annual report to their State insurance department?"

Our requirements for financial statements to be included in annual reports under the Securities Exchange Act of 1934 can be met by insurance companies in a mannner agreeable to us by their filing a copy of the annual statement filed with State regulatory authorities supplemented by explanatory notes covering matters not required to be reported to the State authorities.

The explanatory notes filed by both life and fire and casualty insurance companies should relate to the following matters, if present:

1. A summary of the accounting principles and practices characteristic of the insurance industry followed in preparing the financial statements.
2. Investments in affiliated companies which can be given by indicating such items on the investment schedules with an appropriate symbol and by stating on the schedule or in a note the amount of equity in net profit and loss for the period.
3. Company policy with regard to accounting for fixed assets, personal property expenditures and leasehold improvements. Rates of depreciation should also be stated.
4. The segregation of unassigned surplus between earned surplus, paid-in capital and accumulated gains or losses on investments. In the alterative the company may present a historical analysis of surplus since organization.
5. Statutory, tax, and other limitations on the availability of surplus for payment of dividends to stockholders.
6. Liability for employee benefit and pension plans.
7. Stock options.
8. Transactions with affiliates.
9. Basis of conversion of items in foreign currencies.
10. Where material, information as to commitments for the acquisition of fixed assets by purchase or construction, rentals under long-term leases, and the acquisition of permanent investments other than in the normal course of business. The note should also indicate the extent of contingent liabilities not reflected in the balance sheet including the policy with regard to reinsurance and the amount thereof.

In addition to the foregoing matters fire and casualty insurance companies should include with the financial statments reconciliations of material differences between (*a*) capital share equity as reported on the balance sheet and as determined in accordance with generally accepted accounting principles and

practices and (*b*) net income or loss as reported on the profit and loss or income statement and as determined in accordance with generally accepted accounting principles and practices. This requirement is generally met by tabulations in which there are added to or deducted from capital share equity and net income or loss as reported on the financial statements the amounts representing the differences between the annual statement accounting requirements and generally accepted accounting principles and practices.

The explanatory notes can be prepared by the insurance company as financial statements in annual reports of insurance companies filed pursuant to the Securities Exchange Act of 1934 are not required to be certified by independent public accountants. Semiannual reports are not required to be filed by insurance companies.

THE 44 INSURANCE COMPANIES WHOSE FINANCIAL AND PROXY MATERIAL WERE EXAMINED BY THE SPECIAL STUDY

American Fidelity & Casualty Co.
American Foundation Pioneer Western Life Insurance Co.
Atlantic National Life Insurance Co. (Alabama).
California Western States Life Insurance Co.
Carolina Casualty Insurance Co. (North Carolina).
Central States Life Insurance Co. (Texas).
Citizens Life Insurance Co. of New York.
Combined Insurance Co. of America.
Continental American Life Insurance Co.
Continental Fidelity Life Insurance Co. (Texas).
Employers Reinsurance Corp.
Gibraltar Life Insurance Co. of America.
Glens Falls (N.Y.) Insurance Co.
Great Commonwealth Life Insurance Co. (Texas).
Great Southern Life Insurance Co.
Guaranty Savings Life Insurance Co.
Hawkeye-Security Insurance Co.
Home Life Insurance Co. of America (Philadelphia).
Ideal National Insurance Co.
Industrial Life Insurance Co.
Interstate Life & Accident Insurance Co. (Tennessee).
Lamar Life Insurance Co.
Liberty Universal Insurance Co.
Life Insurance Co. of Florida.
Lone Star Life Insurance Co.
Manhattan Life Insurance Co. (New York).
Municipal Insurance Co. of America.
New American Life Insurance Co.
New Hampshire Insurance Co.
Northeastern Life Insurance Co.
Northwestern National Insurance Co. (Wisconsin).
Occidental Life Insurance Co. of North Carolina.
Old Line Life Insurance Co. of America.
Pacific Southwest Life Insurance Co.
Palmetto State Life Insurance Co.
Pyramid Life Insurance Co.
St. Paul Fire & Marine Insurance Co.
Sequoia Insurance Co.
Trans-Continental Life Insurance Co.
United American Life Insurance Co.
United Benefit Life Insurance Co.
United Security Life Co.
Wayne National Life Insurance Co.
Wilshire Insurance Co.

Mr. CURTIN. Now, Mr. Cary, in your prepared statement—and I refer you now to pages 33 and 34—you say that one of the things that you are particularly concerned about is the absence of taking care of the shareholders, particularly in mergers, and that you feel that some-

times these mergers may not be completely equitable so far as their interest in the company is concerned.

You cite as an example of this the Texas Insurance Code where you say that all the commissioner is primarily interested in the policyholder rather than the stockholder in mergers.

Now, as I understand it, you cite this State as an example of what is the general attitude of the insurance commissioners of the various States relative to mergers; is that correct?

Mr. CARY. Yes, sir.

I would say this: That the reason we had a considerable amount of material on mergers in this statement, Mr. Curtin, was not because we want to overemphasize this versus a lot of other features, but because I think this was emphasized by the insurance industry when they appeared before you. Therefore, really this is in a sense a rebuttal of some of the material they presented.

Mr. CURTIN. Mr. Cary, when you use Texas as an example to how the various State insurance commissioners look at these mergers relative to shareholders, aren't you taking an exception rather than the rule with the State insurance commissioners?

Mr. CARY. Our counsel advised us that this is the general pattern of insurance rules. I will just check this out with Mr. Loomis. I would like to have him speak to it.

Mr. LOOMIS. Sir, we picked Texas because the Texas statute was cited in the prior testimony as the most comprehensive code.

I looked at various of the other States and most of them didn't specify the criteria under which the insurance commissioner should act but merely said he had to approve the merger; this is all.

Mr. CURTAIN. Well, my information is—and that is the reason I am asking for clarification—that most of the State insurance commissioners' requirements do take care of the shareholders primarily. For example, I quote from the West Virginia statute, which says:

> No such merger or consolidation shall be effectuated unless in advance thereof the plan, agreement, and other supporting documents, have been filed with and approved in writing by the commissioner. The commissioner shall give such approval within a reasonable time after such filing unless he finds such plan or agreement (1) is contrary to law, or (2) is inequitable to the stockholders of any domestic insurer involved.

Now, there it would look as if in West Virginia that the primary interest of the insurance commission on a proposed merger is the stockholders; would you not say so?

Mr. CARY. That one bears in that direction. There is no doubt that, if they were all like West Virginia, that would have some effect on our statement. As I understand it, West Virginia is not typical.

Mr. CURTIN. Well, as I understand it, the following States have exactly similar wording in their corresponding statutes: Arizona, Arkansas, Connecticut, Florida, Idaho, Montana, Oklahoma, and Oregon.

A number of other States vary in some small degree from West Virginia, but they do have stockholders' protection in addition to the requirements that mergers must be approved by certain stockholders, percentagewise.

Now, if that is true with a majority of the States, it would seem to me that the stockholders are protected in these proposed mergers by the State laws.

Mr. CARY. There is some protection in those States to which you refer, except let me point one further fact out—it is a question of attitude. Our whole thrust on mergers, may I say, is just a small segment of our general policy position with respect to the need for information and with respect to the annual reports which should get out to shareholders which have not in the past or, if they have, they have been inadequate.

Quite apart from that and noting therefore that the merger situation is a small segment of the whole approach we are taking, I would point out further that what we are aiming for is that the kind of information that all shareholders receive in all types of companies, industrial and otherwise, should be available to the shareholders of the insurance companies so that they can vote in an informed manner upon the mergers.

As it is, what you are now referring to is that the State insurance commissioner is the man who passes on it in a paternalistic sense, a Government agency passing on it, whereas what we are aiming for is that information be available to the shareholders and that they can intelligently pass upon it and vote for it or against it. That is our basic principle.

Mr. CURTIN. When you speak of a paternalistic sense, that is exactly the role of the SEC as well as the local State, isn't it?

Mr. CARY. No, sir. Our whole philosophy is absolutely contrary to that with the limited exception of certain segments of Investment Company Act of 1940.

Our basic philosophy is to have the information available to the shareholders so that they can make up their mind. It is basically a disclosure philosophy and nothing more.

Mr. CURTIN. What you are interested in, primarily, is protection of the shareholders of the company involved?

Mr. CARY. That is correct.

Mr. CURTIN. Then, isn't it true that the information that would be necessary for the shareholder of an industrial company, for example, to have for full information and to be protected would be completely different than the information necessary for him to have from a life insurance company?

Mr. CARY. Yes, sir, and we think that the information is comparable but certainly not the same, as you say, with respect to life insurance companies and other insurance companies.

Mr. CURTIN. Don't you propose to standardize this information with this proposed law?

Mr. CARY. No. For instance, Mr. Barr has been working on S–X with the insurance industry for 2 years, our Regulation S–X. One part, article 7(A), deals specifically with life insurance companies. It provides the financial information that the insurance industry, itself, and we agree that would be the kind of information that shareholders would want.

Mr. CURTIN. Now, isn't there a provision in the present Securities and Exchange Act which gives you jurisdiction when the State insurance commissioner does not pass on this particular feature of it?

I refer to section 77(C)10 which relates to SEC authority in cases of exchange of stock for stock and that is the format for the usual merger as I understand, exchange stock for stock.

Does that section not state that unless the appropriate State insurance commissioner says such exchange is fair to the stockholders as well as the policyholders, then the SEC has jurisdiction?

Mr. CARY. Mr. Curtin, I am not sure but I understand from my colleagues that you are now relating yourself to the 1933 act.

Mr. CURTIN. That is right.

Mr. CARY. Which is exclusively with respect only to new issues or issues to the public. We are relating ourselves to the stock and issues that are outstanding. In other words, the bill to which we are addressing ourselves now would be only an amendment to this 1934 act.

Mr. CURTIN. My understanding of that section of the act is that it relates to exchange of stock for stock, not just new issues. It is one of the exemptions set forth in the Securities and Exchange Act.

Mr. CARY. Mr. Curtin, I might ask Mr. Cohen to speak to this.

Mr. COHEN. Mr. Curtin, unless I am mistaken, I think the section you have in mind is a section of the 1933 act.

Mr. CURTIN. That is right.

Mr. COHEN. Which is concerned with new issues of securities. The particular section provides an exemption for the issuance by an insurance company of a new issue of stock in exchange for an outstanding issue—when the particular securities commissioner having proper authority has passed upon the issue. If he has done so in those circumstances, there is an exemption from registration under the 1933 act. In other words, the furnishing of a prospectus for the new issue of stock to be offered in exchange is not subject to that act.

Mr. CURTIN. Well, a new issue of stock offered in exchange for stock of another company, is one way mergers are effected.

Mr. COHEN. It may be a merger, although I think section 3(a)10 encompasses all types of exchange offerings.

Mr. CURTIN. Therefore, under that act, does not the SEC presently have jurisdiction, under that exemption, in case the State insurance commissioner has not certified that such exchange is fair to the stockholder?

Mr. COHEN. We have no jurisdiction over the vote of shareholders with respect to a merger.

Mr. CARY. We do want it to in part supplement the information filed with the insurance authorities, as I have indicated. We do not believe, without any independent certified public accountant being necessary, that the expense of the initial registration will be great.

Mr. CURTIN. Now, also referring back to your statement, Mr. Commissioner, you stated that the provisions of the regulations controlling the various insurance commissioners, unlike those of the Exchange Act, do not prohibit short selling by insiders, which "historically has been an area of abuse."

Now, do I take it from that, that you mean that inside trading of insurance stock is an area of abuse? That is on page 42 of your statement.

Mr. CARY. What we are saying there, Mr. Curtin, is that there have been problems with respect to short selling by insiders of securities generally. We are pointing out that this provision, which exists in

section 16(c) of the Securities and Exchange Act of 1934, is not being applied to insurance companies at the present time and that the gap is not filled by any provision suggested by the insurance commissioners. That is as far as we are going on that particular point.

Mr. LONG. Would the gentlemen yield?

Mr. CURTIN. I yield.

Mr. LONG. Mr. Cary, have the commissioners in their discussions with you suggested any approach toward solving that problem?

Mr. CARY. This specific problem, Mr. Long?

I do not know that they have. In fact, I don't want to carry my argument too far. They have not raised it and we have not raised this particular point with them.

Mr. LONG. That seemed to me to be one of the major shortcomings of the proposals of the insurance commissioners; along with two others that were of comparable importance.

Mr. CARY. We would like to argue that there are more shortcomings than that in our statement, Mr. Long.

Yesterday, I did try to bring out, particularly at the pages starting around 39, the very bottom, all of pages 40 and 41 and then 42, pointing out specifically the difference between this stockholders' information supplement, which, by the way, is really a voluntary operation. The wide differences between that and the sort of pattern of disclosure that we would enforce and expect to have under sections 12, 13, 14, 16, and so forth of our act. In other words, there is quite a wide discrepancy.

Not only is it voluntary in nature, but the facts of the matter are that the same kind of proxy material would not be sent out; it would not be reviewed by the State insurance commissioner. They would say, "Did you send out proxy material?"

But it would not be the same kind; it would not be reviewed, for example, by any insurance commissioner counterpart as it would by the Securities and Exchange Commission. All of those things are lacking in this which exists under our jurisdiction.

Mr. LONG. But this specific point is a good example of the difference in approach of (1) on the one hand the insurance commissioners in the various States; and (2) what you are recommending in the proposed legislation.

Mr. CARY. I would say yes, sir.

Mr. LONG. Thank you, Mr. Curtin.

Mr. CURTIN. I am not sure I got your answer as to whether or not you feel that the inside trading of insurance stock is "an area of abuse."

Mr. CARY. I cannot say that it is an area of specific abuse vis-a-vis another industry. I cannot specifically say yes.

Mr. CURTIN. Why do you say that in your statement?

Mr. CARY. Well, we didn't say that in the statement, as I understand it, Mr. Curtin.

May I return back to what we said at page 42? We merely said that we were comparing the provision of the insurance——

Mr. CURTIN. May I read the sentence that I have reference to?

Quoting from your statement at page 42:

> Finally the provisions of the insurance commissioners, unlike those of the Exchange Act, do not prohibit short selling by insiders, which historically has been an area of abuse.

Mr. CARY. Of all types of stock. That is what historically there has been, an abuse which has been remedied. Wherever sections 16 (A), (B), and (C) became applicable, historically there has been abuse by insiders via the short-selling route. That is what I intended to say. It may appear to be an overstatement and if so I would correct it on the record this way.

Mr. CURTIN. Mr. Cary, do you have any knowledge of any short sale of an over-the-counter insurance company stock? They never do that, do they?

Mr. CARY. We have made no study of the matter; we have no knowledge one way or the other.

Mr. CURTIN. You have none?

Mr. CARY. No; I do not.

Mr. CURTIN. Now, getting back, for just a moment, to this discussion between life stock companies and fire and casualty stock companies. Which business writes more premiums, the stock fire and casualty business or the stock life business?

Mr. CARY. We assume life, but I do not know, really.

Mr. CURTIN. How does the total number of stock fire and casualty companies compare with the total number of stock life insurance companies?

Mr. CARY. I am sorry, Mr. Curtin. We don't have the figures broken down between stock fire and stock life. If you would like, we could attempt to supply that.

Just a minute, if I may.

I am sorry. Perhaps I cannot supply it for the record. I am not sure that we can run it down in that form.

Mr. CURTIN. Sir, the Report of the Special Study of the Securities Market, to which you referred in your earlier testimony, states, on page 40, that you sent out a questionnaire to 110 insurance companies, 96 of which responded.

Now, would you know how many of those were life insurance companies and how many were fire and casualty companies?

Mr. CARY. We could supply that for the record, but I don't think we have it right here.

Mr. LOOMIS. Twelve of them were fire and casualty and the rest were life.

(The following information was later submitted for the record:)

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., March 10, 1964.

Hon. WILLARD S. CURTIN,
House of Hepresentatives,
Washington, D.C.

DEAR MR. CURTIN: Enclosed is a memorandum [1] in response to a question raised by you at the hearings on H.R. 6789 before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce. The question related to what financial material the Commission would require insurance companies to file under H.R. 6789 in addition to that which these companies already file with the State insurance commissioners. The limited nature of the supplemental information required by the Commission is apparent from the memorandum. It is our firm conviction that the preparation of this supplemental material will impose minimal expense and burden on an insurance company.

You also asked at the hearing that we supply for the record a breakdown with respect to certain figures used in the special study report. First, I have been informed that, of the 96 insurance companies that responded to the special

[1] Memorandum appears on p. 1273.

study's questionnaire—which was sent to over-the-counter companies generally—61 were life insurance companies and the remaining 35 were fire, casualty, and surety companies. Second, you inquired why only 53 of the 110 insurance companies that received the over-the-counter questionnaire were asked to supply financial and proxy material. I would point out that 1,965 companies received this questionnnaire of the study. Only half of the 1,965 were asked to submit financial and proxy material. It was thought that this would provide a sufficiently large sample upon which to base a conclusion. In addition, the burdens on both the study's staff, which analyzed this material, and the issuers, who supplied it, were reduced. This random sample of every other company of the 1,965 issuers included 53 who were insurance companies, of which 44 responded. Finally, you asked for a list of the 44 insurance companies that responded to the study's questionnaire. I have enclosed such a list.

I am sending a copy of this letter to the clerk of the committee for inclusion in the record.

If you have any further questions, please call me.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

Mr. CURTIN. Thank you.

Then you say, on page 41, that of the insurance companies that received the OTD form, 53 were asked to submit financial and proxy material submitted to shareholders in 1961. Forty-four insurance companies responded to this request.

Now, what I am curious about, why were only 53 of the 110 asked to supply financial and proxy material rather than all of them?

Mr. CARY. I am sorry to say that I cannot answer that. The head of our special study, of course, has left, and I simply think we might be able to find out a reason and supply it for the record. I cannot give that information at this time.

Mr. CURTIN. Of the 44 insurance companies that did respond, how many of these were stock fire and casualty insurers and who were they, if you know?

Mr. CARY. I think we can supply that for the record. I am sorry I cannot supply it in this hearing.

Mr. CURTIN. Do that, please.

Now, I believe Mr. Loomis has just said that 12 of the 44 companies were stock fire and casualty companies and 32 were life or other kinds of insurance.

Mr. CARY. That is right. That is what Mr. Loomis confirmed.

Mr. CURTIN. Now, if there are approximately 850 stock fire and casualty companies, is the sampling of just 12, which is really less than 1½ percent, a credible basis upon which to draw general conclusions as to the practice of the entire stock fire and casualty insurance business?

Mr. CARY. I will ask Mr. Cohen to speak to this.

Mr. COHEN. Mr. Curtin, I cannot give you the details as to the particular companies selected, but I can say this. The problems with respect to reporting and proxy soliciting practices of insurance companies have been studied on several previous occasions by the Commission. It is my understanding that the Special Study engaged in a limited review to determine whether or not the earlier results, which were based on a somewhat larger scale study were still valid today. I think that their study today indicated that those earlier results were still valid.

Now, on at least two other occasions the reporting practices and the proxy soliciting practices of unlisted companies, including insur-

ance companies, have been studied in great depth and in each case it was found that their practices did not measure up in any way to the minimum requirements under the Exchange Act.

Mr. CURTIN. Does the Commission have any information on the extent to which insurance companies' stocks are purchased by institutional investors as compared with individual investors?

Mr. CARY. I don't think we have that information, Mr. Curtin. I just cannot say that we do.

Mr. CURTIN. Then, Mr. Cary, isn't it a fact that so far as your investigation of the practices and the procedures of the different fire and casualty insurance companies and life insurance companies are concerned, it was quite limited, on which to base these conclusions and ask for this legislation?

Mr. CARY. Mr. Curtin, let me read to you a letter addressed to Congressman Harris which I believe is in the record, dated December 31, 1963, from the Financial Analysts Federation of the United States:

> It is recognized that insurance companies prepare and submit comprehensive and detailed annual statements to the State insurance departments having jurisdiction and that these statements can be inspected by the public. However, the statements are designed for regulatory purposes to insure the adequate protection of policy owners and they are not in a form which can be conveniently utilized by the investor. Furthermore, because of the nature of the reports and the fact that they are only available in State insurance department offices the information contained therein, while included in abbreviated form in insurance service manuals, is not widely disseminated in investment circles. If insurance companies conform with the requirements proposed in the legislation being considered, adequate information would be more readily available and in a form more familiar to those in the securities business and to investors. Since the basic information contained in reports to be submitted to the Securities and Exchange Commission would be the same as that compiled for the annual statements for the States, it is not believed that the requirements would be unduly burdensome.
>
> Our profession has for some time been concerned with the inadequacy of annual reports to stockholders of many of the stock insurance companies. In 1959 a subcommittee of the corporate information commitee of the federation studied and analyzed the annual reports of 20 stock life insurance companies. As published in our 1960 annual report, the subcommittee stated that "It is our conclusion that the annual reports of the life insurance industry are the poorest of any major industry in the United Sates." A new report on stock life insurance companies currently is being prepared by our corporate information committee and it is expected to show that there has been relatively little improvement since the previous study.

Now, I confess to you that he addresses himself to life insurance companies. I have no reason to believe that fire and casualty have shown any marked difference. Mr. Cohen would like to say something.

Mr. COHEN. Mr. Curtin, I have found some further information in response to your question.

On page 41 of the same report to which you refer there is reference to a 1956 study which covered 169 insurance companies. I think the results are shown on that page and I won't burden the record at this time, except by way of reference.

There was an earlier study. I think the first study was made around 1949 or 1950 and I think the results were very much the same. So, the current study is really a reaffirmation of a situation that has existed over these years. Despite these continual reviews by the Commission and by the Congress of this situation over a period now of almost 20 years, the practices have not changed very much.

Mr. CURTIN. What practices are you referring to?

Mr. COHEN. The reporting practices and the proxy soliciting practices.

Mr. CURTIN. But I thought we agreed that the reporting was quite adequate with the State insurance commissioners and all you wanted was a copy of the annual statements filed with you, plus some supplemental information, and you would be happy.

Mr. COHEN. As the fellow said, I am glad you asked that question, Mr. Curtin.

There is a difference between the report that is filed with the Commission and the report that goes to shareholders. One of the things that we are trying to achieve through this program by subjecting insurance companies to this legislation is to provide a means whereby shareholders are placed in possession of information not in the halls of the Commission and not at the State capital in a particular State but at their homes in the form of an acocmpanying proxy statement which permit the shareholders to arrive at an informed evaluation of the matters they are asked to act upon, whether it is a merger, whether it is an election of directors, or any other important event in the life of their company. This is the practice which these insurance companies are very defiicent in and concerning which the chairman has spoken.

Apart from this, I wanted to add one further thing to the record. In addition to these studies, as has been pointed out, in excess of 100 insurance companies are required now to file reports with the Commission and they do so.

There is no great difficulty that we are aware of. One of the requirements that attends this reporting is that they file as an exhibit copies of the report they sent to shareholders. We look at these regularly, not by way of criticism or anything else, but they do provide us with a current picture of what is going on in the area of the reporting to shareholders.

All of this points to the same conclusion, that the reporting is very poor as the Society of Security Analysts have now indicated.

Mr. CURTIN. Then is it your thought that, with this proposed law, the insurance companies, be they fire or casualty or life, in addition to filing annual statements with you as to their operation and condition, shall also be required to furnish copies of that information to the shareholders?

Mr. COHEN. Not that information, but we would hope and we would expect that the managements of these insurance companies would prepare a document in the form of an annual report which would contain financial information drawn in a manner that they would choose, not a manner that we would choose, so that the investor would have a fair picture of the position of the company and its past financial experience.

Mr. CURTIN. Assuming that, when you get this report filed with you, you do not conclude that the mention therein of the type of reports to the stockholders is either adequate enough or sent with sufficient regularity, what would you then propose to do?

Mr. COHEN. You know that is a sort of "iffy" question, Mr. Curtin. I can only answer it this way: If the insurance companies today sent a report to shareholders which contained only a fair amount of the information they supply to the State capital, the Commission would have no quarrel.

Mr. CURTIN. Do I understand that what you want to do, as one of your services to the public, is to see that the stockholders get reports periodically and in detail?

Mr. COHEN. Part of the scheme involves an annual solicitation of proxies or the furnishing annually to shareholders of the information that would be provided in a proxy solicitation. This would include an annual report to be drawn by the management as they see fit, not as the Commission sees fit, but which would provide some information upon the basis of which they would have an understanding of the position and the past experience of the company.

Mr. CURTIN. Let me go back to my previous question.

What happens when you get this annual report and you don't think the stockholders are getting the information which you feel they are entitled to? What is your next step?

Mr. COHEN. I think our experience has shown that once there is such a requirement of law as implemented by Commission rules, a substantial variance from the information that is filed in the State capital as with the Commission is a very unusual situation. The case to which you referred this mornng is one such unusual circumstance. It is a rare situation, so the question rarely arises.

Mr. CARY. May I read Mr. Curtin the pertinent sections of the proxy rules that relate to this? It is rule 14(a) (3) (B) which would become applicable to insurance companies.

Mr. CURTIN. What rule is it?

Mr. CARY. Rule 14(a) (3) (B):

> If the solicitation is made on behalf of the management of the issuer and relates to an annual meeting of security holders at which directors are to be elected, each proxy statement furnished pursuant to paragraphs (A) and (B) accompanied or preceded by an annual report to said security holders containing such financial statements for the last fiscal year will in the opinion of the management adequately reflect the financial position and operation of the issuer.

Well, even though it is left in the opinion of the management, I would assume that any reasonable management would want to put in the earning statement and a profit and loss statement, in other words, and a balance sheet, which, by the way, is not the common practice among insurance companies at the present time.

Mr. CURTIN. One other question, Mr. Gary.

Getting back again to the compulsory membership in NASD. Now, you mentioned this morning that there would be certain exceptions granted by the Commission to classes of dealers who would not have to join because of the type of activity in which they were engaged; am I correct in that?

Mr. CARY. Yes, sir. Mr. Whitney referred to that in discussion.

Mr. CURTIN. How would you feel about the dealers in mutual funds? I understand that there are presently three different agencies that have jurisdiction over such dealers. Do you think that such dealers are now sufficiently regulated? As you said this morning, you would look at each case and decide. Do you think they would come under it?

Mr. CARY. I would think they would. Just a minute. Excuse me.

Mr. Loomis says you may be asking whether we were planning to exempt mutual fund dealers from this.

Mr. CURTIN. Yes; that is my question.

Mr. CARY. And the answer is no; we certainly would not.

By the way, they have asked the question whether they might form their own organization and, as you may recall in our statement at page 43 we did say that we have repeatedly noted that any group of dealers meeting the standards enumerated in the Exchange Act may form and register an association but they would be subject to the same kinds of standards and requirements and the same kind of review that we furnish otherwise.

Mr. CURTIN. Thank you, Mr. Cary.

I think that is all the questions I have, Mr. Chairman.

Mr. DINGELL. Mr. Long.

Mr. LONG. No further questions, Mr. Chairman.

Mr. DINGELL. Mr. Van Deerlin.

Mr. VAN DEERLIN. I yield back to my colleague from Michigan, Mr. Dingell.

Mr. DINGELL. Mr. Keith.

Mr. KEITH. I have no questions at this time, Mr. Chairman.

Mr. DINGELL. Mr. Cary, I notice in the bill on page 8 there is language in section 2(E) which says:

> Provision of this subsection shall not apply in respect of any security of a foreign issuer including any certificate of the depositor for such security unless the Commission by rules or regulations or by order notice an opportunity for hearing on its own motion or upon application of any interested person finds that a substantial public market for the equity securities of such issuer or of a class of issuers, which includes such issuer, exists in the United States and that continued exemption of securities of such issuer or class of issuer is not in the public interest or consistent with the protection of the investors.

Mr. CARY. Yes, sir.

Mr. DINGELL. Now, was that language recommended in the $1 million special study which this committee authorized and which was just completed under the direction of the Commission?

Mr. CARY. Mr. Dingell, I believe it was not.

Mr. DINGELL. All right.

Now, Mr. Cary, would you be good enough to tell this committee, then, why that language is included in this bill?

Mr. CARY. As I understand it, I would like to ask Mr. Cohen to speak more fully to that.

Mr. DINGELL. I would like you to tell us, you are the Chairman of the Commission.

Mr. CARY. I don't have a universal knowledge, so occasionally I may have to consult some of my valued colleagues. I will attempt to.

The industry, as I understand it, recommended that foreign securities be exempted from the over-the-counter registration but the Commission had the power to bring them within the coverage of the statute.

Mr. DINGELL. You say the industry recommended that?

Mr. CARY. That is correct. That is one of the things which we changed, to some extent, in our discussions with the industry in connection with this bill. Now, we did so because there is a difficulty in enforcing this vis-a-vis foreign securities, as you can understand. We therefore decided that this would be a more feasible way to handle a difficult problem of enforcement.

Mr. DINGELL. All right.

Now, let's take a look at this. The Commission must find before it goes in and scrutinizes these foreign issues that the public interest requires that it so do. Am I correct?

Mr. CARY. If I may read that 2(E) again. Just a minute, please.

finds a substantial public market for the equity securities of such issuer and continued exemptions not in the public interest or consistent with the protection of the investors.

Mr. DINGELL. That is right?

Mr. CARY. Yes, sir.

Mr. DINGELL. So the burden is on the Commission under this section, is it not?

Mr. CARY. Yes, sir.

Mr. DINGELL. This would mean that if the Government of Yugoslavia, let's say, or the Government of Poland or the Government of Soviet Russia, were to give a large investment banker or house in New York against which this New York entity or other entity in the United States would issue certificates of deposit that it would be necessary for you to make certain affirmative findings before you could act to protect the public interest; am I correct?

Mr. CARY. I am afraid Mr. Cohen knows this particular field more than I do.

Mr. DINGELL. All right, Mr. Cohen. Go ahead.

Mr. COHEN. If I understood your facts, the answer would be no, because if, as I understood you, this would have been an issuance by or on behalf of the issuer and this provision would have no relationship to it.

Mr. DINGELL. This provision then would have no relation to issue of certificates of deposit by an American investment house; am I correct?

Mr. COHEN. I wanted to finish.

In a situation such as you have described, if I heard you correctly, I believe the Securities Act of 1933 would apply. Registration under that statute would be required, and in connection with the distribution of the security a prospectus would have to be provided to all purchasers of securities. This provision to which you are now addressing yourself might come into play after the securities are out in the hands of the American public.

Mr. DINGELL. Now, supposing you tell me why we should apply a lesser standard of protection for the American investor from issues of this sort than we apply in the case of issuance of securities by corporations which exist and are regulated by authorities within the boundaries of the United States?

Mr. COHEN. On principle, there is absolutely no reason. In fact, on principle one would argue it the other way.

Mr. DINGELL. In principle, as a matter of fact, we would argue very strenuously with the American investor, would require a substantially higher quality and quantity of protection with regard to foreign issues and certificates of deposit which are issued against foreign issues than are being issued by certificates of deposit and issues of securities by wholly American-held corporations; am I correct?

Mr. COHEN. As a matter of principle, I cannot quarrel with that statement.

Mr. DINGELL. All right.

As a matter of principle and as a matter of practicality, that is all the same.

Mr. COHEN. If we are coming back to the section I would like——

Mr. DINGELL. We are not coming back to anything other than the philosophical requirements of this thing which to me are very clear and very simple.

Mr. COHEN. But if we are talking about the initial issue, I want to make it perfectly clear registration is required.

Mr. DINGELL. I am not talking about original issue.

Mr. COHEN. I want to be sure we are talking about the same thing.

Mr. DINGELL. I am talking about the philosophy of the thing. Here you have corporations which are held abroad which have no real interest in the American investor who seek merely to market their securities on terms and under conditions which are most advantageous to them and to get the American dollar under the best circumstances and who really frankly don't give a damn about the American investor. Now, isn't that correct?

Mr. COHEN. Well, I don't know that I want publicly to subscribe to that latter part of your statement.

Mr. DINGELL. Let's put it on the other hand.

You don't deny that this is so or in many instances would be so, do you, sir?

Mr. COHEN. Now, if you are talking in terms of the sale of securities by an issuer seeking funds from the American public, I want to emphasize again, although I don't want to appear argumentative, that registration is required. This provision relates to outstanding securities in the hands of the public.

Mr. DINGELL. I don't really care about that. I think we are nitpicking on that particular point.

I am talking about the broad matter of public policy. You have already conceded the broad matter of public policy that the American investor should have a higher quality and quantity of protection from foreign issues than he should have from issues of corporations which do business and which are owned by citizens of the United States.

Mr. COHEN. I agree to that; yes, sir.

Mr. DINGELL. All right.

So, it appears to me, very frankly, gentlemen, that this is a rather extraordinary provision of law and it appears to me that it is a substantial diminution in the quality of protection which is afforded to American investors.

Mr. COHEN. May I speak to that, Mr. Dingell?

Mr. DINGELL. Briefly, yes.

Mr. COHEN. Well, you are talking to the wrong fellow to get a brief answer.

The fact of the matter is that with respect to over-the-counter securities there is no present protection of this kind at all under present law.

Now, with respect to listed securities——

Mr. DINGELL. Mr. Cohen, let's get away from that. I will concede for purposes of the argument that the 1933 act would apply.

Mr. COHEN. No. I am now going to the outstanding securities.

Mr. DINGELL. I don't really care about these peripheral issues. What I wanted nailed down hard and fast, if I may, is why you good

gentlemen from the Commission charged with the protection of the American investor, and this is a very high duty, are coming forward and offering to the American investor a statute which affords to the American investor a lesser quality and quantity of protection with regard to foreign issues marketed in this country than you are affording to the same American investor with regard to domestically owned and operated corporations.

Mr. COHEN. Well, I will try to explain the Commission's position in that area.

Mr. DINGELL. I hope you will because it appears to me to be a rather extraordinary position.

Mr. COHEN. First, so far as securities now traded in the over-the-counter market are concerned, of course none of these provisions apply so it is a question of bringing these securities under the statute.

Now, so far as listed securities are concerned, they are now subject to the 1934 act and the reporting insider trading provisions and the proxy provisions of that statute.

Mr. DINGELL. That is right.

Mr. COHEN. Forgive me.

But even in that area, because of the tremendous enforcement problems that have been involved, the Commission has had on the books for longer than I can remember a provision which exempts many of these listed companies from sections 14 and 16 of the 1934 act.

Coming back to the over-the-counter market, and I want to get to the answer to your question, there are many foreign securities now traded in the over-the-counter market. There are many Americans who hold these securities. In recent years, until the recent interest equalization bill came on the scene, there was increasing interest in foreign securities by American investors. First of all, the Commission has no jurisdiction over foreign issuers and if the statute were to cut off——

Mr. DINGELL. Now, Mr. Cohen, you have——

Mr. HARRIS. Let him answer the question. Let him go ahead and finish.

Mr. DINGELL. Very well.

Mr. COHEN. If the statute or the Commission were to withdraw in some way these markets from the American public, it is not entirely clear that anybody would be hurt except the American investor.

Now, as I said, we agree that these protections should be provided. There is a real problem in enforcing these protections as against issuers and insiders in foreign countries who, as you pointed out before, may have little interest in the Commission's requirements. It was for this reason the Commission felt that the existing interest of American investors in an untold number of foreign countries and the markets for those securities, should not be jeopardized by a bill which would immediately withdraw them from the market or make it unlawful to trade in these securities.

Mr. DINGELL. Now, first of all, this bill, if it did not have this language, would not make it unlawful to trade in foreign securities in this Nation; it would simply impose upon the issuer of foreign securities and upon those issuing certificates of deposit on foreign securities

the same responsibilities that we impose upon American corporations and upon issuers of American securities under the same circumstances. Am I right?

Mr. COHEN. Yes, sir.

Mr. DINGELL. So, in effect, then, we are giving preferential treatment to issuers of foreign certificates and foreign securities as opposed to what we require of issuers of securities with regard to American corporations insofar as stock and also insofar as bonds; am I correct?

Mr. COHEN. Now, again, because you keep referring to issuers, I don't want to seem argumentative, but the section is so drawn that, for example, if a new foreign issuer were to come to the American market and offer securities and they were registered under the Securities Act, the Commission has power under this section to write a rule which would require that the issuer assume an obligation to continue to furnish all this information, but that is not what we are focusing on.

What the Commission was concerned about was hurting a great many American investors who now hold securities of issuers who may not have had anything to do with coming to the American market.

Mr. DINGELL. Now, supposing you be good enough to tell me how the striking of this section would adversely affect American investors.

Mr. COHEN. American dealers might hesitate to trade in securities when there is an obligation under a statute that is not being fulfilled.

Mr. DINGELL. Now, would it not be just as easy for this committee to change this statute to permit the Commission to give exemptions had found it to be in the public interest so to do and after it had found that American investors would not thereby be injured?

Mr. COHEN. Yes; it would be. As a matter of fact, in previous legislation, Mr. Dingell, that is precisely the way the legislation was drawn.

Mr. DINGELL. All right.

What happened, then, gentlemen, is that the Commission met with members of the industry and substantially changed this section to afford additional prerogatives and rights to issuers of foreign securities and to those who would place them on the market which are not available to persons similarly situated with regard to certificates and securities in American corporations and in American investments. In a nutshell, isn't that what happened?

Mr. COHEN. No, sir, Mr. Dingell. That is not so.

This particular provision was changed by the Commission before it met with the industry. It was changed by the Commission in consideration of the various problems I have mentioned. It is true that in the draft that went out to the industry it was the other way. However, as I recall, before we met with the industry, the Commission decided to turn it around.

Coming back to the point that you make, I want to emphasize again that even with respect to listed securities where you are dealing with issuers of a far higher grade and a greater importance, the Commission because of the enforcement problems has felt it necessary through the years to grant exemptions from sections 14 and 16 to listed companies.

Mr. DINGELL. Now, would that be an undue burden upon the Commission to issue exemptions where it felt the public required?

Mr. COHEN. If the Congress asked us to do it, it would not be an undue burden?

Mr. DINGELL. It would not be an undue burden; it would substantially protect the class of American investors to whom you have referred.

Mr. COHEN. The fact of the matter——

Mr. DINGELL. Wait. It would not be detrimental to the American investors.

Mr. COHEN. It was the Commission's judgment that to do it the other way would be detrimental.

Mr. DINGELL. This is not in response to my question. I am asking you and I said it would not be detrimental to the interests of American investors about whom you expressed concern to authorize the Commission to afford exemptions under these circumstances where it found it to be in the public interest and not in the interest of the American investor.

Mr. COHEN. I thought I was answering your question. This is precisely the question the Commission considered, and the Commission came to a decision that it would be more detrimental to the interest of the investors to do it that way.

Mr. DINGELL. Now, Mr. Cohen, supposing you tell me very briefly why.

Mr. COHEN. I indicated a few minutes ago that earlier bills had been prepared in the manner you have suggested, but since that time there has been a tremendous growth in American investments in foreign securities and there are a great many foreign securities now traded in the American market either directly or through ADR certificates.

Now, just to answer your question, the Commission thought that the statute drawn the other way would have a very unsettling effect on the markets for those securities. That was part of the Commission's reasoning.

Mr. DINGELL. We might have an unsettling effect on the market on this kind of security but it might also provide protection to the other American investors.

Mr. COHEN. It might, provided the issuer complied; but that is part of the problem, Mr. Dingell.

Mr. DINGELL. Now, you regularly engaged in activities to proscribe trading in foreign securities which do not meet certain standards; do you not?

Mr. COHEN. I am sorry; I didn't get that question.

Mr. DINGELL. You regularly in the Commission move against foreign securities which do not comply with the provisions of American law; do you not?

Mr. COHEN. To repeat, I am glad you asked the question.

There again, that is a situation where the issuer is illegally coming into the American market with a new issue of securities and has not registered under the 1933 act and that is not to be changed in one iota by this legislation.

Mr. DINGELL. You also move against foreign securities in which certain illegal activities appear in the marketing; do you not?

Mr. COHEN. We do in all securities; yes, sir.

Mr. DINGELL. Sure, you do. So, it would not be an undue burden to permit the Commission to afford the exemption rather than to require the issuance of the exemption; would it not?

Mr. COHEN. I think perhaps I might add this, and I don't know that this is really a controlling factor. I might refer a little bit to the history on the Senate side if you spare me a moment because I think it illustrates the point. If you turn it the other way, Mr. Dingell, I think the Commission would be deluged by applications, the very next day.

Mr. DINGELL. This is your real objection; is it not?

Mr. COHEN. No.

Mr. DINGELL. The responsibility that the Commission is going to be deluged with applications?

Mr. COHEN. No; that is not the point. I merely bring that out to illustrate. I want to refer to what happened on the Senate side.

On the Senate side, the problem was not the way the legislation was written but there was some concern that the Commission might withdraw the exemption in too many cases.

Mr. DINGELL. All right.

Now, I want to ask you some more questions.

Mr. Chairman, you have then scrupled to remove foreign securities from the market when you found they were not complying with the provisions of the law, have you, nor has the Commission scrupled so to do? You have issued stop orders against them. I remember you did so in the case of Canadian stocks and in the case of some other securities in which similar practices have been engaged; have you not?

Mr. CARY. Mr. Loomis, who is my counsel, at this point on this question indicates that we have brought them against issuers but we have hesitated in respect of securities.

Mr. DINGELL. And you have also suspended trading in these securities; have you not?

Mr. CARY. Sometimes.

Mr. DINGELL. Yes. And in these instances, you were never particularly concerned about the American investors who had previously bought these securities; you were concerned about American investors who might in the future be prevailed upon to buy these securities which were being marketed in defiance of the various statutes and regulations; isn't that a fact?

Mr. CARY. I will ask Mr. Woodside to respond to this.

Mr. DINGELL. It is a very simple question. I think all it requires is a yes or no.

Mr. WOODSIDE. Perhaps a little background.

Mr. CARY. This is a complicated field.

Mr. DINGELL. I don't care about background. I think it is a yes-or-no question.

Mr. WOODSIDE. It is not a yes-or-no question. Your hand does not reach across the sea.

Mr. DINGELL. I am aware of that.

Mr. WOODSIDE. We have many issuers right today listed on the New York and other exchanges which have chosen not to comply with the reporting requirement of the 1934 act and the Commission and the exchange has had the decision to make should you throw them off the exchange and close off the listed market; or do you leave them there, notwithstanding the fact that the companies don't supply the information and we can't compel it. The policy decision reached throughout the years, not just by this Commission but by its predecessors, also is to leave them alone.

I was in Germany in 1952. I happened to be a member of a small group that went there to try to negotiate with the Germans some arrangement by which they would provide the information that the listing agreements called for. These were issues on the New York Stock Exchange. The Germans, in effect, said goodby.

But we did work out an arrangement by which the company supplied us with the reports that the German companies furnished to their own security holders.

Mr. DINGELL. You are telling us, then, that you apply one standard to issuers of American securities insofar as disclosure and protection of American investors and that you apply to domestic concerns a very different quantum of concern for American investors and a very different standard of law. Is this, in effect, what you are saying?

Mr. WOODSIDE. If you want a yes-or-no answer, the answer is "Yes." It has been that way from the beginning and the Congress has sanctioned it.

Mr. KEITH. Would the gentleman yield?

Mr. DINGELL. Yes.

Mr. KEITH. One point. It would seem to me that the American investor would be more in need of the protection in which Mr. Dingell is interested because of the relatively remote opportunities to protect the investments they have in these oversea corporations. Is that not so?

Mr. CARY. Yes, but how do you get it? That is the question.

Mr. KEITH. I do not have the answer to it.

Now, it seems to me that this interest in foreign securities is at variance with the present policy of the administration to discourage oversea investment.

Mr. CARY. Well, I can see what you mean. Let us remember that we are dealing here not with new issues which is the thrust of the equalization tax; we are dealing really with securities that are presently traded on the American market. In other words, the funds have already gone out of this country, if you like. Therefore, we are not dealing with new issues of securities at this point because there the Securities Act of 1933 would apply and they would have to furnish the information in order to float these securities on the American market. We are dealing with existing issues on the American market.

Mr. KEITH. These existing issues, as they change hands in our markets, do have an influence on overall buying and selling of securities, do they not?

Mr. CARY. They may have some; I really can't quite analyze that out in this hearing.

Mr. KEITH. Do you know why the administration has proposed a tax on these oversea investments?

Mr. CARY. Well, sir, I would hesitate to speak too authoritatively on it, but the general thrust of it, as I understand it, is for the purpose of protecting our balance-of-payments position.

Mr. HARRIS. If the gentleman will yield, that was the analysis that was made at the time the message came up to the Congress. There was one exception, I think, in dealing with it and that is the way that the Canadian situation was handled.

Mr. CARY. Yes, sir. I don't want to speak too authoritatively.

Mr. DINGELL. Now, gentlemen, we have been talking about foreign issues, and I want to know about the issuers and certificates of deposit or despository receipts. When you approve certificates under the 1933 act, don't they subscribe to section 15(d)?

Mr. COHEN. The issuer of the depository receipt does but the issuer of the receipt is usually a bank and it would file a report with respect to its activities as a depository and in the issue of receipts. Now, I don't know how frequently, but frequently an issuer may join with the depository and undertake to furnish reports. That does happen.

Mr. DINGELL. Well, does this section (E) that we have been discussing not let issures of these certificates of deposits out from under the statute?

Mr. COHEN. No, sir. You will have to bear with me about 45 seconds. Since the issuance of an ADR certificate is part of a continuous offering of securities, it is therefore continuously subject to the 1933 act and therefore it has to have in effect continuously a prospectus and that prospectus must contain current information so that in effect the ADR arrangement fulfills completely your objective.

Mr. DINGELL. I hope you are right.

Mr. COHEN. I think I am right about this, Mr. Dingell.

Mr. DINGELL. I am speaking about my objectives, of course.

I want to yield to the chairman here and then I would like to ask some more questions, if I may, Mr. Chairman. I have quite a few.

Mr. STAGGERS. Mr. Harris?

Mr. HARRIS. I do have one question I would like to ask. I do not want to interrupt my colleague.

Mr. DINGELL. That is all right. Go ahead.

Mr. HARRIS. If my colleague would indulge me at this time there has been some question, Mr. Cary, with reference to the provision in the bill which gives to the various agencies of Government responsibility administering the banking law.

Mr. CARY. Yes, sir.

Mr. HARRIS. The authority to carry out the provision as applicable to the banks and such agencies.

Mr. CARY. Yes.

Mr. HARRIS. I think that is subsection (i) of section (E).

Mr. CARY. That is my understanding, yes, sir.

Mr. HARRIS. You are familiar with it?

Mr. CARY. I am.

Mr. HARRIS. Of course in the first place you know that the agencies involved in this would much prefer the matter be stricken out altogether and the national banking laws to become applicable without any reference to the SEC laws.

Mr. CARY. Mr. Saxon would like that, the Federal Reserve Board to the contrary. They would like to have us administer it but they are willing to do so if this provision is applicable across the board to all the Federal regulatory agencies. Only Mr. Saxon speaks that strongly.

Mr. HARRIS. Well, I had understood there were others beside Mr. Saxon. I had not had any information directly from the Federal Reserve Board.

Mr. CARY. Mr. Martin.

Mr. HARRIS. Nevertheless, I want to see if we cannot resolve one question between agencies of the Government with regard to the responsibility. I don't want to get into one of these interagency fights if we can help it, as long as we get through with the job that needs to be done.

Mr. CARY. That was our intention, sir, to try to avoid that kind of dispute.

Mr. HARRIS. Was there any intention of any rules or regulations that you would issue would be binding to the agencies to which this responsibility would be referred?

Mr. CARY. No, sir. In other words, if we cede jurisdiction to another Federal agency we have to cede it here. However, they would be applying our law, the law which you, the Congress, have enacted.

Mr. HARRIS. I thought that would be the reasonable position to take.

Mr. CARY. Yes, sir.

Mr. HARRIS. As I have tried to analyze it this does raise a problem. I believe it has been left in the unusual situation that the responsibility of the administration of this provision as far as they are concerned would be extended to the various agencies such as the Comptroller General and Federal Reserve Board, the FDIC, and so forth.

Mr. CARY. Yes, sir.

Mr. HARRIS. Apparently the way it is analyzed by some that I have discussed it with, any rules or regulations that you might issue would be binding on them unless there was some provision here to make it very clear.

Would you object to a provision in this that would make it abundantly clear?

Mr. CARY. I would not object at all, sir. That is what we contemplated, and when we said delegated, we meant it.

Mr. HARRIS. The staff will have the power, then, to go over the right kind of language to be sure that the intention is carried out.

Mr. CARY. Yes, sir.

Mr. HARRIS. I did not want to proceed any further. I wanted to get that one thing cleared up.

Of course I will say to Mr. Cary when we go into this one big issue of the insurance people, very frankly I think you have made a very good case. On the other hand, I think they have come up with some improvements in which they propose, notwithstanding what you say in your report here. It appears to me that they are supposed to do precisely the same thing that you say that needs to be done and that it has become a question of who is going to do it. It is unfortunate that we had to get in between the vise here, and I hope you understand what kind of vise I am talking about.

Mr. CARY. Yes, sir; I understand.

Mr. HARRIS. We do not like to be put in that position but it does seem to me that there might be some merit in their program if they propose to carry out the requirements that you have indicated if there are proper reports made.

Mr. CARY. Mr. Chairman, I can only hope the rationale provision prevail. We have argued this out and I understand——

Mr. HARRIS. I don't intend to get into an argument with you, but I wanted to see if I understood your personal conversation we have had on this.

Mr. CARY. Yes, sir.

Mr. HARRIS. As well as during the course of the hearings if the information which you say is necessary for a full disclosure on proxies and inside trader, and so forth, is required, and is included in the reports which they make to the various States under the State law. If a copy of your request was filed and made available to the Commission, would that not meet requirements insofar as you know what is going on?

Mr. CARY. Well, Mr. Chairman, that——

Mr. HARRIS. I am not talking about authority now; I am talking about information.

Mr. CARY. That would probably be adequate with respect to the reporting; that is, this annual reporting form.

Mr. HARRIS. That is what I was asking about.

Mr. CARY. But we are addressing ourselves to a broader area.

Mr. HARRIS. I know it, I have read all of that and I do not want to get into an argument.

Mr. CARY. I think that is perfectly clear to you.

Mr. HARRIS. Thank you very much.

Mr. STAGGERS. Thank you, Mr. Chairman.

Mr. Keith?

Mr. KEITH. Thank you, Mr. Chairman.

I was unable to be here during the morning and early afternoon session but the chairman has graciously allowed me to ask a couple of questions which you may have answered earlier.

I would appreciate it if you would give me as brief an answer as possible to each of these.

Will the mutual fund direct sellers be exempted by the SEC from NASD membership?

Mr. CARY. No, sir.

Mr. KEITH. Will mutual fund sole underwriters be exempted by SEC from compulsory NASD membership?

Mr. CARY. No, sir.

Mr. KEITH. To what extent do these direct sellers and/or sole underwriters differ from the other 800 broker-dealers you have testified you will exempt?

Mr. CARY. This number refers to those whom we would exempt; as I understand it, they are perhaps not that magnitude of 700 or 800. The ones we would exempt would be persons engaged in real estate or insurance and in which the sale of securities is a very incidental part of their business. This, on the other hand, is a complete commitment on the part of these men to the sale of securities. Granted, there are a limited number of securities or at least their mutual funds, but at least it would be a total commitment on their part to the sale of securities.

Mr. KEITH. Would your mutual fund directors and/or sole underwriters not be in a different type of business from the broker-dealers who buy and sell on a commission basis for the accounts of investing customers?

Mr. CARY. They are different in that they are not selling as broad an inventory of securities. On the other hand, they are selling securities, they are subject to some of the same problems with respect to selling practices which we set forward in our report of the Special

Studies and therefore for that reason we think they should be subjected to similar standards.

Mr. KEITH. But are they not already more stringently regulated under the Investment Company Act of 1940, the 1933 and 1934 acts, than were many of the broker-dealers?

Mr. CARY. I would think not on the sales side, because we are addressing ourselves to the selling side of this situation.

Mr. KEITH. Are they not more closely regulated under the 1933, 1934, 1940 acts than the NASD rules require?

Mr. CARY. I don't think so, as far as sales are concerned, no, sir.

Mr. KEITH. Thank you, Mr. Chairman.

Mr. STAGGERS. Mr. Cary, I have some questions I want to ask. I will defer some of mine. I know you have had a pretty full day.

Mr. CARY. I appreciate the opportunity to present this material today.

Mr. STAGGERS. A lot of these are referred to in your statement, but there are some I believe that ought to be asked for the record.

I ask you to answer as briefly as possible.

When you were here last November you were questioned concerning statements you had made about manipulation and fraud being rampant in the securities market; whether this was as true last November as when you had made the statement to this committee in June of 1961. You replied that it was. Now, 3 months later, have you observed any change as a result of your Special Study Report or as a result of the Ira Haupt failure, or as a result of other factors * * * or do you adhere to your decision of last November?

Mr. CARY. Chairman Staggers, that is a very difficult question for any of us to answer in terms of a quantity and fixing a quantity. I hesitated to answer the question the last time and I hesitate to answer it today. Let me try to explain what I said last time and admit my inability to answer your question fully today, or even then, really.

What I was speaking to was that our enforcement actions this year are as great as, if not greater than, prior years. In other words, our thermometer or standard of measurement is largely how many enforcement actions we bring. But the point is that enforcement actions are brought with respect to activities that occurred maybe 2 years ago. Therefore, when I quantify something at least on our practical level it is largely on the basis of what happened several years ago, and they have reached the proceeding stage.

Now when I said to you that the number of actions taken this year, and I was speaking of November, are as great as 2 years ago, one might properly have construed that to mean that therefore there is as much fraud. Now, quite frankly, I am not in a position to really give a fair answer on whether there is as much fraud or any less or any more.

I can say that when I was here before you a couple of years ago I had before me the facts, let's say, of the re case and other problems of the American Stock Exchange, which has been largely cleared up, things of that kind. I don't have anything of that magnitude before me at this time. I really don't think I am in position to give you an absolute quantity. I just can say that I don't have any particular situations of the same magnitude that we had on one exchange at that time which has since been clarified. I am sorry, I can't give you more but I don't think I can responsibly go beyond that.

Mr. STAGGERS. Mr. Cary, one of the objections that has been voiced in the course of the hearings to the Federal-State relationship has been that the NASD is a self-regulatory agency apart from the SEC, and that NASD does not cooperate with the State enforcement agency.

Do you believe that it might be desirable to provide that NASD may, in given circumstances, supply information to the State agencies?

Mr. CARY. I would certainly believe that it is a provision that would be perfectly satisfactory. Indeed I think the NASD is moving more and more toward a quasi-public regulatory organization because we are giving it more responsibility. It is bound to take on more public character, I think, and that in itself will be moving toward a greater collaboration with the State security commissioners than it has in the past.

Mr. STAGGERS. In your letter of June 5, 1963, transmitting your legislative recommendations, you indicated that you were then deferring recommendations as to the registration and regulations of the quotations bureaus until the industry had an opportunity to review the chapters of your Special Study Report.

What is your program now with respect to your recommendation of legislation in this area?

Mr. CARY. Yes, sir. In that area, as we indicated in in our report when we were dealing with the industry, we did not have that segment of the report available. Now, of course, it is available and it has been discussed.

On the quotations bureau—and now I am referring to the so-called national quotations bureau which furnishes the inside quotes—there has been a change of ownership since our report. As I told you at that time, it was then owned by really an estate and one man and he was running it. Now the whole interest has been purchased by the Commerce Clearing House. We are working out with Commerce Clearing House at the present time pursuant to our general rulemaking powers steps to make the quotations more meaningful. In fact the company is already taking steps informally in that direction. Therefore we have no statutory suggestion at this time and we don't really know at this moment whether it is going to be necessary on that question.

Mr. STAGGERS. I think it is an important question. I think it is highly important.

Mr. CARY. Indeed, it is. We are working on a variety of problems dealing with quotations. I mentioned one this morning—I think you brought it up. Some of these problems we are dealing with the NASD at the present time on. I might say we are not making too great a progress at this time but we are still negotiating with them.

Mr. STAGGERS. Well, Mr. Cary, I will say this: Before this bill is written up we would like to have the opportunity to talk with you more on this subject and some others which I think are highly important.

Mr. CARY. We would like very much the opportunity; yes, sir.

Mr. STAGGERS. There are one or two questions that I believe should be asked in regard to accounting and I will base these questions on statements of yours made on November 19 when you were before the committee.

Mr. CARY. Yes, sir.

Mr. STAGGERS. Do you consider the financial statements now filed with the Commission are on a sufficiently sound and uniform basis to protect investors?

If you want me to go back and quote what you had to say, I will. This is the first of your quotes:

> Most important investors in the over-the-counter securities are entitled to be assured that corporate reporting meets all the tests of timliness, sound accounting, reliability, responsibility, and consistency. This can be achieved only by the imposition of legal obligation which would shape the development of appropriate accounting and other disclosure practices.

Mr. CARY. We believe that we have established pretty good standards in the field of accounting over a period of years. Indeed, I think we have been one of the pioneers in that area through the accounting releases and the actions we have taken. I think if these standards are made applicable to over-the-counter companies, it would raise the level of accounting in that area up to a proper standard.

Mr. STAGGERS. All right.

Who has the primary responsibility for the determination of appropriate accounting principles to be followed in the preparation of financial statements?

Mr. CARY. I think I can say quite truly that we have cooperated with the accounting profession very carefully on this subject over a period of years. I would take it as a joint responsibility.

Mr. Barr has been working with them, I know, on an almost day-to-day basis over a period of years—particularly the American Institute of Certified Public Accountants.

One of my colleagues says the ultimate responsibility is ours, but I think in many areas we have encouraged them to move ahead and we have stood behind them. Sometimes we have differed but in general we have been going along with them in many areas and we have pushed them.

Mr. STAGGERS. I think it is one of the areas in which we must determine responsibility.

Is it true that the Commission now accepts financial statements from various companies following alternative accounting practices with materially different results for similar transactions and the certifying statement that all of these practices are in accordance with generally accepted accounting principles?

Mr. CARY. It is, sir. In other words, in some areas of accounting there are more than one, shall we say, accepted accounting principles applicable. In those cases we are in a position where we would accept more than one. I think Mr. Barr, who has had such infinite experience in this field, might speak a little more to that point.

Mr. STAGGERS. Mr. Barr.

Mr. BARR. There are many areas in accounting in which there have been longstanding differences in the application of the principles involved and this has been recognized in our administration from the beginning. It is particularly identified in Accounting Series Release identified as No. 4 in which the Commission expressed its accounting policy as recognizing authoritative support for more than one method of accounting unless the Commission had itself acted in the case in which they concluded that only one method was appropriate. That

is the history of that accounting problem. It was reiterated in connection with the investment credit problem about a year ago. The same problem was restated.

Mr. STAGGERS. Do you consider that the Commission now has the responsibility of determining whether the accounting profession has taken appropriate action to determine adequate accounting principles?

Mr. CARY. I think we have that responsibility; yes, sir. And I trust we are exercising it.

Mr. STAGGERS. If you do not have any, it is your responsibility if there is a laxity in that?

Mr. CARY. I think it has to be our responsibility; yes, sir.

Mr. STAGGERS. Can you file with this committee a statement setting forth what you understand to be the areas of accounting where alternative practices could produce materially different results under generally accepted accounting principles?

Mr. CARY. Yes, sir. There have been a number of papers written on that and, to my knowledge one in the last year, and I am sure we will be glad to provide an analysis right along those lines.

Mr. STAGGERS. If you would, with your conclusions as to the significance of each such area and with the reasons why you consider that investors who are considering and comparing various companies are adequately protected by your acceptance of these alternative practices.

Mr. CARY. Yes, sir; we will try to supply that.

Mr. STAGGERS. For the record.

Mr. CARY. Yes, sir.

Mr. Barr advises me on the last point we can supply you with the first part readily; in other words, the examples, the cases, the situations.

To measure it, which is I think the second point of your question, is going to be much more difficult. We will attempt to do so, but I don't want to hold out any assurances that we can do it as adequately as we can identifying the problems.

Mr. STAGGERS. What do you mean, the second part? The reasons?

Mr. CARY. As I recall, I have forgotten your question exactly, sir, but I thought that after identifying the areas in which there was an application of more than one accounting principle which would be acceptable you wanted us to do, shall we say, measure their impact. I think that is exceedingly difficult. That is the point I was addressing myself to. We will do our best but I cannot promise to do a very satisfactory job on that second phase.

Mr. STAGGERS. It will be in the record, I won't read it again, with your conclusions as to the significance of each such area and with the reasons why you consider that investors who are considering and comparing various companies are adequately protected by your acceptance of these alternative practices.

Mr. CARY. That is a tough question. We will do our best.

(The material requested was subsequently supplied for the record:)

MEMORANDUM PREPARED BY THE OFFICE OF THE CHIEF ACCOUNTANT, SECURITIES AND EXCHANGE COMMISSION, IN RESPONSE TO REQUEST OF THE SUBCOMMITTEE ON COMMERCE AND FINANCE OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, HOUSE OF REPRESENTATIVES, ON H.R. 6789 AND H.R. 6793

At page 1289 of the stenographic report of proceedings of the Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, on February 19, 1964, Hon. Harley O. Staggers (chairman of the subcommittee) made the following request of Chairman Cary: "Can you file with this committee setting forth what you understand to be the areas of accounting where alternative practices could produce materially different results under generally accepted accounting principles?" and "If you would, with your conclusions as to the significance of each such area and with the reasons why you consider that investors who are considering and comparing various companies are adequately protected by your acceptance of these alternative practices."

Some general observations appear to be in order as a basis for listing areas of alternative practices in accounting and for discussing the significance of each for investors. The Commission's authority for dealing with accounting matters under the Securities Exchange Act of 1934 is found in sections 13 and 15(d).

Section 13(b) of the act gives the Commission authority to prescribe the form and the items or details to be shown in the financial statements, the methods to be followed in the preparations of reports and accounting for assets and liabilities and income and expenses.[1]

The authority contained in the act has been implemented by the adoption of forms and regulations of which regulation S–X prescribes the form and content of financial statements. The preface of this regulation as presently in effect states: "This regulation (together with the accounting series releases) states the requirements applicable to the form and content of financial statements. The instructions as to what financial statements are required to be filed are contained in the form prescribed for the respective registration statement, application for registration, or report. * * *" The last comprehensive amendment of this regulation was adopted pursuant to the requirements of the Administrative Procedure Act and was published December 20, 1950, as Accounting Series Release No. 70. A copy of this release, the regulation, and four more recent releases (Nos. 85, 86, 95, and 96) of continuing current interest are attached to this memorandum.

With the exception of banks, insurance companies, and railroads, as to which exemption is provided in the forms, financial statements filed for registrants under the act must be certified by independent public accountants. Rules 2–02 (c) and (d) prescribe the opinions and exceptions to be expressed as follows:

"(c) *Opinions to be expressed.*—The accountant's certificate shall state clearly: (i) the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein; (ii) the opinion of the accountant as to any material changes in accounting principles or practices or method of applying the accounting principles or practices, or adjustments of the accounts, required to be set forth by rule 3–07; and (iii) the nature of, and the opinion of the accountant as to, any material differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review.

"(d) *Exceptions.*—Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given."

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[1] "The Commission may prescribe, in regard to reports made pursuant to this title, the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earning statement, and the methods to be followed in the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparaton, where the Commission deems it necessary or desirable, of separate and/or consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer; * * *"

Rule 3–07 referred to above reads:

"Changes in accounting principles and practices and retroactive adjustments of accounts.

"(a) Any change in accounting principle or practice, or in the method of applying any accounting principle or practice, made during any period for which financial statements are filed which affects comparability of such financial statements with those of prior or future periods, and the effect thereof upon the net income for each period for which financial statements are filed, shall be disclosed in a note to the appropriate financial statement.

"(b) Any material retroactive adjustment made during any period for which financial statements are filed, and the effect thereof upon net income of prior periods shall be disclosed in a note to the appropriate financial statement."

Also pertinent to the discussion to follow is Rule 3–06: Additional Information:

"The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. This rule shall be applicable to all statements required to be filed, including copies of statements required to be filed in the first instance with other governmental agencies."

Early in the Commission's administration of the act it was argued by representatives of registrants that a change in accounting could not be required when full supplemental disclosure was made of alternative practices deemed by the Commission to be preferable to those reflected in the financial statements. The Commission dealt with this problem by issuing the following statement of its administrative policy in Accounting Series Release No. 4 on April 25, 1938:

"In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant."

This policy was reaffirmed and clarified in Accounting Series Release No. 96 issued on January 10, 1963.

The requirement for certification of financial statements to be filed with the Commission was introduced in the Securities Act of 1933. Recognizing that this placed a heavy responsibility upon the accounting profession, which some of its leaders expressed a willingness to assume, the Commission has encouraged the profession to exercise leadership in accounting and auditing matters. At the same time the Commission has not hesitated to criticize and prod, to take exception to accounting presentations, and to discipline members of the profession when circumstances warranted.

The Commission is well aware of the controversial nature of many accounting issues and over the years has authorized its chief accountants to participate in the work of the American Institute of Certified Public Accountants and other organizations in their efforts to narrow the areas of differences in accounting. Such efforts are clearly in the interest of investors. This is an unending process for as uniformity of practice is achieved in some areas new problems arise in others because of changing economic conditions and business practices. Much improvement in financial reporting practices has occurred since the enactment of the first Federal securities law in 1933. The Commission believes that its policy of working with and supporting the accounting profession in the development of accounting principles has directly influenced this progress and is the best means of assuring continuing improvement of accounting practices.

I

Some areas of accounting where alternative practices could produce materially different results under generally accepted accounting principles are discussed in the following paragraphs:

1. Valuation of inventories

It is readily recognized that a single method of valuation is not suitable for all industries or for all companies within the same industry. The best known alternatives perhaps are "first in, first out" (fifo) and "last in, first out" (lifo). It took some time and litigation for the latter to be widely accepted for income tax purposes. This method affords a tax benefit but one of the conditions of its use is that the lifo inventory be reflected in the books. As the use of lifo was extended it attained the status of general acceptance while fifo retained that status.

Consistent application of either method is considered appropriate in reporting the results of operations. Failure to disclose the method used deprives the investor of significant information; hence, rule 5–02–6(b) of regulation S–X requires the disclosure. Continued use of lifo in periods of rising price levels results in an increasingly conservative valuation of the inventory in the balance sheet which analysts should recognize when making comparisons between companies which have adopted lifo at widely different times or between lifo and fifo companies. The accounting staff of the Commission and some public accountants encourage companies using lifo to disclose in footnotes the inventory values on a current basis.

2. Depreciation and depletion

The basis for determining depreciation, depletion, and amortization of fixed assets vary by industries and by companies within industries. Even in regulated utilities different methods have been approved by authorities having jurisdiction—both straightline and accelerated methods are acceptable. Perhaps here more than in some other areas of accounting, managerial judgment, subject to critical review by independent accountants, is a significant factor. An assumption of precise comparability between companies may not be warranted, even though the methods followed appear to be the same, because of variations in amounts depending on whether the management is conservative or liberal in making provisions for depreciation and amortization. Recognition of this problem is found in regulation S–X in rules 3–12 and 3–20(c) which require disclosure of the basis of valuation, methods of depreciation, depletion and amortization, and of the related accounting for maintenance, repairs, renewals, and betterments as well as the method of accounting for properties retired or sold. The Commission's staff challenges the methods followed when the facts warrant.

3. Income tax allocation

Accounting for income taxes is a problem when items of income and deductions are reported in different periods for tax purposes than for corporate reporting purposes. The problem has been dealt with in publications of the American Institute of Certified Public Accountants for the guidance of the profession and in accounting series releases by this Commission. The most recent of the latter are release Nos. 85, 86, and 96. In release No. 96, which deals with the "investment credit," the Commission found authoritative support for an alternative solution to the problem although the majority of the accounting principles board of the AICPA in its opinion No. 2 found only one solution to be acceptable. This problem aroused extensive and intensive discussion among public accountants, businessmen, and regulatory agencies. Experience so far shows that in most cases the amounts involved in the credit are not significant. The recent amendment of the Internal Revenue Code will require a reexamination of this problem.

4. Pensions

The variety of plans in this area and the many factors that enter into the determination of the amounts involved make uniformity among companies and even consistency in application year by year in the same company difficult to attain. Various aspects of the problem have been dealt with by the Commission from the earliest days, and the AICPA has issued statements for the guidance of the profession. Differences in accounting result from the methods of providing for past service costs and for current costs of accruing pensions not

yet vested. These problems are currently under study by the research staff of the AICPA and by our staff. SEC disclosure requirements as to pensions are specified in rule 3–10(e) of regulation S–X.

5. Research and development costs

In the post-World War II period proper accounting for the vast expenditures on research and development has been a highly significant factor in the financial reporting of many companies. Two principal methods of accounting are generally accepted. It is common practice for large, well-established companies to expense such outlays as they are incurred on the theory that this is a regularly recurring cost of maintaining the position of the company it in its industry.

New companies organized to develop and exploit new products are more prone to capitalize these costs and amortize them as the product is produced and sold. However, when failure of the project is evident the loss must be recognized.

An intermediate position can be sustained for the company which maintains a research staff and allocates part of its cost to specific ventures and the remainder as current expense for sustaining the activity.

It is clear that the propriety of any of these methods depends upon the facts. The Commission's practice in this area is to make appropriate inquiries, challenge the method of accounting if this seems necessary, and to require pertinent disclosure of the company's policy. It is believed that this practice provides the necessary information for the protection of investors.

6. Goodwill

Goodwill, which usually arises from the acquisition of another business, under generally accepted accounting practice may be retained on the balance sheet as an asset until there is evidence of loss in value, or it may be amortized by charges to income even though there is no evidence of loss in value. An often-quoted author, Charles B. Couchman, in commenting on this situation, said 40 years ago: "To put it briefly, if you can write it down, you need not; it you cannot, you should."

In Accounting Series Release No. 50, published January 20, 1945, the then Chief Accountant of the Commission expressed a preference for the writeoff of goodwill through timely charges to income rather than in a lump sum when it became worthless. This is the staff's preference today but businessmen are reluctant to make charges of this kind against income when they are not deductible for income tax purposes and the activity with which the goodwill is associated continues to be prosperous. This is an area in which a clear disclosure of the method followed is required (by rule 3–20(c)(2) of regulation S–X) so that the investor may apply his own judgment for purposes of comparison.

7. When is income realized?

The proper assignment of revenues and related costs to accounting periods is one of the most important (some would say the most important) problems in financial reporting. Carman C. Blough, the first Chief Accountant of the Commission and from 1944 to 1961 director of research of the AICPA, stated this problem in one sentence in an article in the Journal of Accountancy for December 1959 when he said, "While it is generally understood that income should be recognized when services are rendered or goods delivered, in practice the time of taking it up ranges all the way from the time of production, as in the case of some mining enterprises, to the time the cash is received, as is sometimes done in the case of installment sales." As this quotation indicates, the solution of the problem depends upon a careful consideration of the facts in each situation. A single rule of practice in this area would not necessarily result in a proper reporting of realized income in all circumstances. The Commission and staff are alert to the difficulties that may be encountered in this area and request explanations and supporting data from registrants where necessary to reach a conclusion as to the propriety of the accounting. Examples of problems of this nature encountered in the real estate business are set forth in Accounting Series Release No. 95. Alternative practices are appropriate here, as elsewhere, only if the result is to attain a fair determination of income in each case.

8. "All-inclusive" versus "current operating performance" profit and loss or income statement

This is one of the classic controversial issues in accounting. The Commission over the years has supported the view that all items of profit or loss given recognition in the accounts during the period covered by a profit and loss or income statement should be included in the statement, whereas some accountants

advocate the exclusion of items not related to current operating performance. The former view may be designated as the "clean" surplus theory whereas the latter (the so-called operating performance theory) permits direct debits and credits to surplus for items material in amount not deemed to be related to current operations. The issue came to a head in the 1950 revision of regulation S–X and was compromised by the introduction of a provision for "special items" to be reported on the profit and loss or income statement after the caption "Net Income or Loss." In reports to stockholders such items are often shown as direct debits or credits to earned surplus in accordance with the "current operating performance" theory. The AICPA considers both theories acceptable and accordingly accountants certify to both presentations as being in accordance with generally accepted accounting principles. While this solved the problem for financial statements required to be filed with the Commission, examination of reports to stockholders reveals that some companies have a tendency to report favorable items in the income statement and unfavorable items as direct charges to earned surplus without adequate comment elsewhere. This practice has resulted in deemphasis of significant adverse situations in some cases that have come to the attention of the Commission. While a careful reading of all the financial statements usually reveals the facts, this matter warrants reexamination by the accounting profession and the Commission.

The items above are discussed as being illustrative of areas in which alternative accounting practices exist which could materially affect comparability as between companies and as between periods for the same company if a change in practice is made. It would be impractical to attempt to list all such areas. However, additional alternative accounting practices exist in other major areas such as intercorporate investments, long-term leases, principles of consolidation, business combinations, income measurement in finance and small loan companies, and intangible costs in the oil and gas industries. As indicated in the general discussion at the beginning of this memorandum, all changes in accounting in areas such as these and the effect thereof, if material, must be disclosed in financial statements filed with the Commission in the interest of adequate financial reporting for the protection of investors. These disclosures also afford the Commission and its staff an opportunity to challenge the accounting if it seems inappropriate in the circumstances. When financial statements are considered misleading as presented, the Commission recognizes its responsibility to require that changes be made.

II

In order to place the financial reporting problems in proper perspective, particularly with respect to the part the judgment factor plays in adequate financial reporting and the Commission's policy in dealing with these problems, a further outline of the development of the Commission's present policies and practices is provided. It is believed that this background data will be of value to the committee in appraising these problems.

After the stock market debacle of 1929, when the New York Stock Exchange began to reconstitute itself, it set about to see what could be done to improve accounting reports furnished to stockholders by listed companies in order to prevent excessive abuses in the future growing out of inadequate information regarding companies listed on that exchange. In this endeavor exchange representatives solicited the cooperation of the listed companies, the Controllers Institute of America, and the American Institute of Accountants (now the American Institute of Certified Public Accountants). The AIA created a special committee composed of distinguished accountants from nine leading accounting firms to cooperate with the New York Stock Exchange in this endeavor. The results of this endeavor as set forth in correspondence between the AIA Special Committee on Cooperation with Stock Exchanges and the Committee on Stock List of the New York Stock Exchange was published in 1934 by the AIA in a pamphlet titled "Audits of Corporate Accounts." One of these letters, dated September 22, 1932, from the special committee to the committee on stock list, carried a note in this pamphlet stating that it "was placed in evidence by the chairman of that committee in a hearing on exchange practice before a subcommittee of the U.S. Senate Committee on Banking and Currency January 12, 1933, and is now circulated for the information of the members of the institute and others interested."

Reference to this early document is not made in order to bypass progress in financial reporting since that date but because it is a succinct statement of the

problems of financial reporting and was developed by the best minds of the profession and industry under almost ideal conditions of objectivity. It has a special relevance to the SEC in that it was a basic document used in the drafting of the Commission's original financial reporting and certification requirements, which are basically the same as those in effect today although they have been extended and expanded in the light of experience and of changing economic conditions and business practices.

The letter summarizes the problems of financial reporting and demonstrates the importance of the judgment factor, based on integrity, competence, and experience, in accounting decisions and in financial reporting and concludes that:

"The purpose of furnishing accounts to shareholders must be not only to afford them information in regard to the results being achieved by those to whom they have entrusted the management of the business, but to aid them in taking appropriate action to give effect to the conclusions which they reach regarding such accomplishments. In an earlier day, stockholders who were dissatisfied with the results secured by the management could perhaps move effectively to bring about a change of policy, or, failing that, a change of management. With the growth in magnitude of corporations, and the present wide diffusion of stock holdings, any such attempt is ordinarily impracticable because of the effort and expenditure that it would entail. The only practical way in which an investor can today give expression to his conclusions in regard to the management of a corporation in which he is interested is by retaining, increasing, or disposing of his investment, and accounts are mainly valuable to him insofar as they afford guidance in determining which of these courses he shall pursue.

"There is no need to revolutionize, or even to change materially, corporate accounting; but, there is room for great improvement in the presentation of the conclusions to which accounts lead. The aim should be to satisfy (so far as is possible and prudent) the investor's need for knowledge, rather than the accountant's sense of form and respect for tradition, and to make very clear the basis on which accounts are prepared."

The AIA special committee in this letter recommended to the committee on stock list certain objectives which included a recommendation "to make universal the acceptance by listed corporations of certain broad principles of accounting which have won fairly general acceptance (five examples were listed in an exhibit) and, within the limits of such broad principles, to make no attempt to restrict the right of corporations to select detailed methods of accounting deemed by them to be most adapted to the requirements of their business." The recommendation also urged the exchange: (*a*) to ask each listed corporation to cause a statement of the methods of accounting and reporting employed by it to be formulated in sufficient detail to be a guide to its accounting department; (*b*) to secure assurance that the methods so formulated will be followed consistently from year to year and that, if any change is made in the principles, or any material change in the manner of application, the stockholders and the exchange shall be so advised; and (*c*) to endeavor to bring about a change in the form-of-audit certificates so that the auditors would specifically report to shareholders whether the accounts as presented were properly prepared in accordance with the accounting methods regularly employed by the company.

The Commission at its inception was faced with the problem of whether it should prescribe detailed uniform accounting instructions, and came to the conclusion early in its deliberations that it would require full disclosure of financial facts and accounting practices, but that it was not desirable to prescribe accounting methods, or even reporting methods, in detail. On the recommendation of a committee composed of prominent accountants and distinguished university professors, who were engaged in helping the Commission draft its requirements, it adopted a rule which was incorporated in the original

form 10 (for listed companies) and in subsequent financial statement requirements. It is now stated in rule 3-01(a) of regulation S-X as follows:

"Financial statements may be filed in such form and order, and may use such generally accepted terminology, as will best indicate their significance and character in the light of the provisions applicable thereto."

The adoption of detailed rules on accounting methods has been strongly advocated and strongly opposed by various groups since that time, but the Commission has followed the principle and the congressional philosophy that, basically, the securities acts are disclosure statutes, and that it is the fairness of financial statements, taken as a whole, which is more important to investors in carrying out the purposes of these statutes. In 1937, at the American Institute of Accountants' 50th anniversary celebration, the then Chief Accountant of SEC, Mr. Carman G. Blough, made the following statement on the subject of generally accepted accounting principles:

"The expressions of opinion that have come from my office have been expressions of opinion as to what we considered to be the most generally accepted accounting practice among the better accountants in the country, and not a promulgation of any new ideas or anything that had not been followed by accountants rather generally.

"If the time comes when the Commission is convinced that a procedure which is not generally accepted in the profession is a procedure that should nevertheless be followed, the matter will be handled not through a release of an opinion by the chief accountant but through a rule or regulation of the Commission requiring that such procedure be followed."

The procedure indicated in the last paragraph quoted above is consistent with the authority provided in section 13(b) of the Securities Exchange Act, as discussed previously. Accounting series release No. 96 contained, in addition to the statement of policy on the question of uniformity of accounting practice with respect to the treatment to be accorded the "investment credit," the following statement in regard to the Commission's general policy on financial reporting and its development:

"In accounting series release No. 1, published April 1, 1937, the Commission announced a program for the purpose of contributing to the development of uniform standards and practice in major accounting questions. Accounting series release No. 4 recognizes that there may be sincere differences of opinion between the Commission and the registrant as to the proper principles of accounting to be followed in a given situation and indicates that, as a matter of policy, disclosure in the accountant's certificate and footnotes will be accepted in lieu of conformance to the Commission's views only if such disclosure is adequate and the points involved are such that there is substantial authoritative support for the practice followed by the registrant, and then only if the position of the Commission has not been expressed previously in rules, regulations, or other official releases of the Commission, including the published opinions of its Chief Accountant. This policy is intended to support the development of accounting principles and methods of presentation by the profession but to leave the Commission free to obtain the information and disclosure contemplated by the securities laws and conformance with accounting principles which have gained general acceptance"

As stated previously, and alluded to in this release, the Commission has cooperated throughout the years of its existence with representatives of the American Institute of Certified Public Accountants, and others, in an endeavor to develop and promote better financial reporting, and a more general acceptance of sound accounting practices. Experience has borne out that the investor, and the public, are best served by this practice, and by the policy of requiring a certificate of independent accountants which expresses an opinion as to the overall fairness of the financial position and operating results reported upon, and the avoidance of prescribing detailed regulations as to accounting methods, practices, or principles. No legislative endorsement of this policy is considered necessary.

For IMMEDIATE Release Wednesday, December 20, 1950

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C.

ACCOUNTING SERIES
Release No. 70
SECURITIES ACT OF 1933
Release No. 3402
SECURITIES EXCHANGE ACT OF 1934
Release No. 4538
INVESTMENT COMPANY ACT OF 1940
Release No. 1550

The Securities and Exchange Commission today announced a general revision of Articles 1, 2, 3, 4, 5 and 11 of Regulation S-X. While amendments and changes pertaining to specific items in the regulation have been made from time to time, this is the first comprehensive amendment since its promulgation in February 1940.

The amended regulation reflects the adoption by the Commission of a number of suggestions made by practicing accountants, professional accounting groups, financial officers of corporations, educators and others to whom drafts of the revision were sent. 1/ The amendment makes it clear also that the several requirements previously expressed in published opinions continue to reflect considered Commission policy. This has been accomplished, to a large extent, by amending Rule 1-01, which now reads, in part, as follows:

> "Rule 1-01 (a). This regulation (together with the Accounting Series Releases) 2/ states the requirements applicable to the form and content of all financial statements required to be filed as part of . . . [applicable statements are listed]."

1/ A preliminary staff draft of the proposed revision was sent to approximately 600 persons on September 21, 1949, and more than 3,000 persons received copies of a second draft dated July 12, 1950, which was published in the Federal Register pursuant to the requirements of the Administrative Procedure Act. Approximately 175 persons commented upon each draft.

2/ The Accounting Series Releases, of which presently there are seventy (70), are obtainable from the Superintendent of Documents, U. S. Government Printing Office, Washington 25, D. C.

The principal new requirement pertains to Profit and Loss or Income Statements and is contained in Rule 5-03 (a) which states:

> "All items of profit and loss given recognition in the accounts during the period covered by the profit and loss or income statements shall be included."

The inclusion of this requirement, which states a long established policy of the Commission 3/, is deemed necessary because of the not always consistent practice followed by some registrants of excluding certain items from the profit and loss or income statements with the result that the amount shown thereon as net income or loss has been susceptible to misinterpretation by investors. Recognizing that there might be exceptional circumstances which would make it appropriate to deviate from this rule, but keeping in mind the Commission's responsibility for prohibiting the dissemination of financial statements which might be misleading to investors, Rule 5-03. Profit and loss or income statements was amended to read:

> "Except as otherwise permitted by the Commission, the profit and loss or income statements filed for persons to whom this article is applicable shall comply with the provisions of this rule." [Underscored phrase added in revision.]

The purpose of this revision is to make clear to registrants that they are not forestalled from giving exceptional treatment to exceptional items when both the representatives of the registrant and the Commission are convinced that such treatment is appropriate.

Notwithstanding this provision, representatives of the Executive Committee of the American Institute of Accountants appeared before the Commission and proposed that either Rule 5-03 (a) be eliminated from the regulation or the requirements with respect to the presentation of the final section of profit and loss or income statements be amended to permit, where appropriate, the exclusion of extraordinary items from those making up the caption Net income or loss.

3/ Attention is directed to the 14th Annual Report, Securities and Exchange Commission, 1948, at page 111, wherein the Commission's views advocating the "all-inclusive" as opposed to the "current operating performance" profit and loss or income statement are expressed. This report is obtainable from the Superintendent of Documents, U. S. Government Printing Office, Washington 25, D. C.

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ARTICLE 1. APPLICATION OF REGULATION S-X

Rule 1-01. Application of Regulation S-X.

(a) This regulation (together with the Accounting Series Releases) states the requirements applicable to the form and content of all financial statements required to be filed as part of--

(1) Registration statements under the Securities Act of 1933, filed on form S-1, S-2, S-3, S-4, S-5, S-6, or S-11, except as otherwise specifically provided in such forms;

(2) Applications for registration of securities under the Securities Exchange Act of 1934, filed on form 8-A, 8-B, 10 or 14;

(3) Supplemental or periodic reports under section 13 of the Securities Exchange Act of 1934 filed on form 8-K, 10-K, 14-K, 16-K, or U5-K;

(4) Supplemental or periodic reports under section 15 (d) of the Securities Exchange Act of 1934, filed on form 2-MD, 4-MD, or U5-MD; and

(5) Registration statements and annual reports under the Investment Company Act of 1940.

(b) The term "financial statements" as used in this regulation shall be deemed to include all supporting schedules.

Rule 1-02. Definitions of Terms Used in Regulation S-X.

Unless the context otherwise requires, terms defined in the General Rules and Regulations or in the instructions to the applicable form, when used in regulation S-X, shall have the respective meanings given in such instructions or rules. In addition the following terms shall have the meanings indicated in this rule unless the context otherwise requires:

Affiliate.--An "affiliate" of, or a person "affiliated" with, a specified person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

Bank holding company.--The term "bank holding company" means a person which is engaged, either directly or indirectly, primarily in the business of owning securities of banks, for the purpose and with the effect of exercising control.

Control.--The term "control" (including the terms "controlling" "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person,

whether through the ownership of voting securities, by contract, or otherwise.

Equity security.--The term "equity security" means any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right.

Fifty-percent owned person.--The term "fifty-percent owned person" means a person in respect of which the registrant owns directly or indirectly approximately 50% of the voting securities and approximately 50% of the voting securities of such person is owned directly or indirectly by another single interest.

Material.--The term "material", when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered.

Majority-owned subsidiary.--The term "majority-owned subsidiary" means a subsidiary more than fifty percent of whose outstanding securities representing the right, other than as affected by events of default, to vote for the election of directors, is owned by the subsidiary's parent and/or one or more of the parent's other majority-owned subsidiaries.

Parent.--A "parent" of a specified person is an affiliate controlling such person directly, or indirectly through one or more intermediaries.

Principal holders of equity securities.--The term "principal holders of equity securities", used in respect of a particular registration statement or report, means the persons named in the item of such statement or report calling for holders of record or beneficial owners of more than 10 percent of any class of equity securities. If the particular statement or report contains no such item, the term means the persons named in the most recent related registration statement, application or report of the registrant which contains such an item.

Registrant.--The term "registrant" means the issuer of the securities for which an application, a registration statement, or a report is filed.

Significant subsidiary.--The term "significant subsidiary" means a subsidiary meeting any one of the following conditions:

(a) The assets of the subsidiary, or the investments in and advances to the subsidiary by its parent and the parent's other

subsidiaries, if any, exceed 15 percent of the assets of the parent and its subsidiaries on a consolidated basis.

(b) The sales and operating revenues of the subsidiary exceed 15 percent of the sales and operating revenues of its parent and the parent's subsidiaries on a consolidated basis.

(c) The subsidiary is the parent of one or more subsidiaries and together with such subsidiaries would, if considered in the aggregate, constitute a significant subsidiary.

Subsidiary.--A "subsidiary" of a specified person is an affiliate controlled by such person directly, or indirectly through one or more intermediaries.

Totally-held subsidiary.--The term "totally-held subsidiary" means a subsidiary (a) substantially all of whose outstanding securities are owned by its parent and/or the parent's other totally-held subsidiaries, and (b) which is not indebted to any person other than its parent and/or the parent's other totally-held subsidiaries in an amount which is material in relation to the particular subsidiary, excepting indebtedness incurred in the ordinary course of business which is not overdue and which matures within one year from the date of its creation, whether evidenced by securities or not.

ARTICLE 2. CERTIFICATION

Rule 2-01. Qualifications of Accountants.

(a) The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the place of his residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of the place of his residence or principal office.

(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will not be considered independent with respect to any person, or any affiliate thereof, in whom he has any financial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

(c) In determining whether an accountant is in fact independent with respect to a particular registrant, the Commission will give appropriate consideration to all relevant circumstances including evidence bearing on all relationships between the accountant and

that registrant or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.

Rule 2-02. Accountants' Certificates.

(a) Technical requirements.--The accountant's certificate shall be dated, shall be signed manually, and shall identify without detailed enumeration the financial statements covered by the certificate.

(b) Representations as to the audit.--The accountant's certificate (i) shall state whether the audit was made in accordance with generally accepted auditing standards; and (ii) shall designate any auditing procedures generally recognized as normal, or deemed necessary by the accountant under the circumstances of a particular case, which have been omitted, and the reaons for their omission.

Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this rule.

(c) Opinions to be expressed.--The accountant's certificate shall state clearly: (i) the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein; (ii) the opinion of the accountant as to any material changes in accounting principles or practices or method of applying the accounting principles or practices, or adjustments of the accounts, required to be set forth by rule 3-07; and (iii) the nature of, and the opinion of the accountant as to, any material differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review.

(d) Exceptions.--Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.

Rule 2-03. Certification by Foreign Government Auditors.

Notwithstanding any requirements as to certification by independent accountants, the financial statements of any foreign governmental agency may be certified by the regular and customary

auditing staff of the respective government, if public financial statements of such governmental agency are customarily certified by such auditing staff.

Rule 2-04. Certification of Financial Statements of Persons Other Than the Registrant.

If a registrant is required to file financial statements of any other person, such statements need not be certified if certification of such statements would not be required if such person were itself a registrant.

Rule 2-05. Certification of Financial Statements by More Than One Accountant.

If, with respect to the certification of the financial statements of any person, the principal accountant relies on an examination made by another independent public accountant of certain of the accounts of such person or its subsidiaries, the certificate of such other accountant shall be filed (and the provisions of rules 2-01 and 2-02 shall be applicable thereto); however, the certificate of such other accountant need not be filed (a) if no reference is made directly or indirectly to such other accountant's examination in the principal accountant's certificate, or (b) if, having referred to such other accountant's examination, the principal accountant states in his certificate that he assumes responsibility for such other accountant's examination in the same manner as if it had been made by him.

ARTICLE 3. RULES OF GENERAL APPLICATION

Rule 3-01. Form, Order, and Terminology.

(a) Financial statements may be filed in such form and order, and may use such generally accepted terminology, as will best indicate their significance and character in the light of the provisions applicable thereto.

(b) All money amounts required to be shown in financial statements may be expressed in even dollars or thousands of dollars, provided that, in the latter case, an indication to that effect is inserted immediately beneath the caption of the statement or schedule, or at the top of each money column. The individual amounts shown need not be adjusted to the nearest dollar or thousand if in a note it is stated that the failure of the items to add to the totals shown is due to the dropping of amounts less than $1.00 or $1,000, as appropriate.

Rule 3-02. Items Not Material.

If the amount which would otherwise be required to be shown with respect to any item is not material, it need not be separately set forth in the manner prescribed.

Rule 3-03. Inapplicable Captions and Omission of Unrequired or Inapplicable Financial Statements.

(a) No caption need be shown in any financial statement as to which the items and conditions are not present.

(b) Financial statements not required or inapplicable because the required matter is not present need not be filed.

(c) Financial statements omitted and the reasons for their omission shall be indicated in the list of financial statements required by the applicable form.

Rule 3-04. Omission of Substantially Identical Notes.

If a note covering substantially the same subject matter is required with respect to two or more financial statements, the required information may be shown in a note to only one of such statements provided that a clear and specific reference thereto is made in each of the other statements with respect to which the note is required.

Rule 3-05. Omission of Names of Certain Subsidiaries.

Notwithstanding the requirements as to particular statements, subsidiaries, the names of which are permitted to be omitted from the list of affiliates required by the applicable form, need not be named in any financial statement. Reasonable grouping of such subsidiaries may be made, with an explanatory group caption which shall state the number of subsidiaries included in the group.

Rule 3-06. Additional Information.

The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. This rule shall be applicable to all statements required to be filed, including copies of statements required to be filed in the first instance with other governmental agencies.

Rule 3-07. Changes in Accounting Principles and Practices and Retroactive Adjustments of Accounts.

(a) Any change in accounting principle or practice, or in the method of applying any accounting principle or practice, made during any period for which financial statements are filed which affects comparability of such financial statements with those of prior or future periods, and the effect thereof upon the net income for each period for which financial statements are filed, shall be disclosed in a note to the appropriate financial statement.

(b) Any material retroactive adjustment made during any period for which financial statements are filed, and the effect thereof upon net income of prior periods shall be disclosed in a note to the appropriate financial statement.

Rule 3-08. Summary of Accounting Principles and Practices.

Information required in notes as to accounting principles and practices reflected in the financial statements may be presented in the form of a single statement. In such case specific references shall be made in the appropriate financial statements to the applicable portion of such single statement.

Rule 3-09. Conversion of Items in Foreign Currencies.

The basis of conversion of all items in foreign currencies shall be stated, and the amount and disposition of the resulting unrealized profit or loss shown.

Rule 3-10. Opening Balances.

Instructions which permit the balance of an account at the beginning of the period for which financial statements are being filed to be "as per the accounts" shall not be applicable with respect to companies which have previously filed financial statements under the Securities Act of 1933 or the Securities Exchange Act of 1934. As to such companies, however, balances as per accounts may be taken as of the close of the most recent period for which certified financial statements are on file.

Rule 3-11. Valuation and Qualifying Reserves.

Valuation and qualifying reserves shall be shown separately in the financial statements as deductions from the specific assets to which they apply.

Rule 3-12. Basis of Determining Amounts--Book Value.

If an instruction requires a statement as to "the basis of determining the amount," the basis shall be stated specifically.

The term "book value" will not be sufficiently explanatory unless, in a particular instruction, it is stated to be acceptable with respect to a particular item.

Rule 3-13. Current Assets.

Items classed as current assets shall be generally realizable within one year. However, generally recognized trade practices may be followed with respect to the inclusion of items such as instalment receivables or inventories long in process, provided an appropriate explanation of the circumstances is made and, if practicable, an estimate is given of the amount not realizable within one year.

Rule 3-14. Current Liabilities.

Items due and payable within one year shall in general be classed as current liabilities. However, generally recognized trade practices may be followed with respect to the exclusion of items such as customers' deposits and deferred income, provided an appropriate explanation of the circumstances is made.

Rule 3-15. Reacquired Evidences of Indebtedness.

Reacquired evidences of indebtedness shall be shown separately as a deduction, under the appropriate liability caption. However, reacquired evidences of indebtedness held for pension and other special funds not related to the particular issues may be shown as assets of such funds, provided that there be stated parenthetically the amount of such evidences of indebtedness, the cost thereof, and the amount at which carried.

Rule 3-16. Reacquired Shares.

Reacquired shares shall be shown separately as a deduction from capital shares, or from the total of capital shares and surplus, or from surplus, at either par or stated value, or cost, as circumstances require.

Rule 3-17. Discount on Capital Shares.

Discount on capital shares, or any unamortized balance thereof, shall be shown separately as a deduction from capital shares or from surplus, as circumstances require.

Rule 3-18. Commitments.

(a) If material in amount the pertinent facts relative to firm commitments for the acquisition of permanent investments and fixed assets and for the purchase, repurchase, construction, or rental of assets under long-term leases shall be stated briefly in the balance sheet or in footnotes referred to therein.

(b) Where the rentals or obligations under long-term leases are material there shall be shown the amounts of annual rentals under such leases with some indication of the periods for which they are payable, together with any important obligation assumed or guarantee made in connection therewith. If the rentals are conditional, state the minimum annual amounts.

Rule 3-19. General Notes to Balance Sheets.

If present in regard to the person for which the statement is filed the following shall be set forth in the balance sheet or in notes thereto:

(a) Assets subject to lien.--The amounts of assets mortgaged, pledged, or otherwise subject to lien shall be designated and the obligations secured shall be briefly identified. However, in the case of commercial, industrial, and public utility companies this rule need not be followed with respect to assets (other than current assets and securities) given as security for bonds, mortgages and similar debt.

(b) Intercompany profits and losses.--The effect upon any balance sheet item of profits or losses resulting from transactions with affiliated companies shall be stated. If impracticable of accurate determination, without unreasonable effort or expense, give an estimate or explain.

(c) Defaults.--The facts and amounts concerning any default in principal, interest, sinking fund, or redemption provisions with respect to any issue of securities or credit agreements, or any breach of covenant of a related indenture or agreement, shall be stated. Notation of such default or breach of covenant shall be made in the balance sheet.

(d) Preferred shares.--

(1) If callable, the date or dates and the amount per share at which such shares are callable shall be stated.

(2) Arrears in cumulative dividends per share and in total for each class of shares shall be stated.

(3) Preferences on involuntary liquidation, if other than the par or stated value, shall be shown. When the excess involved is material there shall be shown (i) the difference between the aggregate preference on involuntary liquidation and the aggregate par or stated value; (ii) a statement that this difference, plus any arrears in dividends, exceeds the sum of the par or stated value of the junior capital shares and the surplus, if such is the case; and (iii) a statement as to the existence, or absence, of any restrictions upon surplus growing out of the fact that upon involuntary liquidation the preference of the preferred shares exceeds its par or stated value.

(e) Pension and retirement plans.--

(1) A brief description of the essential provisions of any employee pension or retirement plan shall be given.

(2) The estimated annual cost of the plan shall be stated.

(3) If a plan has not been funded or otherwise provided for, the estimated amount that would be necessary to fund or otherwise provide for the past service cost of the plan shall be disclosed.

(f) Restrictions which limit the availability of surplus for dividend purposes.--Describe any such restriction, other than as reported in (d) above, indicating briefly its source, its pertinent provisions, and, where appropriate and determinable, the amount of the surplus so restricted.

(g) Contingent liabilities.--A brief statement as to contingent liabilities not reflected in the balance sheet shall be made. In the case of guarantees of securities of other issuers a reference to the appropriate schedule shall be included.

Rule 3-20. General Notes to Profit and Loss Statements.

If present in regard to the person for which the statement is filed, the following shall be set forth in the profit and loss statement or in notes thereto:

(a) Instalment or deferred sales.--If sales are made on a deferred basis, such as instalment sales or sales of equipment long in process of manufacture, the basis of taking profits into income shall be stated.

(b) Intercompany profits and losses.--The amount of any profits or losses resulting from transactions between affiliated companies shall be stated. If impracticable of determination without unreasonable effort and expense, give an estimate or explain.

(c) Depreciation, depletion, obsolescence, and amortization.--State for the period for which profit and loss statements are filed, the policy followed with respect to--

(1) The provision for depreciation, depletion, and obsolescence of physical properties or reserves created in lieu thereof, including the methods and, if practicable, the rates used in computing the annual amounts;

(2) The provision for depreciation and amortization of intangibles, or reserves created in lieu thereof, including the methods and, if practicable, the rates used in computing the annual amounts;

(3) The accounting treatment for maintenance, repairs, renewals, and betterments; and

(4) The adjustment of the accumulated reserves for depreciation, depletion, obsolescence, amortization or reserves in lieu thereof, at the time the properties are retired or otherwise disposed of, including the disposition made of any profit or loss on sale of such properties.

ARTICLE 4. CONSOLIDATED AND COMBINED STATEMENTS

Rule 4-01. Application of Article 4.

This article shall govern the preparation of consolidated and combined statements.

Rule 4-02. Consolidated Statements of the Registrant and Its Subsidiaries.

The registrant shall follow in the consolidated statements principles of inclusion or exclusion which will clearly exhibit the financial condition and results of operations of the registrant and its subsidiaries: Provided, however, That--

(a) The registrant shall not consolidate any subsidiary which is not a majority-owned subsidiary;

(b) If the statements of a subsidiary are as of a date or for periods different from those of the registrant, such subsidiary may be consolidated only if all the following conditions exist: (1) Such difference is not more than 93 days; (2) the closing date of the subsidiary is expressly indicated; (3) the necessity for the use of different closing dates is briefly explained; and (4) any changes in the respective fiscal periods of the registrant and the subsidiary made during the period of report are clearly indicated, together with the manner of treatment;

(c) Consolidation of foreign subsidiaries.--Due consideration shall be given to the propriety of consolidating with domestic corporations foreign subsidiaries whose operations are effected in terms of restricted foreign currencies. If consolidated, disclosure should be made as to the effect, insofar as this can be reasonably determined, of foreign exchange restrictions upon the consolidated financial position and operating results of the registrant and its subsidiaries.

Rule 4-03. Group Statements of Subsidiaries Not Consolidated.

For majority-owned subsidiaries not consolidated with the registrant there may be filed statements in which such subsidiaries

are consolidated or combined in one or more groups pursuant to principles of inclusion or exclusion which will clearly exhibit the financial condition and results of operations of the group or groups. If it is essential to a properly summarized presentation of the facts, such consolidated or combined statement shall be filed.

Rule 4-04. Statement as to Principle of Consolidation or Combination Followed.

(a) The principle adopted in determining the inclusion and exclusion of subsidiaries in each consolidated balance sheet and in each group balance sheet of unconsolidated subsidiaries shall be stated in a note to the respective balance sheet.

(b) As to each consolidated statement and as to each group statement of unconsolidated subsidiaries, a statement shall be made as to whether there have been included or excluded any persons not similarly treated in the corresponding statement for the preceding fiscal period filed with the Commission. If the answer to the foregoing is in the affirmative, the names of such persons shall be given.

Rule 4-05. Reconciliation of Investment of Parent in Subsidiaries and Fifty-Percent Owned Persons and Equity of Parent in Their Net Assets.

(a) Consolidated subsidiaries.--There shall be set forth in a note to each consolidated balance sheet filed a statement of any difference between the investment in subsidiaries consolidated, as shown by the parent's books, and the parent's equity in the net assets of such subsidiaries, as shown by the books of the latter. If any such difference exists, there shall be set forth the amount of the difference and the disposition made thereof in preparing the consolidated statements, naming the balance sheet captions and stating the amount included in each.

(b) Subsidiaries not consolidated.--A statement shall be made of the amount of any difference between the investment of the parent and its consolidated subsidiaries, as shown by their books, in the unconsolidated subsidiaries and fifty-percent owned persons for which statements are filed and the equity of such persons in the net assets of such unconsolidated subsidiaries, and fifty-percent owned persons, as shown by the books of the latter.

Rule 4-06. Reconciliation of Dividends Received From, and Earnings of, Unconsolidated Subsidiaries.

The proportion of the sum of, or difference between, current earnings or losses and the dividends declared or paid by the unconsolidated subsidiaries required to be included in the

schedule prescribed by rule 12-17 that is applicable to the parent and its consolidated subsidiaries shall be set forth in a note to each consolidated profit and loss statement.

Rule 4-07. Minority Interests.

(a) Minority interests in the net assets of subsidiaries consolidated shall be shown in each consolidated balance sheet. Separation shall be made between the minority interest in the capital and in the surplus.

(b) The aggregate amount of profit and loss accruing to minority interests shall be stated separately in each consolidated profit and loss statement.

Rule 4-08. Intercompany Items and Transactions.

In general, intercompany items and transactions shall be eliminated. If not eliminated, a statement of the reasons and the methods of treatment shall be made.

Rule 4-09. Special Requirements as to Insurance Companies.

(a) Except as provided in paragraph (b) of this rule, the statements of an insurance company shall not be consolidated or combined with the statements of any person.

(b) The statements of an insurance company other than a life insurance company may be consolidated if all of the following conditions exist:

(1) The insurance company is a totally-held subsidiary of the top parent included in the consolidation;

(2) Such top parent is not an insurance company, investment company, or bank holding company;

(3) The insurance company engages in no business of a material amount other than the insuring of risks arising in the ordinary course of business of such top parent and its other subsidiaries; and

(4) Separate financial statements for the insurance company are filed.

Rule 4-10. Special Requirements as to Registrants Which Are Bank Holding Companies.

If the registrant is a bank holding company--

(a) Statements of the registrant may be consolidated only with the statements of subsidiaries which are bank holding companies.

(b) A consolidated statement of the registrant and any of its bank holding company subsidiaries shall not be filed unless accompanied by a consolidating statement which sets forth the individual statements of each subsidiary included in the consolidated statement.

(c) Consolidated or combined statements filed for subsidiaries not consolidated with the registrant shall not include any bank holding companies unless accompanied by consolidating or combining statements which set forth the individual statements of each included bank holding company subsidiary.

Rule 4-12. Special Requirements as to Banks.

If two or more majority-owned subsidiaries of a person are banks and are directly owned by a single parent, there shall be filed, in lieu of individual statements for such subsidiaries, combined statements showing the minority interest separately and eliminating any material inter-bank items; except that the statements of any such subsidiary which on the date of filing is a closed or liquidating bank shall not be included in any combined statement. Except as provided in the preceding sentence, statements of banks shall not be included in any consolidated or combined statements.

Rule 4-13. Special Requirements as to Public Utility Holding Companies.

There shall be shown in the consolidated balance sheet of a public utility holding company the difference between the amount at which the parent's investment is carried and the underlying book equity of subsidiaries as at the respective dates of acquisition.

Rule 4-14. Special Requirements as to Commercial, Industrial and Mining Companies in the Promotional, Exploratory or Development Stage Subject to Article 5A.

The financial statements required by Article 5A shall not be prepared on a consolidated basis but shall, insofar as practicable, be prepared so as to show the information for the registrant and each of its subsidiaries in parallel columns.

ARTICLE 5. COMMERCIAL AND INDUSTRIAL COMPANIES

Rule 5-01. Application of Article 5.

(a) This article shall be applicable to financial statements filed for all persons except--

(1) Commercial, industrial, and mining companies in the promotional, exploratory or development stage (see article 5A).

(2) Management investment companies (see article 6).

(3) Unit investment trusts (see article 6A).

(4) Insurance companies other than life and title insurance companies (see article 7).

(5) Committees issuing certificates of deposit (see article 8).

(6) Banks (see article 9, rule 9-05).

(7) Brokers and dealers (see rule and form X-17A-5).

(b) Bank holding companies.--Financial statements and schedules filed for bank holding companies shall be prepared in accordance with this article except that rules 9-01 to 9-04, inclusive, of article 9 shall be applicable thereto.

Rule 5-02. Balance Sheets.

Except as otherwise permitted by the Commission, the balance sheets filed for persons to whom this article is applicable shall comply with the following provisions:

ASSETS AND OTHER DEBITS

Current Assets (see rule 3-13)

1. Cash and cash items.--State separately (a) cash on hand, demand deposits and time deposits; (b) call loans; and (c) funds subject to withdrawal restrictions.

2. Marketable securities.--Include only securities having a ready market. Securities of affiliates shall not be included here. State the basis of determining the amount at which carried. The aggregate cost, and aggregate amount on the basis of current market quotations, shall be stated parenthetically or otherwise.

3. Notes receivable (trade).

4. Accounts receivable (trade).

5. Reserves for doubtful notes and accounts receivable (trade).- Notes and accounts receivable known to be uncollectible shall be excluded from the assets as well as from the reserve accounts.

6. Inventories.--(a) State separately, if practicable, the major classes of inventory such as (1) finished goods; (2) work in process; (3) raw materials; and (4) supplies.

(b) The basis of determining the amounts shall be stated. If a basis such as "cost," "market," or "cost or market whichever is lower" is given, there shall also be given, to the extent practicable, a general indication of the method of determining the "cost" or "market": e.g., "average cost," "first-in, first-out," or "last-in, first-out."

7. Other current assets.--(a) State separately (1) total of current amounts, other than trade accounts subject to the usual trade terms, due from directors, officers, and principal holders of equity securities other than affiliates; (2) total of current amounts due from parents and subsidiaries; and (3) any other amounts in excess of ten percent of total current assets, indicating any such amount due from affiliates other than parents and subsidiaries.

(b) Indebtedness of a parent or subsidiary, or any affiliate designated under (a)(3) shall not be considered as current unless the net current asset position of such person justifies such treatment. In the registrant's balance sheet show separately that indebtedness which in the related consolidated balance sheet is (1) eliminated and (2) not eliminated.

8. Total current assets.

Investments

9. Securities of affiliates.--State the basis of determining the amount. State separately the amounts which in the related consolidated balance sheet are (a) eliminated and (b) not eliminated.

10. Indebtedness of affiliates--not current.--State separately the indebtedness which in the related consolidated balance sheet is (a) eliminated and (b) not eliminated.

11. Other security investments.--State the basis of determining the amount. If available, state parenthetically or otherwise, the aggregate amount on the basis of market quotations.

12. Other investments.--State separately, by class of investments, any items in excess of ten percent of the amount of all assets other than fixed and intangible.

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Fixed Assets

13. Property, plant and equipment.--

(a) State separately, if practicable, each major class, such as land, buildings, machinery and equipment, leaseholds, or functional grouping, and the basis of determining the amounts.

(b) Tangible and intangible utility plant of a public utility company shall be segregated so as to show separately the original cost, plant acquisition adjustments, and plant adjustments, as required by the system of accounts prescribed by the applicable regulatory authorities. This rule shall not be applicable in respect of companies which are not otherwise required to make such a classification or have not completed the necessary original cost studies. If such classification is not otherwise required or if such original cost studies have not been completed, an appropriate explanation of the circumstances shall be set forth in a note which shall include a specific statement as to the status of the original cost studies and, to the extent practicable, the results indicated thereby.

14. Reserves for depreciation, depletion, and amortization of property, plant and equipment (or reserves in lieu thereof).

Intangible Assets

15. Patents, trade marks, franchises, goodwill, and other intangible assets.--State the basis of determining the amounts.

16. Reserves for depreciation and amortization of intangible assets.

Deferred Charges

17. Prepaid expenses and other deferred items.--State separately any material items. Prepayments of services to be received within one year may, however, be included under caption 7.

18. Organization expense.--State the method of amortization, if any.

19. Debt discount and expense.--State the method of amortization.

20. Commissions and expense on capital shares.--State the method of amortization, if any. These items may be shown as deductions from surplus.

Other Assets

21. Other assets.--State separately (a) total of amounts due from directors, officers, and principal holders of equity securities other than affiliates; (b) each pension or other special fund; and (c) any other item in excess of ten percent of the amount of all assets other than fixed and intangible.

LIABILITIES, CAPITAL SHARES, AND SURPLUS

Current Liabilities (see rule 3-14)

22. Notes payable.--State separately amounts payable (a) to banks; (b) to trade; and (c) to others.

23. Accounts payable (trade).

24. Accrued liabilities.--State separately (a) accrued payrolls; (b) tax liability; (c) interest; and (d) any other material items.

25. Other current liabilities.--State separately (a) dividends declared; (b) bonds, mortgages and similar debt; (c) total of current amounts due to parents and subsidiaries, showing separately in the registrant's balance sheet the amounts which in the related consolidated balance sheet are (1) eliminated and (2) not eliminated; (d) total of current amounts, other than items arising in the ordinary course of business, due directors, officers, and principal holders of equity securities other than affiliates; and (e) any other item in excess of ten percent of total current liabilities, indicating any such liability due to affiliates other than parents and subsidiaries. Remaining items may be shown in one amount.

26. Total current liabilities.

Deferred Income

27. Deferred income.

Long-Term Debt

28. Bonds, mortgages and similar debt.--State separately here, or in a note referred to herein, each issue or type of obligation and such information as will indicate (a) the general character of each type of debt including the rate of interest; (b) the date of maturity, or if maturing serially, a brief indication of the serial maturities, such as "maturing serially from 1950 to 1960"; (c) the aggregate amount of maturities, and sinking fund

requirements, each year for the 5 years following the date of the balance sheet; (d) if the payment of principal or interest is contingent, an appropriate indication of such contingency; (e) a brief indication of priority; and (f) if convertible, the basis.

29. Indebtedness to affiliates--Not current.--State separately indebtedness which in the related consolidated balance sheet is (a) eliminated and (b) not eliminated.

30. Other long-term debt.--Include under this caption all amounts of long-term debt not provided for under captions 28 and 29 above. State separately (a) total amounts due banks, (b) total amounts due directors, officers, and principal holders of equity securities other than affiliates and (c) other long-term debt, specifying any material item. Indicate whether secured. Show here, or in a note referred to herein, the information required under caption 28.

Other Liabilities

31. Other liabilities.--State separately any amount in excess of ten percent of the total of liabilities other than long-term debt.

32. Commitments and contingent liabilities.--(See rules 3-18 and 3-19(g).)

Reserves, Not Shown Elsewhere

33. Reserves, not shown elsewhere.--State separately each major class and indicate clearly its purpose.

Capital Shares and Surplus (see rule 3-01(a).)

34. Capital shares.--State for each class of shares the title of issue, the number of shares authorized, the number of shares outstanding and the capital share liability thereof, and, if convertible, the basis of conversion. Show also the dollar amount, if any, of capital shares subscribed but unissued, and of subscriptions receivable thereon.

35. Surplus.--(a) Separate captions shall be shown for (1) paid-in surplus; (2) surplus arising from revaluation of assets; (3) other capital surplus; and (4) earned surplus (i) appropriated and (ii) unappropriated.

(b) If undistributed earnings of subsidiaries are included, state the amount thereof parenthetically or otherwise. However, in a consolidated statement the preceding sentence shall have reference only to the undistributed earnings of subsidiaries not consolidated in such statement.

(c) Subsequent to the effective date of a quasi-reorganization any description of earned surplus shall indicate the point of time from which the new earned surplus dates and for a period of at least three years shall indicate the total amount of the deficit eliminated.

(d) An analysis of each surplus account setting forth the information prescribed in rule 11-02 shall be given for each period for which a profit and loss statement is filed, as a continuation of the related profit and loss statement or in the form of a separate statement of surplus, and shall be referred to here.

Rule 5-03. Profit and Loss or Income Statements.

Except as otherwise permitted by the Commission, the profit and loss or income statements filed for persons to whom this article is applicable shall comply with the provisions of this rule.

(a) All items of profit and loss given recognition in the accounts during the period covered by the profit and loss or income statements shall be included.

(b) Only items entering into the determination of net income or loss may be included.

(c) If income is derived from both gross sales (caption 1A below) and operating revenues (caption 1B below), the two classes may be combined in one amount if the lesser amount is not more than 10 percent of the sum of the two items. If these items are combined, the cost of goods sold (caption 2A below) and operating expenses (caption 2B below) may be combined in one amount.

1A. Gross sales less discounts, returns, and allowances.--State separately, if practicable, (a) sales to parents and subsidiaries and (b) sales to others.

2A. Cost of goods sold.--

(a) State the amount of cost of goods sold as regularly computed under the system of accounting followed. Indicate the amount of opening and closing inventories used in the computation, and state the basis of determining such amounts.

(b) Merchandising organizations, both wholesale and retail, may include occupancy and buying costs under this caption. However, publicity costs shall be included under caption 4 below or shown separately.

1B. Operating revenues.--State separately, if practicable, revenues from (a) parents and subsidiaries and (b) others. A

public utility company using a uniform system of accounts or a form for annual report prescribed by Federal or State authorities, or a similar system or report, shall follow the general segregation of revenues prescribed by such system or report.

2B. Operating expenses.--State separately, if practicable, purchases from and services rendered by (a) parents and subsidiaries and (b) others. A public utility company using a uniform system of accounts or a form for annual report prescribed by Federal or State authorities, or a similar system or report, may follow the general segregation of operating expenses prescribed by such system or report.

3. Other operating expenses.--State separately any material amounts not included in caption 2A or 2B above.

4. Selling, general, and administrative expenses.

5. Provision for doubtful accounts.

6. Other general expenss.--Include items not normally included in caption 4 above. State separately any material amount.

Other Income

7. Dividends.--State separately, if practicable, the amount of dividends from (a) securities of affiliates, (b) marketable securities, and (c) other security investments.

8. Interest on securities.--State separately, if practicable, the amount of interest from (a) securities of affiliates, (b) marketable securities, and (c) other security investments.

9. Profits on securities.--Profits shall be stated net of losses. No profits on the person's own securities, or those of its affiliates, shall be included under this caption. State here or in a note herein referred to the method followed in determining the cost of securities sold, e.g., "average cost," "first-in, first-out," or "identified certificate."

10. Miscellaneous other income.--State separately any material amounts, indicating clearly the nature of the transactions out of which the items arose.

Income Deductions

11. Interest and debt discount and expense.--State separately (a) interest on bonds, mortgages or similar debt; (b) amortization of debt discount and expense or premiums; and (c) other interest.

12. Losses on securities.--Losses shall be stated net of profits. No losses on the person's own securities, or those of its affiliates, shall be included under this caption. State here or in a note herein referred to the method followed in determining cost of securities sold, e.g., "average cost," "first-in, first-out" or "identified certificate."

13. Miscellaneous income deductions.--State separately any material amounts, indicating clearly the nature of the transactions out of which the items arose.

14. Net income or loss before provision for taxes on income.

15. Provision for income and excess-profits taxes.--State separately (a) Federal normal income and excess-profits taxes; (b) other Federal income taxes; and (c) other income taxes.

16. Net income or loss.

17. Special items.--State separately and describe each item of profit and loss given recognition in the accounts, included herein pursuant to rule 5-03(a), and not included in the determination of net income or loss (Item 16).

18. Net income or loss and special items.--

(a) See rule 5-02 (caption 35(d)).

ARTICLE 11. CONTENT OF STATEMENTS OF SURPLUS

Rule 11-01. Application of Article 11.

The article prescribes the content of the statements of surplus specified in rules 5-02 (caption 35) and 7-03 (caption 20).

Rule 11-02. Statement of Surplus. (See rules 5-03 (a) and (b).)

The analysis shall be given as to each class of surplus set forth in the related balance sheet.

1. Balance at beginning of period.--(a) The balance at the beginning of the period of report may be as per the accounts.

(b) If the schedule is filed as part of an annual or other periodic report and the balances at the beginning of the period differ from the closing balances, as filed for the previous fiscal period, state the difference and explain.

2. Net income or loss (or net income or loss and special items) from profit and loss statement.

3. Other additions to surplus.--State separately any material amounts, indicating clearly the nature of the transactions out of which the items arose.

4. Deductions from surplus other than dividends.--State separately any material amounts, indicating clearly the nature of the transactions out of which the items arose.

5. Dividends.--For each class of shares state the amount per share and in the aggregate.

(a) Cash.

(b) Other.--Specify.

6. Balance at close of period.--The balance at the close of the most recent period shall agree with the related balance sheet caption.

The following are the only changes in prescribed schedules reflected in the amended regulation. (Schedules changed as indicated will be included in the printed amended regulation which will be obtainable from the Superintendent of Documents, U. S. Government Printing Office, Washington 25, D. C.)

Rule 5-04. Schedules To Be Filed.

Schedule IX.

Change caption Funded debt to Bonds, mortgages and similar debt.

Schedule XIII.

Change 33 to 34.

ARTICLE 12. FORM AND CONTENT OF SCHEDULES

Rule 12-10. Funded Debt.

Change caption to Bonds, mortgages and similar debt.

Column E. Change "funded debt" to "bonds, mortgages and similar debt."

Rule 12-16. Supplementary Profit and Loss Information.

Column B(1). Change heading to To cost of goods sold (rule 5-03-2A) or operating expenses (rule 5-03-2B) 3/

Note 3. Add, after Other operating expenses, (rule 5-03-3).

Note 4. Substitute material for significant.

Note 5. Substitute material for significant in first and second sentences. Eliminate third and fourth sentences.

The foregoing action shall be effective with respect to financial statements for any fiscal year ending on or after December 31, 1950, filed as a part of any registration statement, application for registration, or report.

By the Commission.

(SEAL)

Orval L. DuBois,
Secretary

December 20, 1950

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For IMMEDIATE Release Monday, February 29, 1960

SECURITIES AND EXCHANGE COMMISSION
Washington 25, D. C.

SECURITIES ACT OF 1933
Release No. 4191
SECURITIES EXCHANGE ACT OF 1934
Release No. 6189
HOLDING COMPANY ACT
Release No. 14173
INVESTMENT COMPANY ACT OF 1940
Release No. 2977
ACCOUNTING SERIES
Release No. 85

STATEMENT OF ADMINISTRATIVE POLICY REGARDING BALANCE SHEET TREATMENT OF CREDIT EQUIVALENT TO REDUCTION IN INCOME TAXES

On December 30, 1958, in Securities Act Release No. 4010 1/ the Commission gave notice of its intention to announce a statement of administrative policy regarding the balance sheet treatment, in financial statements filed with the Commission, of the credit equivalent to the reduction of income taxes arising from the deduction of costs for income tax purposes at a more rapid rate than for financial statement purposes. Comments and views thereon were submitted and oral presentation before the Commission was made by interested persons on April 8 and 10, 1959.

Under various statutes administered by it, the Commission has the authority and the corresponding responsibility to require that the financial statements filed with it be prepared in a manner which provides adequate and fair disclosure. This statement of policy is designed to advise all interested persons of the Commission's views as to the presentation in financial statements filed with the Commission of the credit arising when deferred tax accounting is employed. It pertains to the propriety of designating as earned surplus (or its equivalent) or in any manner as a part of equity capital, in financial statements filed with this Commission, the accumulated credit arising from accounting for reductions in income taxes for various items, including those under Section 167 (liberalized depreciation) and Section 168 (accelerated amortization of emergency facilities) of the Internal Revenue Code of 1954. It is not intended to direct or establish any system of accounts or to specify the manner in which a particular item shall be recorded on the books of the reporting companies, nor is it intended in any way to affect the requirements of any other governmental agency, federal or

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1/ This was also issued as Securities Exchange Act Release No. 5844; Holding Company Act Release No. 13894; and Investment Company Act Release No. 2814. It was also published in 24 Federal Register 271 and bears Federal Register Document No. 59-243.

state, with respect to the manner in which such books of account shall be kept. 2/

The problem arises from the deduction of costs for income tax purposes at a faster rate than for financial statement purposes where the difference is material. The amount of income tax payable for any period is affected by the amount of costs deducted in determining taxable income. In a year in which costs are deducted for tax purposes in amounts greater than those used for financial statement purposes, then, unless corrected, there is a failure properly to match costs and revenues in the financial statements by the amount of the tax effect of the cost differential. To correct the resultant distortion in periodic net income after taxes, it is therefore necessary to charge income in earlier years with an amount equal to the tax reduction and to return this amount to income in subsequent years when the amount charged for financial statement purposes exceeds the amount deducted for tax purposes. 3/ It is our understanding

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2/ Representatives of companies subject to the jurisdiction of the Commission under the Public Utility Holding Company Act of 1935 as registered holding companies or subsidiary companies thereof have contended that this Commission has no power to prescribe the manner in which the accumulated credit arising from deferred tax accounting should be classified in the accounts of the company. In support of this contention, reference was made to Section 20(b) of that Act. That section provides that "in the case of the accounts of any company whose methods of accounting are prescribed under the provisions of any law of the United States or of any State, the rules and regulations or orders of the Commission in respect of accounts shall not be inconsistent with the requirements imposed by such law or any rule or regulation thereunder; . . ." /emphasis supplied/ For reasons stated above, this contention misconceives the nature of the action herein taken.

In this connection the Commission today modified Rule 28 promulgated under the Public Utility Holding Company Act of 1935 (17 CFR 250.28) so as to conform the language of that rule with the policy here announced. Rule 28 provided, so far as is here pertinent, that no registered holding company or subsidiary thereof could publish financial statements inconsistent with its book accounts. The rule as modified provides, in effect, that a registered holding company or subsidiary thereof need not conform its published financial statements with its book accounts where such deviation is authorized or required by this Commission by rule, regulation, order, statement of administrative policy, or otherwise. (Holding Company Act Release No. 14172)

3/ Since the deferral is made for the purpose of allocating to future periods the effect on income of the current tax reduction, it is not contemplated that the portion returned to income will exactly offset the increased tax to be paid in future years. The amount of additional taxes payable in future years may vary from the reduction obtained earlier because of changes in the tax rates or because of failure to earn taxable income corresponding to the tax reduction previously taken.

that such deferred tax accounting is in accordance with generally accepted accounting principles. 4/

With specific reference to depreciation, since the total deduction allowed over the life of an asset is limited to its cost and hence is not affected by the method by which it is deducted from income, acceleration of tax deductions in earlier years results in deferring to later years the payment of taxes on an amount equivalent to the cost differential. 5/ Because of the interrelationship between income taxes and depreciation, the Commission is of the view that in the earlier years the charge equivalent to the tax reduction should be treated either (1) as a provision for future taxes in the income statement with a corresponding credit in the balance sheet to a non-equity caption such as a deferred tax credit, 6/ or (2) as additional depreciation in the income

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4/ Accounting Research Bulletins issued by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants: No. 42, November 1952; No. 43, June 1953, Chs. 9c and 10b; No. 44, October 1954; No. 44 (Revised), July 1958.

An exception to this practice is stated in paragraph 8 of Accounting Research Bulletin No. 44 (Revised), which provides that:

> "Many regulatory authorities permit recognition of deferred income taxes for accounting and/or rate-making purposes, whereas some do not. The committee believes that they should permit the recognition of deferred income taxes for both purposes. However, where charges for deferred income taxes are not allowed for rate-making purposes, accounting recognition need not be given to the deferment of taxes if it may reasonably be expected that increased future income taxes, resulting from the earlier deduction of declining-balance depreciation for income-tax purposes only, will be allowed in future rate determinations."

It is the understanding of this Commission that the exception recognizes the position of those regulatory agencies which permit public utilities to deduct only the actual taxes payable in a given year, and the Commission raises no question as to the propriety of the exception.

5/ Where there is no difference between the amount of cost deducted for income taxes and the amount deducted for financial statement purposes, such as where declining-balance depreciation is taken both for tax and financial statement purposes, there is, of course, no occasion for deferred tax accounting.

6/ This would not prohibit companies from utilizing in financial statements filed with this Commission the balance sheet captions and classification of deferred taxes prescribed by the Federal Power Commission in its Orders Nos. 203 and 204, Dockets Nos. R-158 and R-159,

/continued/

statement with a corresponding addition to the accumulated provision for depreciation in the balance sheet. 7/ In the Commission's view it is improper to charge income with an item required for the proper determination of net income and concurrently to credit earned surplus.

A number of comments indicated that, should the Commission take the foregoing position, it should be limited to matters connected with depreciation and amortization or, if not so limited, any additional items embraced within this principle should be clearly specified. It is the Commission's view, however, that comparable recognition of tax deferment should be made in all cases in which there is a tax reduction resulting from deducting costs for tax purposes at faster rates than for financial statement purposes. 8/

The Committee on Accounting Procedure of the American Institute of Certified Public Accountants agrees with the position expressed above. Accounting Research Bulletin No. 44 (Revised) states, in connection with the deduction of depreciation for income tax purposes at a more rapid rate than for financial accounting purposes, that the accounting company should employ deferred tax accounting and that it is "alternatively appropriate, instead of crediting a deferred tax account, to recognize the related tax effect as additional amortization or depreciation applicable to such assets in recognition of the loss of future deductibility for income-tax purposes." A difference of opinion arose among certifying accountants whether the language of this bulletin permitted the deferred tax account to be classified as earned surplus restricted for future income taxes. To resolve the controversy, the Committee on Accounting Procedure sent a letter dated April 15, 1959, to all members of the Institute in which it clarified the bulletin on the point. The pertinent portion of the letter reads:

6/ /continued/ respectively, issued May 29, 1958. Nor has there been called to the Commission's attention the provisions of any law of the United States or any rule or regulation thereunder prescribing methods of accounting which would prohibit any companies from following, in reports filed with us pursuant to the Securities Exchange Act of 1934, the balance sheet treatment set forth herein. See Section 13(b) of that Act.

7/ In either case there should be an appropriate explanation with disclosure of the amounts involved.

8/ This is, of course, subject to the general qualification under our rules that the amounts in question are material. The term "material," when used to qualify a requirement for the furnishing of information as to any subject, unless the context of a provision in a form otherwise requires, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before buying or selling the security registered. (See the rules and regulations under certain of the pertinent Acts: 17 CFR 230.405; 17 CFR 240.12b-2; 17 CFR 270.8b-2.)

> "Question has been raised with respect to the intent of the committee on accounting procedure in using the phrase 'a deferred tax account' in Accounting Research Bulletin No. 44 (revised), Declining-balance Depreciation, to indicate the account to be credited for the amount of the deferred income tax (see paragraphs 4 and 5).
>
> "The committee used the phrase in its ordinary connotation of an account to be shown in the balance sheet as a liability or a deferred credit. A provision in recognition of the deferral of income taxes, being required for the proper determination of net income, should not at the same time result in a credit to earned surplus or to any other account included in the stockholders' equity section of the balance sheet." 9/

While some accounting firms that appeared before the Commission urged that it was appropriate to designate as a part of earned surplus the credit arising from deferred tax accounting despite the opinion of the Committee on Accounting Procedure, the Commission disagrees. Moreover, the fact that there may be some authoritative support for different methods of classifying this deferred tax account does not preclude the Commission from determining for the future the manner in which the item should be classified in financial statements filed with it. In fact, as enunciated by the Commission in Accounting Series Release No. 4, dated April 25, 1938, the question of authoritative support is pertinent only where the position of the Commission has not previously been published in official releases. 10/

Arguments have been advanced, particularly on behalf of public utility companies, to the effect that from analytical and rate-making viewpoints the treatment prescribed herein might have undesirable results upon investors and consumers. However, it is entirely appropriate that regulatory agencies treat the accumulated credit arising from

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9/ It may be noted that 18 of the 21 members of the Committee approved the letter. The three who did not merely dissented to the issuance at that time of any letter interpreting the bulletin.

10/ That release provided in pertinent part:

> "In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant."

deferred tax accounting in whatever manner they deem most relevant to their purposes. 11/

Some of the comments on Release No. 4010 questioned the authority of the Commission to deal with the subject of this release. But these comments apparently fail to recognize that a statement of administrative policy is merely an announcement of the manner in which the Commission intends to enforce the statutes which it administers. Publication of a statement of administrative policy such as this is in accord with long-established Commission practice expressed in Accounting Series Release No. 4, quoted above. Although the Commission is of the view that there is ample authority for it to adopt specific rules as to the form and content of financial statements filed with it with respect to the subject of this release, 12/ it is, instead, hereby announcing that, since any requirement in the statutes it administers calling for the filing of financial statements contemplates that they not be misleading or inaccurate, the filing with it of such statements which do not conform to the policy expressed herein would require appropriate action to be taken by the Commission. 13/

11/ So far as this Commission is concerned, since it believes that classifying the item as a component part of common stock equity is misleading for financial statement purposes, it does not intend to consider the item as a part of common stock equity for analytical purposes, although it may give consideration to the item as one of a number of relevant factors in appraising the overall financial condition of a company. The Commission, of course, does not have jurisdiction over rate-making, although under the Public Utility Holding Company Act of 1935 it is concerned with the interests of consumers. Alleged adverse results as to investors and consumers are no different from those complained of whenever any requirement designed to assure financial stability is imposed.

12/ See, e.g., Section 19(a) and paragraphs 25 and 26 of Schedule A of the Securities Act of 1933; Sections 12, 13, and 23 of the Securities Exchange Act of 1934; Sections 5(b)(2), 7(a), 10(a), 14, and 20(a) of the Public Utility Holding Company Act of 1935; and Sections 30 and 38 of the Investment Company Act of 1940.

13/ For example, in connection with applications filed under Section 6(b) or declarations filed under Section 7 of the Public Utility Holding Company Act of 1935, where the financial statements do not conform to the policy expressed herein, the Commission would presumably condition any order granting the application or permitting the declaration to become effective so as to require that such financial statements do so conform.

For the foregoing reasons, on and after the effective date of this statement of administrative policy, any financial statement filed with this Commission which designates as earned surplus (or its equivalent) or in any manner as a part of equity capital (even though accompanied by words of limitation such as "restricted" or "appropriated") the accumulated credit arising from accounting for reductions in income taxes resulting from deducting costs for income tax purposes at a more rapid rate than for financial statement purposes will be presumed by the Commission to be misleading or inaccurate despite disclosure contained in the certificate of the accountant or in footnotes to the statements, provided the amounts involved are material.

This statement of administrative policy shall become effective on April 30, 1960.

By the Commission.

Orval L. DuBois
Secretary

February 29, 1960

For IMMEDIATE Release Tuesday, April 12, 1960

SECURITIES AND EXCHANGE COMMISSION
Washington 25, D. C.

ACCOUNTING SERIES
Release No. 86
SECURITIES ACT OF 1933
Release No. 4206
SECURITIES EXCHANGE ACT OF 1934
Release No. 6233
HOLDING COMPANY ACT
Release No. 14209
INVESTMENT COMPANY ACT OF 1940
Release No. 3010

RESPONSE TO COMMENT ON STATEMENT OF ADMINISTRATIVE POLICY REGARDING BALANCE SHEET TREATMENT OF CREDIT EQUIVALENT TO REDUCTION IN INCOME TAXES

The Securities and Exchange Commission today made public a letter sent by its Chief Accountant, Andrew Barr, to Mr. Carman G. Blough, Director of Research, American Institute of Certified Public Accountants, in response to his comment on this Commission's Statement of Administrative Policy Regarding Balance Sheet Treatment of Credit Equivalent to Reduction in Income Taxes published February 29, 1960. The text of the letter follows:

"The Commission has authorized me to respond to your letter in which you express concern over the wording of the last sentence in the first full paragraph on page 4 and the first sentence of the paragraph immediately following it in Securities Act of 1933 Release No. 4191 (also identified as Securities Exchange Act of 1934 Release No. 6189, Holding Company Act Release No. 14173, Investment Company Act of 1940 Release No. 2977, and Accounting Series Release No. 85). The full paragraph to which you refer and the following sentence read as follows:

> 'A number of comments indicated that, should the Commission take the foregoing position, it should be limited to matters connected with depreciation and amortization or, if not so limited, any additional items embraced within this principle should be clearly specified. It is the Commission's view, however, that comparable recognition of tax deferment should be made in all cases in which there is a tax reduction resulting from deducting costs for tax purposes at faster rates than for financial statement purposes. (Footnote omitted.)
>
> 'The Committee on Accounting Procedure of the American Institute of Certified Public Accountants agrees with the position expressed above.'

"It was not the Commission's intention by the publication of this release, stating an administrative policy regarding balance sheet treatment of the credit equivalent to the reduction in income taxes when deferred tax accounting is employed, to make mandatory the use of deferred tax accounting beyond the requirements of generally accepted accounting principles."

For IMMEDIATE Release Tuesday, April 12, 1960

SECURITIES AND EXCHANGE COMMISSION
Washington 25, D. C.

ACCOUNTING SERIES
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>
> 'The Committee on Accounting Procedure of the American Institute of Certified Public Accountants agrees with the position expressed above.'

"It was not the Commission's intention by the publication of this release, stating an administrative policy regarding balance sheet treatment of the credit equivalent to the reduction in income taxes when deferred tax accounting is employed, to make mandatory the use of deferred tax accounting beyond the requirements of generally accepted accounting principles."

For RELEASE Friday, December 28, 1962

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C.

SECURITIES ACT OF 1933
Release No. 4566
SECURITIES EXCHANGE ACT OF 1934
Release No. 6982
ACCOUNTING SERIES
Release No. 95

ACCOUNTING FOR REAL ESTATE TRANSACTIONS WHERE CIRCUMSTANCES INDICATE THAT PROFITS WERE NOT EARNED AT THE TIME THE TRANSACTIONS WERE RECORDED

A number of recent cases have come to the attention of the Commission in which the gross profits on certain real estate transactions were taken into income under circumstances which indicate that they were not realized in the period in which the transactions were recorded.

The recognition of profit at the time of sale, in accordance with generally accepted accounting principles, is appropriate if it is reasonable to conclude, in the light of all the circumstances, that a profit has been realized. "Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured." 1/ Thus, recognition of profit is appropriate only when a bona fide sales transaction has taken place, and then only to the extent that the consideration received in the transaction can be reasonably evaluated.

In some of the situations coming before us it appears from the attendant circumstances that the sale of property is a mere fiction designed to create the illusion of profits or value as a basis for the sale of securities. Moreover, even in bona fide transactions the degree of uncertainty as to ultimate realization of profit may be so great that business prudence, as well as generally accepted accounting principles, would preclude the recognition of gain at the time of sale. Circumstances such as the following tend to raise a question as to the propriety of current recognition of profit:

1. Evidence of financial weakness of the purchaser.

2. Substantial uncertainty as to amount of costs and expenses to be incurred.

3. Substantial uncertainty as to amount of proceeds to be realized because of form of consideration or method of settlement; e.g., nonrecourse notes, non-interest-bearing notes, purchaser's stock, and notes with optional settlement provisions, all of indeterminable value.

1/ Accounting Research Bulletin No. 43, Chapter 1, Section A, American Institute of Certified Public Accountants.

4. Retention of effective control of the property by the seller.

5. Limitations and restrictions on the purchaser's profits and on the development or disposition of the property.

6. Simultaneous sale and repurchase by the same or affiliated interests.

7. Concurrent loans to purchasers.

8. Small or no down payment.

9. Simultaneous sale and leaseback of property.

Any such circumstance, taken alone, might not preclude the recognition of profit in appropriate amount. However, the degree of uncertainty may be accentuated by the presence of a combination of the foregoing factors. In the following illustrative cases, taken from recent filings, the Commission deemed it inappropriate to recognize gross profit as recorded as having been realized at the time of sale.

Case No. 1

On the last day of its fiscal year a registrant engaged principally in the development of real estate sold a block of 1,000 lots to a non-affiliated construction company for $1,100,000, receiving a cash payment of $100,000 and a nonrecourse note of $1,000,000 due in one year, secured only by the lots transferred. Interest was limited to 6% for one year or $120 per house. A profit of $500,000 before taxes was recorded on the transaction.

The transaction was subject to, among others, the following conditions and arrangements:

a. Each lot was to be released upon payment of $1,000 plus interest at the time of closing the sale of a house and lot.

b. The registrant was to make the determination of when the houses were to be constructed and to arrange the construction loans.

c. The registrant was to be exclusive sales agent for the construction company, arrange financing and conduct closings with the home buyers.

d. The construction company was to be paid a maximum of $500 profit and an additional $100 to cover overhead expenses on each house sold. Profits to be received by the construction company were to be applied against the note owed to the registrant.

Case No. 2

In September 1961 a registrant sold a block of improved properties to another corporation for consideration of $3,500,000 in cash, a $3,500,000 non-interest-bearing note, and 50,000 shares of the Class A stock of the purchaser which had a current market price of $15 per share. This sale was recorded at these amounts and showed a gain of $2,000,000 after provision of $500,000 for possible loss and $1,000,000 for Federal income taxes. The non-interest-bearing note is payable during the period from 1970 to 1980. Until 1968 the purchaser has the option of liquidating the note by the issuance of capital stock, the number of shares to be determined by dividing the face amount of the note, $3,500,000, by the lesser of $15 per share or 125% of the then current market price. After 1968 registrant may call for payment of the note in stock at $17 per share, and, if such call is made, the purchaser may elect to pay the note in full in cash.

Case No. 3

In September 1961 a registrant acquired approximately 500 acres of undeveloped land for $300,000 in cash and a mortgage of $900,000 and immediately sold the property to an affiliate of the original seller for $2,200,000. The purchaser paid $300,000 in cash, issued a $1,000,000 non-interest-bearing deed of trust note maturing in 18 months, and assumed the $900,000 mortgage. Simultaneously the registrant loaned $1,000,000 to the purchaser on a 6% note maturing in 18 months and made a commitment to loan an additional $1,000,000. Registrant recorded a gross profit of $1,000,000 against which a reserve for possible loss in the amount of $260,000 was provided.

Case No. 4

In June 1961 a registrant purchased 20,000 acres of undeveloped land for $1,000,000 cash and a 5% note for $3,000,000. Simultaneously, the registrant sold the property to another company for a $2,000,000 non-interest-bearing deed of trust note payable in installments of $1,000,000 in June 1962, $500,000 in June 1963, and $500,000 in June 1964, and for the assumption by the purchaser of the $3,000,000 first lien note. A gross profit on the sale of $1,000,000 was recorded and a reserve of $400,000 was provided for a possible loss.

Case No. 5

A registrant purchased a tract of land for a cash payment of $100,000 and a 10-year nonrecourse non-interest-bearing note in the amount of $800,000 with annual maturities of $80,000. On the same date the land was sold to a non-affiliated group for a cash payment of $15,000 and a nonrecourse non-interest-bearing purchase money note for $1,785,000. The latter obligation requires annual payments of approximately $100,000 for seven years and a payment of approximately $1,100,000 at the end of the eighth

year. At the time of the sale the registrant also advanced to the purchaser $350,000 for use in advertising. The proceeds from the sales of land by the purchaser are assigned to the registrant until the $350,000 advance is paid. The registrant recorded a profit of $900,000 at the date of sale.

Case No. 6

Shortly before the close of its fiscal year a registrant recorded the sale of a block of 150 lots for a total consideration of $375,000. Cash of $75,000 was paid on the settlement date and the purchaser then took title to 30 lots. The balance of the consideration consisted of four notes of $75,000 each bearing interest at 5% per annum, due 6, 12, 18, and 24 months after settlement. The purchaser was to take title to 30 lots at the time of settlement of each note. The notes were secured only by a mortgage on the property, and there was no personal liability on the purchaser to complete the payments. In a registration statement filed shortly after the close of the fiscal year this transaction was recorded as a sale in the total amount of $375,000 with an indicated gross profit of $44,000 on the uncollected portion after provision for deferred taxes of $47,000.

Case No. 7

In early 1960 a registrant sold to an unaffiliated purchaser a manufacturing plant and another building used in its operations for a total consideration of $1,500,000 reflecting a profit of $600,000 after taxes. The consideration was realized in the form of cash and assumption of an existing mortgage. The seller simultaneously leased these same properties back at an annual rental of $160,000 for a period of 25 years. The registration statement as effective reported the profit as deferred and to be amortized against rental payments over the life of the leases.

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For RELEASE Thursday, January 10, 1963

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C.

SECURITIES ACT OF 1933
Release No. 4574
SECURITIES EXCHANGE ACT OF 1934
Release No. 6990
HOLDING COMPANY ACT OF 1935
Release No. 14787
INVESTMENT COMPANY ACT OF 1940
Release No. 3611
ACCOUNTING SERIES
Release No. 96

ACCOUNTING FOR THE "INVESTMENT CREDIT"

In view of the extensive public discussion of the accounting for the investment credit provided in the Revenue Act of 1962 and the fact that the Accounting Principles Board of the American Institute of Certified Public Accountants has concluded that the investment credit should be reflected in income over the productive life of acquired property, 1/ the Securities and Exchange Commission deems it appropriate to respond to inquiries with respect to the application of the Commission's accounting and disclosure requirements to this matter.

In Accounting Series Release No. 1, published April 1, 1937, the Commission announced a program for the purpose of contributing to the development of uniform standards and practice in major accounting questions. Accounting Series Release No. 4 recognizes that there may be sincere differences of opinion between the Commission and the registrant as to the proper principles of accounting to be followed in a given situation and indicates that, as a matter of policy, disclosure in the accountant's certificate and footnotes will be accepted in lieu of conformance to the Commission's views only if such disclosure is adequate and the points involved are such that there is substantial authoritative support for the practice followed by the registrant, and then only if the position of the Commission has not been expressed previously in rules, regulations, or other official releases of the Commission, including the published opinions of its Chief Accountant. This policy is intended to support the development of accounting principles and methods of presentation by the profession but to leave the Commission free to obtain the information and disclosure contemplated by the securities laws and conformance with accounting principles which have gained general acceptance.

In recognition of the substantial diversity of opinion which exists among responsible persons in the matter of accounting for the investment credit, the Commission will accept either a method which reflects the investment credit in income over the productive life of the acquired property or a method which reflects 48% of the investment credit (the

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1/ Opinion No. 2, Accounting for the "Investment Credit."

maximum extent to which the credit can normally increase net income) in income as a reduction of the tax expense of the year in which the credit arises and defers the balance of 52% to subsequent accounting periods during which depreciation allowances for tax purposes are reduced because the statutory requirement reduces the basis of the property for tax purposes by the amount of the investment credit. The amount of such deferral should be segregated from taxes currently payable. The 100% flow-through to income of the investment credit benefit in the year in which it arises will be accepted in the case of regulated industries when authorized or required by regulatory authorities. In all cases full disclosure of the method of accounting followed and amounts involved should be made where material.

In any case it is the Commission's opinion that the full cost of the property should be reported and that the credit should not be made directly to the asset account. Income tax expense should not be stated in excess of the amount payable for the year. No objection will be taken to the recording of additional depreciation equal to the amount of the deferral arising from the above methods of accounting for the investment credit. The amounts involved should be segregated at least in the appropriate notes and schedules required by our accounting regulations.

The certification rules of the Commission require that the accountant's certificate shall state clearly the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein. The term "accounting principles and practices" should be read in the light of the discussion of broad principles and practices in the booklet "Audits of Corporate Accounts," 2/ which was recognized as a significant guide to the profession at the time of drafting our original accounting and certification requirements.

2/ This booklet consists of a series of letters passing between the Institute's special committee on cooperation with stock exchanges and the committee on stock list of the New York Stock Exchange during the years 1932-1934 with a view to making the accounts published by corporations more informative. This endeavor resulted in the demonstration that certain accounting principles were so generally accepted that they should be followed by all listed companies, the adoption of these principles as rules by the American Institute of Accountants membership, the requirement by the New York Stock Exchange that certified financial statements be included in all listing applications, and the development of an accountant's certificate which would be more informative and more clearly understood by investors and which is substantially the same as the certificate in general use today.

A note to the booklet states that a letter expressing the recommendations of the American Institute of Accountants committee was placed in evidence "in a hearing before the United States senate committee on banking and currency January 12, 1933."

It is recognized that an accountant who certifies to financial statements reflecting a method of reporting contrary to the majority opinion of the Accounting Principles Board is assuming the burden of justifying departure from the recommended procedure and must take into consideration whether he is departing from an accepted procedure and consequently whether he must qualify his certificate with respect to the fairness of the presentation in the financial statements or to a departure from generally accepted accounting principles and practices. In the usual case where an accountant takes exception to a principle or practice followed, the amount involved is material. In view of the substantial diversity of opinion as to the proper method of accounting for the investment credit, if an accountant deems it necessary to qualify his opinion under various circumstances the Commission will accept certificates containing appropriately worded qualifications in accordance with Rule 2-02 (d) of Regulation S-X when an alternative accounting treatment acceptable to the Commission is followed by the registrant.

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Mr. STAGGERS. We are coming close to the conclusion of our hearing and the gentleman from Michigan on my right has another question that he would like to ask before we close the hearing.

Mr. DINGELL. Mr. Cary, referring again to the section that I have been discussing with you, how do you propose to administer this section to protect the American investor?

Mr. CARY. This is the foreign security?

Mr. DINGELL. Foreign securities.

Now, Mr. Cary, I asked you this question; I would like to have you answer it.

Mr. CARY. Yes, sir; but the area of foreign securities is one which I have personally not dealt with in private practice and is a very tough field. Therefore, I rely on other people in large part on that particular subject. Therefore, I simply cannot give you in my opinion a responsible answer alone on this subject.

Mr. DINGELL. Who can give us the answer briefly, if you please?

Mr. CARY. I will have Mr. Loomis start off. All three on my left side are the ones in the Commission who are the experts in this field.

Mr. LOOMIS. First, of course, it would be necessary to make a determination as to whether there was a trading market in the security and whether American investors were really interested in it. Assuming that they appeared to be, you would then have to make a determination as to whether or not there was any way in which you could make the issuer of that security, who has no concern with the trading market here, file proxy statements, inside trading reports, and so forth.

If it appeared that you could enforce compliance, you would, of course, do so. If it appeared that it was impossible to enforce compliance, then you would have to reach a judgment as to whether the American investors who owned that security or who might deal in it would be better off to have a trading market available to them without this disclosure or whether it would be better to sort of cut off that market, and that would depend to some degree on the degree of interest and the facts in the case.

Mr. DINGELL. Now does this bill deal with equity securities? Does this section deal with equity securities?

Mr. LOOMIS. Yes, sir.

Mr. DINGELL. You have not been discussing equity securities then, have you?

Mr. LOOMIS. I would think so. Our power to reach foreign countries does not depend on whether it is an equity security or a debt security.

Mr. DINGELL. Essentially you are saying, then, that you would have to decide whether or not you were going then to exempt them from the provisions of the act? Isn't that really what you are saying with regard to section 15(b)?

Mr. LOOMIS. I thought you were talking about the——

Mr. DINGELL. In your administration you are saying essentially what you are going to have to do is determine whether you are going to exempt from the provisions of law.

Mr. LOOMIS. From provisions 13, 14, and 16.

Mr. DINGELL. This is going to be the determination you are going to make before you move further?

Mr. LOOMIS. Well, they would be exempt under this statute from 13, 14, and 16 until the Commission moved in and took it away from them but the determination you make is the same either way, should they be exempt or should they not be.

Mr. DINGELL. This is the point I am making, that you will make a determination as to whether they should be exempt or not.

Mr. LOOMIS. Yes.

Mr. DINGELL. This is what you are doing?

Mr. LOOMIS. Yes.

Mr. DINGELL. Is making a determination of whether they are going to be exempt or not, but in this have you imposed the burden of proving essentially upon the Commission under these cases as opposed to placing the burden upon the issuer of the foreign securities, upon the person who wishes to market them in this country, isn't this correct? The burden you have placed upon the Commission as opposed to placing it upon the issuers and the others interested in the security?

Mr. LOOMIS. Yes; the burden is on the Commission rather than the persons interested in the security. It has been pointed out earlier when you get an issuer bringing in a new issue the problem is entirely different. This section is concerned with the trading markets in outstanding securities.

Mr. DINGELL. I understand, but the burden you place upon the Commission and not upon the individual, although essentially you have indicated to me you would proceed as if you were determining whether or not to grant an exemption. This is what you have already told me.

Mr. LOOMIS. I think it would be very similar. I don't think this is a situation—we are not in court where the burden of proof is too significant.

Mr. DINGELL. Let me ask you this, then: I assume Mr. Cary is capable of answering this question, too. Do you gentlemen feel it is the function of the SEC to facilitate marketing of the foreign securities in this country?

Mr. LOOMIS. No. We are not dealing with the marketing of foreign securities in this country; we are dealing with markets that are already here trading securities.

Mr. DINGELL. Let us put it in the affirmative, and say you do not feel, then, it is a function of the SEC to facilitate the marketing of foreign securities.

Mr. CARY. Either way I would think on that because the marketing of foreign securities would be the issuance and this would be where the 1933 act would become applicable.

Mr. DINGELL. Just speaking in the abstract, is it not the responsibility of the SEC under the act to facilitate the marketing of securities of foreign companies?

Mr. CARY. Simply to make the information available to the buyer.

Mr. DINGELL. And the real function of the SEC with regard to foreign securities is to protect the American investor?

Mr. CARY. That is correct.

Mr. DINGELL. Now I notice that there are certain exemptions for the securities in the International Bank and that some time ago you proposed a rule which you later withdrew after hearings by the committee. Am I correct?

Mr. CARY. Yes, sir.

Mr. COHEN. May I speak to that?

Mr. CARY. Mr. Cohen is in my bailiwick.

Mr. DINGELL. Mr. Cohen, as briefly as you can put it.

Mr. COHEN. This was a rule which would relate to a situation under which the Bank having acquired the securities of certain foreign governments or foreign government guaranteed securities proposed to distribute or sell part of its portfolio to others. The issue there was whether or not we could write a rule which would define as precisely as possible such activities by the Bank which would not amount to an underwriting or a public distribution subject to the 1933 act.

Mr. DINGELL. In other words, how the Bank could get around the 1933 act.

Mr. COHEN. I would not say get around.

Mr. DINGELL. How it could escape coverage.

Mr. COHEN. No, we are not talking about the Bank security because the Bank does have to file with the Commission.

Mr. DINGELL. Talking about the provisions of the 1933 act with reference to the Bank offering the securities.

Mr. COHEN. The present law now provides that an investor having acquired securities, not being the issuer or in control of the issuer may normally dispose of those securities absent registration. The Bank claims to be in this position generally. However, with respect to certain of its activities the Commission didn't quite agree with the Bank so the Bank determined that it would limit its activities in this area of redistribution so as to confine it to what might be called a private offering area not involving a public distribution.

Mr. DINGELL. And by offering as a private offering they escape certain provisions of the 1933 act.

Mr. COHEN. If it were the private offering, registration would not be required for the securities of the foreign issuer or the foreign government.

Mr. DINGELL. It sounds to me, Mr. Cohen, like you are telling us that the SEC worked with the Bank to figure out ways whereby the Bank could escape the provisions of the 1933 act.

Mr. COHEN. I have to take extreme issue with that, Mr. Dingell. We never work with the Bank or anybody else to evade the provisions of the 1933 act.

Mr. DINGELL. Did you work with the Bank to figure out how they could come in as a private issuer?

Mr. COHEN. We work with anyone, whether it is a bank or individual banker, to try to determine the application of the act in particular context.

Mr. DINGELL. We keep getting off into these peripheral issues, and I don't like to do it. I have some questions I want to ask.

What I keep coming up here with is regard to this issue, we are talking about the Commission has essentially placed itself in the position of telling the Bank how to offer, as opposed to making a public issue, which would have to be filed with difficulty and more risks.

Mr. COHEN. Under the Administrative Procedure Act of 1946 persons may petition the various agencies for the promulgation of a rule. That does not exclude the Bank. The Bank petitioned the Commission for the adoption of a rule which would specify more clearly the

limits within which it could operate. The Commission proposed such a rule, but after further consideration of the matter determined to withdraw the rule as unnecessary.

Mr. DINGELL. All right.

Now you will concede to me, will you not, that the Bank's function is not to deal in the highest type of securities, the highest type of securities are issued through the regular channels, isn't that correct?

Mr. COHEN. I am not prepared to quite agree with that, Mr. Dingell.

Mr. DINGELL. Then will you say to me that the International Bank's function is to deal in the highest and the best and the most marketable types of securities? Essentially it does not deal in the very best and most desirable types of securities, does it?

Mr. COHEN. What I want to say, Mr. Dingell, is that I did not want to characterize the securities in which the Bank invests. The Bank as I understand it by its charter is limited to investing in securities issued by a foreign government or guaranteed by a foreign government. Now, normally those securities are in a somewhat higher plane that the lowest grade securities. I would not want otherwise to characterize them.

Mr. DINGELL. But they do not rank as the highest type security, do they?

Mr. COHEN. Some may be and some may not.

Mr. DINGELL. As a matter of fact, a substantial portion of them are in fact not, isn't that so?

Mr. COHEN. I have not studied the portfolio and I hesitate to respond to that question.

Mr. DINGELL. At any rate some are not.

Mr. COHEN. I would agree with that.

Mr. DINGELL. Now, the last statement of the International Bank showed it sold a billion dollars of foreign securities, securities which under the Bank's own charter in many instances cannot be top grade investments for the Bank could not have done the financing. This distribution has been with the approval of the SEC, has it not?

Mr. COHEN. No, sir.

Mr. DINGELL. It is not?

Mr. COHEN. Not with the approval of the SEC. The Bank in selling those securities, has relied upon the opinion of its counsel that the sale of those securities it was not subject to registration at the SEC.

Mr. DINGELL. It is done, then, as private offerings?

Mr. COHEN. Yes.

Mr. DINGELL. Has the SEC been consulted whether or not these were private offerings?

Mr. COHEN. At times it has been, Mr. Dingell. I should add in connection with that figure that as I recall it, and I don't have the figures at hand now, the bulk of those securities were sold abroad. It is true that a substantial amount, although a much smaller amount than you have given, if I remember the figures correctly, were sold in the United States.

Mr. DINGELL. They were offered beyond a billion dollars.

Mr. COHEN. Beyond a billion dollars?

Mr. DINGELL. I am so informed.

Mr. COHEN. In the United States?

Mr. DINGELL. Yes.

Mr. COHEN. I will not quarrel with that. I did not think it was quite that much. In any event those securities have been sold to the large institutional investors, banks, insurance companies, and investors of that kind in the United States.

Mr. DINGELL. All right. Now, if the Bank sells a million dollar note that it has from a foreign issuer and the purchaser of the note issues participations in such notes or depository receipts either under the 1933 act or not, does not your new section (E) exempt this purchaser from making any reports?

Mr. COHEN. I think it would.

Mr. DINGELL. I see. Where is the equity security in this case?

Mr. COHEN. I am sorry, I went too fast. First of all, I drew myself into this.

Mr. DINGELL. You did not draw yourself into anything. We are just in a discussion here.

Mr. COHEN. All right. First of all the statute about which we are speaking relates to the registration of equity securities and the exemption, I think, as you suggested a little while ago is an exemption for certain equity securities which might otherwise be subject to registration.

Mr. DINGELL. All right. Now, isn't this exemption, then, as to certificates of deposits themselves?

Mr. COHEN. Yes, but they relate to equity securities.

Mr. DINGELL. So what you really are telling me, Mr. Cohen, I don't want to get involved in a lot of semantics because you know a lot more about the business than I do——

Mr. COHEN. I have not told you the key fact.

Mr. DINGELL. The real key fact is that under the circumstance I mentioned the sale of a million dollars to large institutional investors, the bank does not have to file any reports with the SEC.

Mr. COHEN. First of all, the bank does not acquire equity security. That was the key factor I neglected to mention earlier.

Mr. DINGELL. It required certificates of deposits?

Mr. COHEN. No, it acquires debt securities. I think the case you gave me was one where the bank sold a part of its portfolio to someone who might issue certificates of deposit, that would still be a certificate of interest in a debt security.

Mr. DINGELL. Mr. Cohen, I do appreciate this. I think that in order to facilitate the purpose of the committee we will try and clarify this particular point by letter. I think it would be better.

Mr. COHEN. I appreciate that.

Mr. DINGELL. The next point I want to get into here is we talked about administration of this section, and I think this question is appropriately directed to Mr. Cary, at least I hope so.

Mr. Cary, will you have a staff constantly checking the market in the securities of each issuer from time to time? If you find the market substantial, you will initiate a proceeding?

Mr. CARY. You are still addressing yourself to 2(E)?

Mr. DINGELL. Yes, I am.

Mr. CARY. I cannot guarantee that we will have a staff doing that but I am sure that the inventory, shall we say, of securities which

are presently traded on the American market, foreign securities will have to be examined on occasion and determined whether or not on the facts we have there should be a withdrawal, shall we say, of that exemption. So I think in a sense, I cannot assure you that we will have a day-to-day study of that.

Mr. DINGELL. What alternative, then, do you have for protecting the American investor aside from having a steep checking securities of each issuer so that from time to time you can initiate appropriate proceedings.

Mr. CARY. I would assume we would have a record for example of each of the foreign securities and the ADR's outstanding. I would assume further that we would have continuing information about them to a limited extent so that we would then know whether or not we ought to institute this kind of action which as you indicated earlier would in effect be a withdrawal of the exemption.

Mr. DINGELL. How many securities subject to that would be subject to exemption under this section, or in dollars if you wish, are afloat in this country at this time?

Mr. CARY. I don't think we know. We have a fairly substantial list of the ADR's presently outstanding but I don't think I can give you information of that in dollar terms or even in number of issuers that are involved. I don't have the information.

Mr. DINGELL. As a matter of fact, the practice of issuing securities which would be exempt under this particular section is expanding rather than contracting, is it not?

Mr. CARY. I don't know whether it is so much now in the last year or two, but it certainly was expanding and you are absolutely right on that.

Mr. DINGELL. At any rate it is a substantial amount of securities.

Mr. CARY. Yes, I think it is substantial.

Mr. DINGELL. And this being so it will require a substantial staff endeavor to adequately protect the interests of the American investors with regard to this section, isn't that so?

Mr. CARY. Yes, sir; just as we carry a very substantial staff also to process the applications which we would get if the law were the other way around. So I think we have to face the fact that this will present some problems.

Mr. DINGELL. All right. Now, Mr. Cary, what if the collateral under these circumstances is a bond to a foreign country? Where are the equity securities?

Mr. CARY. Let's see. If it were a collateral equity security I would assume that the only thing I could think of would be some kind of interest in an investment company with its situs in a foreign country which in turn has as one of its assets a bond. I assume that is the only kind of situation you have in mind.

Mr. LOOMIS. Were you referring to a certificate of deposit?

Mr. DINGELL. I am referring to the issue of certificates of deposit.

Mr. LOOMIS. By any institution in this country covering a foreign Government bond?

Mr. DINGELL. Yes.

Mr. LOOMIS. I don't believe that that would be subject to the basic section that we are adding, 12(G), because I don't believe that an interest in a foreign government bond is an equity security. If that

be so, the requirements commonly referred to as the Frear-Fulbright provisions do not apply.

Mr. DINGELL. In other words, that would not be exempt under the section we are discussing?

Mr. LOOMIS. No, it would not be subject to the bill in the first place.

Mr. DINGELL. But an issue of a bond by a private individual abroad or a private corporation would be subject to exemption.

Mr. LOOMIS. No, sir. This section 12(G), this new section that you are adding here to which this is an exemption, applies only to equity securities, it does not apply to bonds.

Mr. DINGELL. In other words, stocks?

Mr. LOOMIS. Yes, stocks and convertible debentures and a few other such things.

Mr. DINGELL. Convertible debentures and such warrants.

Mr. LOOMIS. Yes.

Mr. DINGELL. But under this certificates of deposit it would be isssued against convertible debentures, would they not?

Mr. LOOMIS. Yes, sir.

Mr. DINGELL. Then where would the situs of it be, the equity securities, then, in the instance of a convertible security?

Mr. LOOMIS. I think that there would be an equity security and a certificate of deposit for an equity security, and this exemption provision would be applicable.

Mr. DINGELL. And under this supposing we go sour; the American investor would have to proceed, or the representative of the American investor, to issue the security deposit or the other issue in this country, would have to proceed against the issuer of the security in the country where it orginated, isn't that a fact?

Mr. CARY. Whether or not this existed you would have the same problem, would you not, Mr. Dingell?

Mr. DINGELL. Yes.

Mr. CARY. In other words, this exemption does not relate to the rights to proceed against a party?

Mr. DINGELL. I have one more question I want to ask here. Mr. Cary, what is the proposal of the Commission staff to exempt Sears, Roebuck & Co. from the operation in certain provisions of the Investment Company Act so that Sears itself, then, might get in the mutual fund field.

Mr. CARY. I will start it over and ask Mr. Conwill to fill in the general points about that.

If Sears, Roebuck goes into the mutual fund industry, and I am now oversimplifying, I think Mr. Conwill will build it up from there—if Sears, Roebuck goes into the mutual fund field, then as an institution its securities will constitute interests or securities of an investment company under the Investment Company Act of 1940. Then the issue is whether or not—I am sorry. I don't think I have thought that one through enough. If I may I will stop there and have Mr. Conwill start from the beginning because I am not sure enough of my facts.

Mr. DINGELL. According to the Wall Street Journal, Sears wanted to go into the mutual fund field.

Mr. CONWILL (Director, Division of Corporate Regulations). Yes.

Mr. DINGELL. They proposed to do it through a wholly owned subsidiary; am I correct?

Mr. CONWILL. That is correct.

Mr. DINGELL. And they found that if they did this they would be afoul of the 1940 Investment Company Act.

Mr. CONWILL. No, sir; Sears would not. The restriction in the Investment Company Act is against investment companies or mutual funds owning securities of a company which is engaged in the underwriting or investment advisory business. Therefore, if Sears entered the mutual fund business under the statute at present, mutual funds would not be permitted to buy or hold stock of Sears, but there is nothing at all in the Investment Company Act which would prevent Sears from entering the mutual fund business either directly or through a subsidiary operation.

Mr. DINGELL. All right. Does the SEC contemplate doing anything to prevent Sears from engaging in this business?

Mr. CARY. We have no power either way to prevent it from doing so.

Mr. DINGELL. I see. Do you propose to take any action to prevent Sears from the applicable section so that they can get around this particular snag?

Mr. CARY. They are not getting around it. It permits other companies, mutual funds, to buy interests in Sears once Sears has taken on this additional function because there is a general prohibition against other mutual funds buying interests in a company which is engaged in the underwriting of securities which Sears would be doing in its role as a sponsor and an underwriter of a mutual fund.

Mr. DINGELL. Then putting it briefly, does the SEC have any intentions, either on the Commission level or on the staff level, to change the provisions of law which prohibit the purchase purchased by other mutual funds of Sears' stock if it goes into this business?

Mr. CONWILL. We have noticed a rule, Mr. Dingell, for public comment which subject to certain restrictions would permit mutual funds to buy and hold securities of companies such as Sears if it enters the mutual fund business. I emphasize that this has not been done for Sears because the problem has a much broader scope than that.

Mr. DINGELL. Sears, however, would be the principal and certainly the foremost beneficiary of that.

Mr. CONWILL. I would not say it would be the principal beneficiary at all. It would be among the beneficiaries.

Even now there is a question as to whether a mutual fund can own a bank stock because the banks are in the business of underwriting municipal securities. Technically that is a violation of section 12 (b) (3) of the Investment Company Act.

Mr. DINGELL. What you contemplate, then, is holding hearings which would exempt Sears and others similarly situated from this provision of law; am I correct?

Mr. CONWILL. It is not an exemption from Sears at all. We have no power to keep Sears out of the mutual fund business if it chooses to go in. It is an exemption of the mutual funds permitting them to hold Sears stock or the stock I would estimate conservatively of at least 50 other corporations or institutions.

Mr. DINGELL. Thank you very much, Mr. Chairman.

Mr. Cary, and the other gentleman, I have been somewhat hard on you. I wanted to get some answers. I think you understand I was operating under a very limited time in which to do so.

Mr. CARY. Yes, sir.

Mr. STAGGERS. Mr. Cary, I have a few comments.

With the termination of these hearings on this legislation I should like to conclude by asking you just one question. This is the same question that this subcommittee asked at the time the resolution was up nearly three years ago under which you made this Special Study. The question is the same which the subcommittee asked of Mr. Gadsby in connection with the Commission's legislative proposals of 1959.

The question is simply this. If this bill is considered favorably by the committee and enacted by the Congress, with any amendments that we might put into it, will you then have the tools which you think are adequate for the protection of the American investment public?

I want no slip-up on this. You have indicated in your previous appearance time and time again that the Commission is not lacking power in the rulemaking field to do most of the things that are necessary to protect the American investor. So I ask you again, with this bill, will you have the tools that you need to give adequate protection to the American investment public?

Mr. CARY. Mr. Chairman, I would say we do. In other words, we don't promise to do a perfect job, but we will do the best job we know how and think we would have the powers.

Mr. STAGGERS. At this time I would like to insert in the record a letter from the Comptroller of the Currency and his views on the bill.

(The letter referred to follows:)

COMPTROLLER OF THE CURRENCY, U.S. TREASURY,
Washington, D.C., February, 19, 1964.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: We are pleased to enclose herewith a statement for the record on H.R. 6789 and S. 1642. Sufficient copies have been made for distribution to each member of the committee, if appropriate. This statement strongly opposes the provisions which would subject national banks to certain sections of the Securities and Exchange Act of 1934. Our objection is based on both substantive and procedural grounds.

In view of the ample authority which now exists in this Office to require appropriate disclosure of the financial affairs of national banks, which authority has been implemented and will be further implemented by this Office, we feel that there is absolutely no need to apply the complicated panoply of disclosure law contained in the exchange act to the national banking system.

Procedurally, the proposed bills are another long step in the fragmentation of statutory sources to which national bankers must look prior to virtually every move they make. The statutes governing national banks are now scattered throughout the National Bank Act, the Federal Reserve Act, the Federal Deposit Insurance Corporation Act, the Clayton Act, and 50 various State laws on branching. To bring these banks wholesale into the complicated arena of the SEC laws by the application of its four major provisions, as does this bill, is to open a Pandora's box of complications. As any attorney handling corporate matters knows, it is almost impossible to refer to a single section of the SEC laws for the answer to a particular question. In the 30 years since their enactment, an intricate web of cross references and interdependencies between the regulatory and enforcement provisions of the 1933 and 1934 act, has grown up. There is also a gloss of many court decisions interpreting these sections which may or may not be productive of good results when applied to the banking industry.

Without a thorough study of all of this case law which has not been possible in the time at hand, all of the technical problems inherent in this legislation

cannot be assessed. There are some questions which are readily apparent. For instance:

1. What is the interpretation of the sponsors of this legislation of the meaning of the so-called Williams' banking amendment (sec. 3(e) of S. 1642) which reads as follows?

"In respect of any securities issued by banks the deposits of which are insured in accordance with the Federal Deposit Insurance Corporation Act, the powers, functions, and duties vested in the Commission under this title to administer and enforce sections 12, 13, 14(a), 14(c), and 16 thereof (1) with respect to national banks and banks operating under the Code of Law for the District of Columbia are vested in the Comptroller of the Currency, (2) with respect to all other member banks of the Federal Reserve System are vested in the Board of Governors of the Federal Reserve System, and (3) with respect to all other insured banks are vested in the Federal Deposit Insurance Corporation."

2. What powers or authority, if any, would the SEC retain over banks under the bill including the Williams' banking amendment?

3. Would the sponsors expect the banking agencies to follow the same general standards of disclosure as does the SEC?

4. For instance, would the banking agency have the discretion to designate any reports it might require under the bill as nonpublic files?

5. Specifically, would the banking agency have the discretion under the bill to deny to an inquiring journalist any such report filed by a bank, which might be in temporary financial difficulty?

6. Under the Williams' banking amendment, "The powers, functions, and duties vested in the Commission * * * to administer and enforce the sections 12, 13, 14(a), 14(c) and 16" with respect to securities issued by national banks, "are vested in the Comptroller of the Currency." Does this mean that the Comptroller will have the powers enumerated in sections 19, 20, 21, 22, and 23 of the 1934 act?

7. If the answer to No. 5 is affirmative—

(*a*) Would the Comptroller have the power under section 19 "to expel from a national securities exchange any member or officer" whom the Comptroller finds has violated sections 12, 13, 14(a), 14(c), or 16 with respect to a security issued by a national bank?

(*b*) Would a national bank, under investigation by the Comptroller for suspected violations, have the right to the court proceedings required by sections 21, 25, and 27?

8. New section 15(c)(5) gives the SEC power to suspend trading in any over-the-counter security subject to the bill, if it finds after notice and open hearing that any person has failed to comply with the provisions of sections 12, 13, or subsection (d) of section 15, or any rule or regulation thereunder. Section 15 is not one of the sections which the Comptroller enforces under the Williams' banking amendment. Therefore, has the SEC retained authority to suspend trading in a security issued by a national bank?

9. Would a newly formed bank, selling its first stock to the public be required to file a registration statement under the bill?

10. If the answer to No. 9 is negative, why does the bill require that banks register long outstanding issues?

The above questions are merely illustrative of the many legal uncertainties and problems inherent in the application of this bill to national banks.

We trust that after consideration of our statement and the questions raised herein that the committee will vote to except securities issued by national banks from his bill.

Sincerely,

JAMES J. SAXON,
Comptroller of the Currency.

STATEMENT OF JAMES J. SAXON, COMPTROLLER OF THE CURRENCY

As we stated to the Senate committee, this Office is strongly opposed to the provisions which would subject banks to sections 12, 13, 14, and 16 of the Securities and Exchange Act of 1934. As the Federal official charged with the enforcement of the present laws governing federally chartered banks, I regard this proposal as both unnecessary and unwise, so far as national banks are concerned.

This legislation would not increase the amount of disclosure to the public of the financial affairs of national banks but, in fact, decrease it. Our Office in 1962 imposed disclosure requirements on all national banks with total deposits of $25 million or more. The attached tabulation shows that this regulation covers 654 national banks holding 81.2 percent of the total assets of national banks. If passed, S. 1642 for the first 2 years would cover only 200 national banks having 750 or more shareholders. Thereafter, if the administering agency elected to lower the cutoff point to 500 or more shareholders, 114 additional national banks would be covered.

In addition, S. 1642 does not cover any new issue of securities by a new bank or by an existing bank unless that bank already has 750 or more shareholders. As we stated to the Senate committee, it was our intention to issue expanded disclosure regulations which, among other things, would require offering circulars to be used on all new issues of securities over a minimum dollar amount. In view of the uncertainty concerning the whole field of disclosure which has been engendered by the rapid passage of S. 1642 through the Senate, we have not thought it feasible to issue this regulation as well as additional projected disclosure requirements concerning merger and proxy contests.

In order that the committee might know specifically what national banks are now required to disclose, I will briefly run down our regulatory requirements. Effective as of last February 1, every national bank with deposits of $25 million or more has been required to furnish each of its shareholders with an annual report containing as a minimum the following information:

(*a*) Comparative balance sheets as of the close of the last calendar or fiscal year and as of the close of the preceding calendar or fiscal year.

(*b*) Comparative statements disclosing net operating income after applicable Federal income taxes, and net operating income per share for the last calendar or fiscal year and the preceding calendar or fiscal year.

(*c*) A comparative reconciliation of capital accounts which summarizes the changes in capital accounts for the last calendar or fiscal year and the preceding calendar or fiscal year. This reconciliation includes items of nonoperating income or expense.

Every such national bank is required to furnish every shareholder a proxy statement in connection with any annual or special meeting of shareholders, for which proxies are solicited. The proxy statement must include all of the information necessary for intelligent voting by a shareholder including the following:

1. The identity, age, principal occupation, and the office held by each nominee for a directorship.

2. The remuneration paid to principal officers of the bank.

3. The amounts set aside or approved during the last calendar year for pension or retirement benefits payable to principal officers.

4. If action is to be taken with respect to any bonus, profit-sharing, or other remuneration plan, the material features of the plan and the identity of the persons who would benefit thereby. The amounts which would have been distributed under the plan during the last calendar year. If the plan may be amended, otherwise than by a vote of stockholders, to materially increase the cost to the bank, the nature of the amendment which may be so made.

5. If action is to be taken with respect to any pension or retirement plan, the material features of the plan and the estimated costs thereof.

6. If action is to be taken with respect to the granting or extension of any options, warrants or rights to purchase the stock of the bank, the following information must be disclosed: (*a*) the title and amount of stock called for or to be called for by such options, warrants, or rights; (*b*) the prices, expiration dates, and other material conditions upon which the options, warrants, or rights may be exercised; and (*c*) the market price of the stock called for or to be called for by the options, warrants or rights as of the latest practicable date.

(*d*) The amount of stock called for or to be called for by options, warrants, or rights received or to be received by the following persons, naming each such person: (1) Each director of the bank or each nominee for election as a director of the bank, and (2) each other person who will be entitled to acquire 5 percent or more of the stock called for or to be called for by such options, warrants, or rights.

7. If action is to be taken with respect to the authorization or issuance of any security, the following information must be supplied:

(*a*) The title and amount of securities to be authorized or issued.

(*b*) If the securities are other than additional shares of common stock of a class outstanding, the applicable information with respect to (1) dividend rights, (2) voting rights, (3) liquidation rights, (4) preemptive rights, (5) conversion rights, (6) redemption provisions, (7) sinking fund provision, (8) interest rate, and (9) maturity.

(*c*) If the securities to be authorized or issued are other than additional shares of common stock of a class outstanding, the Comptroller may require financial statements comparable to those contained in the annual report.

8. If action is to be taken with respect to any amendment of the articles of association, a statement of the reasons therefor and the general effect of such amendent and the vote needed for its approval.

In addition to the above regulations, our Office in October of 1963 published a 53-page booklet entitled, "Shareholders' Meeting Instructions" which explained in detail our disclosure requirements. We are pleased to attach a copy together with a pamphlet published by a large national bank at its own expense to explain our regulations to its correspondent banks.

In January of 1964, we had the first extended test of the efficiency of our regulations as every national bank held its annual meeting and distributed its yearend statement. The result was most gratifying. The covered banks and many smaller banks as well, supplied their shareholders with proxy statements and annual financial reports as good as any listed company's.

Under S. 1642 and H.R. 6789, instead of the approach just described, our Office and the other banking agencies would be compelled to issue regulations designed to enforce sections 12, 13, 14, and 16 of the Securities Exchange Act. Under H.R. 6789 the banking agency could elect to leave enforcement up to the SEC. Under S. 1642 the banking agency would be required to enforce the Exchange Act.

In our judgment, neither alternative offers a viable solution to the disclosure needs of banking. As many commentators have noted, banking, and especially national banking, today suffers from an overdose of overlapping statutes and jurisdictions. The laws of affecting the day to day operation of national banks are now spread over the National Bank Act, the Federal Reserve Act, the Federal Deposit Insurance Act, the Clayton Act, and 50 varying State laws on branching.

Since assuming office, I have made every effort to reverse the trend toward further fragmentation of authority over national banks.

Accordingly, we regard this proposal as definitely a step in the wrong direction. In addition to the three existing Federal agencies and the Department of Justice, a fifth agency, the SEC is introduced into the picture. Under this proposal, four of these agencies would be issuing regulations, not necessarily the same, all in enforcement of the same four sections of statute. Even for the field of banking, which is trying to learn to live with overlapping agencies, this would seem to set a record for muddled administration.

The remedy is not to add the SEC to the list of agencies now regulating banks, but rather to leave the enforcement of disclosure to the banking agencies to do in their own way and pursuant to their own statutes. We have demonstrated that the National Bank Act gives us sufficient authority to act over national banks. If the FDIC and the Fed are unwilling to exercise their responsibilities in this area under their general supervisory power, we suggest that their respective acts be amended to require them to do so.

We consider disclosure of great importance as indicated by our efforts described above, but we consider our direct supervisory power over national banks of even greater value to the investor. No one can denigrate the direct supervision of banks as an effective means of public control. The continuous internal supervision, regulation and examination of national banks by our Office provides a protection to investors in banks which is far greater than that afforded by disclosure alone. For example, the National Bank Act requires that a complete examination at least three times in every 2-year period, of the books and records of each national bank, must be made by a bank examiner employed by the Comptroller of the Currency. Each of these examinations involves a detailed analysis and valuation of the assets and liabilities of the institution. This supervision provides protection for depositors and shareholders alike which is not available to investors in any other type of corporation.

We pass on the full details of such capital changes, including the relationship of the offering price to book value and to market value. No change in capital structure which would water the holdings of existing shareholders, or which conversely would cause an undue accretion to the book value of existing shares at the expense of new investors, would be approved.

As the members of the committee well know, it was not considered necessary or desirable to include banks within the provisions of similar legislation whenever it has been proposed before. The Securities Act of 1933 contains a specific exemption for securities issued by banks. The Securities and Exchange Act of 1934, although not containing an express exemption, does not apply to banks by virtue of the fact that bank stock is not listed on national securities exchanges. The Investment Company Act of 1940 contains specific exemption for banks from the provisions of that act. The Frear bill introduced in 1950 contained an exemption for bank stock as did the Fulbright bills of 1955 and 1957. On all of these occasions, the Congress was of the opinion that it was not necessary to subject banks to additional disclosure requirements.

Even in the present proposal, share accounts in savings and loan associations are exempted. Why, if it is thought necessary at this time to remove the exemption for securities issued by commercial banks, are not share accounts in savings and loan associations, similarly treated?

We urge that this legislation be amended to except securities issued by national banks. This could be done by adding the words "Except national banks" after the word "issuer" in section 3(c).

If the above amendment is not acceptable, we recommend that at least the following clarifying language be added to section 3(e), "In view of the authority vested hereunder in the foregoing banking agencies, no rule, regulation, standard, interpretation, policy or procedure of the Securities and Exchange Commission issued heretofore or hereafter in connection with the enforcement and administration of the aforesaid sections shall be applicable with respect to any security issued by a national bank."

[Attachment]

As of Dec. 28, 1962

Total assets all national banks	$160,657,006,000
Total assets of national banks with deposits of $25,000,000 or more (represents 81.2 percent of total assets)	130,484,632,000
Total assets of national banks with deposits of less than $25,000,000 (represents only 18.8 percent of total assets)	30,172,374,000
Total assets of all commercial and stock savings banks (national banks hold 53.8 percent of assets of all commercial and stock savings banks)	298,196,408,000

Mr. STAGGERS. The record will be held open at this point for any further comments made on the Comptroller's statement when received by the subcommittee.

(The following material was subsequently received for the record:)

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., March 17, 1964.

Hon. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance of the Committee on Foreign and Interstate Commerce, House of Representatives, Washington, D.C.

DEAR MR. STAGGERS: I transmit herewith the memorandum of the Securities and Exchange Commission with respect to the statement of the Comptroller of the Currency on H.R. 6789 and S. 1642.

As the enclosed memorandum indicates, the Commission strongly opposes the exemption of national banks from the proposed legislation sought by the Comptroller, but has no objection to an amendment of the bills to state explicitly that the Federal banking agencies would not be bound by Commission standards in the administration of the disclosure provisions of the Exchange Act with respect to the securities of banks over which they have jurisdiction. Appropriate language for this purpose previously has been furnished to the subcommittee.

If I can be of any further assistance in this matter, please don't hesitate to call on me.

Sincerely,

WILLIAM L. CARY, *Chairman.*

Enclosure.

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION WITH RESPECT TO THE STATEMENT OF THE COMPTROLLER OF THE CURRENCY ON H.R. 6789 AND S. 1642

This memorandum is submitted in response to the statement of James J. Saxon, Comptroller of the Currency, on H.R. 6789 and S. 1642 to the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce. Mr. Saxon requests that these bills be amended to exclude national banks from the proposed extension to over-the-counter securities of sections 12, 13, 14(a), 14(c) and 16 of the Securities Exchange Act of 1934 or, alternatively, to provide expressly that "no rule, regulation, standard, interpretation, policy, or procedure of the Securities and Exchange Commission issued heretofore or hereafter in connection with the enforcement and administration of the aforesaid sections shall be applicable with respect to any securities issued by national banks."

The Commission believes that the former proposal is undesirable and the latter proposal is unnecessary and goes too far. The Commission believes, as the Senate committee pointed out, that the jurisdiction vested in the bank regulatory agencies is a complete one and that these agencies would not be bound by any rules, regulations, forms, or decisions of the Commission heretofore or hereafter adopted. The Commission would have no objection to amending the statute to state this explicitly and a draft of a proposed amendment for this purpose has been previously furnished to the subcommittee. The Comptroller's proposal, however, would make all present or future Commission positions inapplicable to banks. This might deprive Federal bank regulatory agencies of the benefit of a considerable body of precedent practice and experience in the administration of these statutes which they might wish to avail themselves of, and would, in effect, require these agencies to start over from the beginning in the administration of these provisions of law.

H.R. 6789 and S. 1642 ultimately would extend to investors in over-the-counter companies with total assets over $1 million and a class of equity securties held of record by 500 or more persons the protections afforded by the registration, reporting, proxy, and insider trading provisions of the Exchange Act now generaly available only to investors in companies with a security listed on a national securities exchange. Both bills would apply to bank securities to the same extent as they would apply to the securities of other corporations with securities traded in the over-the-counter market. There is also no disparity between the treatment accorded securities issued by banks and savings and loans associations or similar institutions. Since deposits in savings and loan type associations, unlike deposits in banks, are represented by share accounts and depositors are commonly referred to as shareholders, section 6(c) of the bills provides an exemption from the registration requirements of the bills for securities issued by such institutions "other than permanent stock, guarantee stock, permanent reserve stock, or any similar certificate evidencing nonwithdrawal capital." The sole purpose of this exemption is to assure that depositors in savings and loan associations and similar institutions are treated exactly as bank depositors and not as shareholders of equity securities for the purpose of the coverage criteria contained in the bills. As the Senate report on S. 1642 makes clear, both banks and savings and loan type institutions ultimately would be subject to the disclosure requirements of the act if they have $1 million in total assets and a class of capital stock held of record by 500 or more persons. (See S. Rept. 379, 88th Cong., 1st sess., 1963, at p. 61.)

Under section 3(e) of H.R. 6789 and S. 1642, as introduced, the powers, duties, and functions of the Commission pursuant to the Exchange Act with respect to securities issued by a bank would be delegated to the Federal banking agency which exercises jurisdiction to examine or supervise the business of such bank upon its request. S. 1642, as passed by the Senate contains an amendment to section 3(e), cosponsored by Senators Williams and Javits, which would directly mandate the administration and enforcement of sections 12, 13, 14(a), 14(c), and 16 with respect to bank securities to designated Federal banking agencies, the Comptroller of the Currency for District of Columbia and national banks, the Federal Reserve Board for all other member banks of the Federal Reserve System and the Federal Deposit Insurance Corporation for other banks insured in accordance with the Federal Deposit Insurance Corporation Act.

Since H.R. 6789 and S. 1642, as introduced, permits, and S. 1642, as amended in the Senate, requires administration and enforcement of its provisions with respect to the securities of banks by the Federal banking agencies already

exercising regulatory jurisdiction over such banks, it does not contribute to the fragmentation of Federal banking regulation. While the Commission supports the Senate amendments to S. 1642, all the bills before this subcommittee would allow for integration of the disclosure requirements of the Exchange Act with existing Federal banking regulation, thereby minimizing the burdens of compliance by banks. Although as the Comptroller states, different agencies would be issuing regulations under the same statute, each federally regulated bank would be required to comply only with the regulations adopted by the Federal banking agency which already exercises regulatory jurisdiction over it. Accordingly, there is no justification for adoption of the Comptroller's suggestion that statutory disclosure requirements for banks be accomplished through amendment of each of the Fedreal banking statutes. It would result only in indefinite delay.

Since the jurisdiction of the Comptroller of the Currency is limited to District of Columbia and national banks, his reporting and proxy solicitation regulations only apply to little more than half of the estimated 600 banks that would be covered by the disclosure requirements contained in H.R. 6789 and S. 1642. Virtually all of the remaining banks that would be covered under the bills are subject to the jurisdiction of the Federal Reserve System and the Federal Deposit Insurance Corporation. These agencies have not, in the past, asserted authority to adopt investor-oriented disclosure requirements for publicly owned banks subject to their jurisdiction and await a congressional mandate before assuming these new responsibilities. However, both the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation as well as the chamber of commerce and the American Bankers Association recognize the need for imposing adequate disclosure obligations on banks in which there is a widespread investor interest, and none have expressed agreement with Mr. Saxon's view that the application of sections 12, 13, 14(a), 14(c), and 16 of the Exchange Act to banks would not be an appropriate means toward accomplishing this end.

There is also no justification for the disparity in bank-investor protection that would be created by the exemption of national banks from the proposed legislation as requested by the Comptroller. Not only would disclosures required of national banks be governed by different statutory standards than those applicable to other banks, but investors in securities of national banks would be deprived of the protections against misuse of inside information provided by the insider trading provisions of section 16 of the Exchange Act.

Although the recently adopted annual reporting and proxy regulations of the Comptroller of the Currency embody a $25 million deposit test and are more inclusive with respect to national banks than the coverage criteria of H.R. 6789 and S. 1642, enactment of the bills would not decrease the amount of public disclosure with respect to the financial affairs of national banks. Neither H.R. 6789 nor S. 1642, as introduced, nor S. 1642, as amended in the Senate, limits in any way the Comptroller's existing authority to impose disclosure requirements on national banks that do not meet the coverage criteria embodied in these bills. As stated in the report of the Senate Committee and Banking and Currency on S. 1642 (S. Rept. 379 supra, at pp. 35–36):

"The Committee wishes to make it clear, however, that the provisions of S. 1642 are in no way to derogate from or to limit other provisions of law giving the Federal and State bank agencies authority to regulate banks within their respective jurisdictions. Thus, the bank agencies will have two statutory bases on which they can proceed. If, for instance, the Comptroller considers it desirable to require certain national banks smaller than those covered by this bill to send simplified reports or other information to their stockholders, he would be free to do so under the authority vested in him by the National Bank Act."

The application of sections 12, 13, 14(a), 14(c), and 16 of the Exchange Act of national banks meeting the coverage criteria contained in H.R. 6789 and S. 1642 would materially improve the limited investor protections now provided by the Comptroller's existing reporting and proxy regulations. While these regulations represent a pioneering effort by the Comptroller, they were adopted without the benefit of statutory guidelines and fall below the standards contemplated by the Exchange Act. Since the Comptroller's regulations are limited to annual reporting and proxy solicitation requirements, they do not provide for the comprehensive disclosure elicited in a registration statement required under section 12 or for the disclosures as to insider trading required under section 16(a) of the Exchange Act. The Comptroller also does not have the authority to adopt

regulations comparable to the important protections against abuses in insider trading contained in sections 16(b) and 16(c) of the Exchange Act, which provide for recovery by the corporation of profits realized by their insiders in short-swing trading in the equity securities of their corporations and prohibit insider short selling and selling "against the box" in such securities. Even in the area of reporting and proxy regulations, as Chairman Cary has pointed out before this subcommittee, the Comptroller's existing regulations lack many of the proven shareholder protections afforded by Commission rules under sections 13 and 14 of the Exchange Act. Finally, it is important to note that the authority for the Comptroller's regulations rests only on the general power of the Comptroller under the National Banking Act to require special reports. First adopted by Mr. Saxon in 1962, there are no statutory restraints against dilution or elimination of these regulations by his successors. The protection of investors in the securities of national banks should not rest wholly in the Comptroller's discretion. They, like investors in the securities of other banks and companies with securities traded in the over-the-counter market, are entitled to the assurance of continuing protections in accordance with standards set by the Congress.

The Comptroller's proposed amendment to section 3(e) of the bills reflects a concern that the Federal banking agencies in performing their functions under the Exchange Act will be bound by rules, regulations, procedures, policies, and interpretations adopted by the Commission. In the opinion of the Commission this concern is entirely unwarranted under the provisions of the proposed legislation. As Senate report on S. 1642 states with respect to section 3(e) of the bill, as amended in the Senate (S. Rept. 379 supra, at p. 36):

"The committee also notes that the disclosure proxy, solicitation, and insider trading provisions of the Securities Exchange Act of 1934 now provide, and would continue to provide under S. 1642, great discretionary authority for the administering agency to make appropriate rules, classifications, and exceptions. Under these provisions, the Federal bank regulatory agencies could adopt rules and forms differing from those of the Commission relating to companies other than banks, whenever the bank regulatory agencies deem it appropriate."

Indeed, even under section 3(e) of H.R. 6789 which is identical to S. 1642, as introduced, and provides for the delegation of the Commission's powers duties and functions under the bill with respect to bank securities upon request of the appropriate Federal banking authority, the Commission has disclaimed any desire to retain authority on bank disclosures. As Chairman Cary testified (hearings before a subcommittee of the Senate Bank and Currency Committee on S. 1642, 88th Cong., 1st sess., 1963 at p. 54):

"There would be no residual control in the Securities and Exchange Commission after this delegation. Moreover, if the Comptroller or the Federal Reserve Board (or the Federal Deposit Insurance Corporation with respect to a minority of banks) did not request such authority, we agree that any functions left with the Commission will be administered for the appropriate banking agencies. If the bill is not crystal clear on these points, we shall be glad to revise it accordingly. In sum, the Commission has no desire, and is indeed reluctant, to take direct responsibility over bank disclosure in any respect. It is only the principle of adequate disclosure which we assert.

In the Commission's view, section 3(e) of S. 1642, as amended by the Senate would provide Federal banking agencies with ample authority to modify, expand, or reject the Commission's disclosure requirements to the extent consistent with the statutory standards and appropriate to the congressional policy of furnishing investors with adequate information for informed investment decisions. While, as noted above, the Commission has no objection to make this more explicit in the bill, the Comptroller's proposal is inappropriate for this purpose.

Although H.R. 6789 and S. 1642 were introduced in the Congress on June 4, 1963, the Comptroller in his letters transmitting his statement to this subcommittee states that "in the time at hand, all of the technical problems inherent in this legislation cannot be assessed" and sets forth a number of questions illustrating these alleged problems which, it is claimed "are readily apparent." In the opinion of the Commission, the answers to these questions, which are set forth below, are clearly evident from the provisions of the bill, the report on S. 1642 of the Senate Committee on Banking and Currency and the statements of the Commission before this subcommittee and the Senate Subcommittee on Securities which considered the legislation. Neither the so-called technical questions posed by the Comptroller nor any other grounds asserted by him justify the special exception sought for National banks. After careful con-

sideration of the problems involved in the administration of the disclosure requirements of the Exchange Act with respect to bank securities both before and since the introduction of H.R. 6789 and S. 1642, the Commission believes that the provisions of S. 1642, as amended in the Senate, provide a most feasible means of providing adequate protections for bank investors with a minimum of burden on the banks.

The questions raised by the Comptroller's and the Commission's responses thereto are as follows:

1. What is the interpretation of the sponsors of this legislation of the meaning of the so-called Williams' banking amendment (§ 3(e) of S. 1642) which reads as follows? (The text of the amendment is omitted.)

The amendment to section 3(e) of S. 1642, as introduced in the Senate, cosponsored by Senators Williams and Javits, makes mandatory the administration and enforcement of sections 12, 13, 14(a), 14(c) and 16 of the Securities Exchange Act of 1934 by the designated Federal banking authorities with respect to the securities of banks otherwise subject to their examining and supervisory authority. S. 1642, as introduced, and H.R. 6789 would leave the administration and enforcement of those provisions to Commission unless delegation thereof was specifically requested by the appropriate Federal banking agency. The Senate amendment to section 3(e) also clarifies the respective responsibilities of the Commission and the Federal banking agencies by expressly designating the banks that are subject to the jurisdiction of each Federal banking agency and the specific provisions of the Exchange Act to be administered and enforced by such agencies. In this manner, it makes more explicit the intent of Commission reflected in the original version of section 3(e) that the Federal banking agencies would administer and enforce the obligations placed on issuer of bank securities under the Exchange Act while the Commission would retain its traditional function of regulating, and supervising industry self-regulation of the securities markets.

2. What powers or authority, if any, would the SEC retain over banks under the bill including the Williams' banking amendment?

Under S. 1642, as passed by the Senate, the Commission would have the authority to administer and enforce the provisions of the bill only with respect to banks not subject to the jurisdiction of either the Comptroller of the Currency, the Federal Reserve System or the Federal Deposit Insurance Corporation. It is estimated that this would include only 4 of the approximately 600 banks that meet the coverage criteria contained in the bills. To avoid any inequities and undue administrative burden, the Commission will coordinate closely its disclosure requirements for such banks with those adopted by the Federal banking agencies under the authority contained in the bills. It should be noted that S. 1642, as passed by the Senate, would transfer to the designated Fedral banking agencies the existing power and authority of the Commission to administer and enforce the provisions of sections 12, 13, 14(a), 14(c), and 16 of the Exchange Act in respect of banks with a security listed for trading on a national securities exchange to the designated Federal banking agencies. The bill would not, however, affect the Commission's existing powers to enforce other provisions of the Exchange Act in respect of bank securities, whether listed for trading on a national securities exchange or traded in the over-the-counter market.

3. Would the sponsors expect the banking agencies to follow the same general standards of disclosure as does the SEC?

As noted above, the registration, reporting, proxy solicitation, and insider trading provisions of the Exchange Act provide, and under the bills will continue to provide, broad discretion to the Commission and the Federal banking regulatory agencies administering these provisions to determine the specific disclosure standards that will best effectuate the statutory purpose of providing investors with the information necessary to informed investment decisions. In addition, section 12(h) of the bill also contains express authority to permit the administering agency to exempt in whole or in part any issuer or class of issuers from the provisions of the bill, to classify issuers, and to prescribe requirements appropriate for each such class. A Federal banking agency administering the provisions of the Exchange Act would not be required to follow the disclosure standards developed by the Commission. It would develop any standards of its own which are necessary or appropriate in the public interest or for the protection of investors in the securities of banks over which they exercise jurisdiction.

4. For instance, would the banking agency have the discretion to designate any reports it might require the bill as nonpublic files?

The underlying purposes of the disclosure requirements of the proposed bills generally require that the information contained in required reports be made available to the investing public. Nevertheless, the Exchange Act expressly provides for confidential treatment in circumstances where the injury to the issuer caused by disclosure may outweigh the benefit to investors. Thus, section 24(a) of the act provides that nothing in the act shall be construed to authorize or require the revealing of trade secrets or processes in any application, report, or document filed with the Commission under the act. Section 24(b) further provides that upon written objection to public disclosure of information contained in any such application, report, or document, the Commission may make such information public only if necessary in the public interest. The report of the Senate Committee on Banking and Currency on S. 1642 (S. Rept. 379, supra, at p. 63) as well as the statement of the Commission before this subcommittee made clear that for the purpose of exercising the functions invested in them by the bills the Federal banking regulatory agencies would have the same powers as the Commission to extend confidential treatment to information filed with them. Thus, pursuant to the provisions of section 24, such agencies could designate as nonpublic information contained in any reports required by it under the bills unless it determined that public disclosure was in the public interest. Moreover, the bills would in no way affect the authority of Federal banking agencies to keep confidential reports required by it under any other law.

5. Specifically, would the banking agency have the discretion under the bill to deny to any inquiring journalist any such report filed by a bank, which might be in a temporary financial difficulty?

Pursuant to the provisions of section 24(b) of the Exchange Act, Federal banking agencies would have authority to extend confidential treatment to deny an inquiring journalist access to a report filed by a bank pursuant to the bills unless it determined that public disclosure was in the public interest.

6. Under the Williams' banking amendment, "The powers, functions, and duties vested in the Commission * * * to administer and enforce the sections 12, 13, 14(a), 14(c), and 16" with respect to securities issued by national banks, "are vested in the Comptroller of the Currency." Does this mean that the Comptroller will have the power enumerated in sections 19, 20, 21, 22, and 23 of the 1934 act?

The report of the Senate Committee on Banking and Currency (S. Rept. 379, supra p. 35), as well as the statements of the Commission, make clear that the authority vested in the designated Federal banking agencies under the bills includes all the powers of the Commission contained in the Exchange Act that are necessary for the administration and enforcement of sections 12, 13, 14(a), 14(c), and 16 of the act with respect to bank securities over which they have jurisdiction. Thus, the Federal banking agencies, with respect to such securities would have the power to delist from a national securities exchange under section 19(a)(2), to suspend summarily trading under section 19(a)(4), to investigate, institute suits to enjoin, and forward evidence to the Attorney General for criminal prosecution under section 21, to hold public hearings under section 22 and to make such rules as may be necessary to carry out their functions pursuant to the Exchange Act under section 23. The provisions of section 20, relating to liabilities of controlling persons, also would apply to banks over which the Federal banking agencies would have jurisdiction. However, this section does not confer any powers upon the Commission and, hence, would not confer power upon the Federal banking agencies.

7. If the answer to No. 5[1] if affirmative: (*a*) Would the Comptroller have the power under section 19 "to expel from a national securities exchange any member or officer" whom the Comptroller finds has violated section 12, 13, 14(a), 14(c) or 16 with respect to a security issued by a national bank?

Section 19 of the Exchange Act is entitled "Powers With Respect to Exchanges and Securities." As this heading indicates, the section confers power in the Commission both with respect to securities traded on national securities exchanges and with respect to oversight of the organization, administration, and operation of such exchanges. As indicated above, the designated Federal banking agencies would have the authority vested in the Commission under sections 19(a)(2) and 19(a)(4) to delist a bank security over which they have juris-

[1] It is assumed that this question relates to the answer to question 6, not question 5.

diction from a national securities exchange or summarily to suspend trading in such a security for violations of sections 12, 13, 14(a), 14(c), and 16 of the Exchange Act. The powers of the Commission that would be vested in Federal banking agencies, however, are limited to those necessary to administer and enforce the provisions of the act with respect to bank securities. The remaining provisions of section 19 relate to the Commission's power to suspend or withdraw the registration of a national securities exchange, to suspend or expel members or officers of an exchange, to suspend temporarily trading on an exchange with the approval of the president and to study, investigate, and alter exchange rules if necessary or appropriate for the protection of investors or to insure fair dealing in the securities traded on the exchange on fair administration of the exchange. Since the exercise of Commission powers under section 19, except for those contained in section 19(a)(2) and 19(a)(4), would affect exchange trading in securities other than bank securities as well as the organization and administration of the exchanges, in the Commission's view, the bill would not vest these powers in Federal banking agencies. Thus, the Comptroller would not have the power to expel an exchange member or officer for violations of sections 12, 13, 14(a), 14(c), and 16 of the Exchange Act with respect to a security issued by a national bank.

7(*b*). Would a national bank, under investigation by the Comptroller for suspected violations, have the right to the court proceedings required by sections 21, 25, and 27?

This question erroneously assumes that an issuer being investigated by the Commission for violations of section 12, 13, 14(a), (14(c) or 16 would have a right to court proceedings under sections 21, 25, and 27 of the Exchange Act. Section 21, however, confers on the Commission, not on private parties, the right to institute suits to enjoin violations of the act or to apply for writs of mandamus to compel compliance with the provisions of the act. Section 27 merely relates to the jurisdiction of U.S. district courts over suits brought under the act. Even section 25(*a*), which provides for review in U.S. courts of appeals of Commission orders issued in proceedings under the act, does not give an issuer being investigated a right to court proceedings. The courts have repeatedly held that orders of the Commission issued in connection with an investigation of violations of the act are not appealable under section 25(a), since that section contemplates that only final orders issued on the basis of a record developed in a Commission proceeding would be subject to judicial review. See e.g., *Securities and Exchange Commission* v. *Andrews* (88 F. 2d 441 (C.A. 2, 1937)); *Stardust, Inc.* v. *Securities and Exchange Commission* (225 F. 2d 255 (C.A. 9, 1955)). Cf. *F.P.C.* v. *Metropolitan Edison Co.* (304 U.S. 373, 385 (1938)), arising under the comparable court review provisions of the Federal Power Act. Accordingly, under the bills only orders of Federal banking agencies issued at the conclusion of administrative proceedings, such as those conducted pursuant to proposed section 15(c)(4) and existing section 19(a)(2), would be reviewable under section 25(a) of the act.

8. New section 15(c)(5) gives the SEC power to suspend trading in any over-the-counter security to that bill, if it finds after notice and open hearing that any person has failed to comply with the provisions of section 12, 13, or subsection (d) of section 15, or any rule or regulation thereunder. Section 15 is not one of the sections which the Comptroller enforces under Williams' banking amendment. Therefore, has the SEC retained authority to suspend trading in a security issued by a national bank?

This question reflects some confusion between the provisions of proposed section 15(c)(4) and those of proposed section 15(c)(5) of section 6(c) of the bills. Proposed section 15(c)(4) would empower the Commission to find, after notice and opportunity for hearing, that any person subject to the requirements of section 12, 13, or 15(d) of the Exchange Act has failed in any material respect to comply with thoes requirements. This would establish an administrative procedure similar to that provided in proceedings to delist securities under esction 19(a)(2). Proposed section 15(c)(5) would be the counterpart to section 19(a)(4) which provides for the summary suspension of trading in securities listed on a national securities exchange for periods of 10 days and would permit a similar suspension of trading in an over-the-counter security if, in the opinion of the Commission, the public interest and the protection of investors so require. Since both proposed section 15(c)(5) and section 19(a)(4) are emergency powers to be used only in circumstances where informed

trading in a security is impossible, it does not provide for notice and opportunity for hearing as do the provisions of proposed section 15(c)(4) and section 19(a)(2).

Although section 3(e) of the bills does not expressly cite either section 15(c)(4) or section 15(c)(5) of the bills, it does vest all the powers, duties, and functions of the Commission in the designated Federal banking agencies for the purpose of administering and enforcing sections 12, 13, 14(a), 14(c) and 16 of the Exchange Act with respect to securities of banks over which they have jurisdiction under the various banking acts. The authority contained in proposed section 15(c)(4) and 15(c)(5) is important to the enforcement of these disclosure provisions of the Exchange Act. Since information required by these provisions would be filed with and examined by the Federal banking agencies, they would often be in the best position to make the determinations required under the proposed sections of the act. For this reason, it is desirable that the Federal banking agencies be empowered, with respect to a security of a bank over which they have jurisdiction to make findings of noncompliance with, and to suspend temporarily trading for violations of, the provisions of the Exchange Act which they will administer and enforce. Similarly, since section 3(e) of the bills is not intended to affect the Commission's power to enforce other provisions of the act with respect to bank securities, the Commission could, for example, temporarily suspend trading in a bank security under section 15(c)(5) when a report filed pursuant to the provisions of the bills also results in violations of the antifraud and antimanipulations provisions of the Exchange Act as just as it may today in the case of a listed security.

9. Would a newly formed bank, selling its first stock to the public, be required to file a registration statement under the bill?

Since the registration provisions of the bills would apply ultimately only to over-the-counter companies having a class of equity securities held of record by 500 or more persons and over $1 million total assets, a newly formed bank normally would not be required to file a registration statement under the bills in connection with a first public offering of its securities.

10. If the answer to No. 9 is negative, why does the bill require that banks register long outstanding issues?

The underlying purpose of H.R. 6789 and S. 1642 is to extend to investors in over-the-counter securities in which there is a significant public interest protections comparable to those now afforded investors in securities listed on national securities exchanges. The provisions of the bills also would apply to securities of savings and loan associations, securities of common carriers subject to the jurisdiction of the Interstate Commerce Commission, and securities of other issuers which, like securities issued by national banks, are exempt from the registration provisions of the Securities Act. The reporting and proxy solicitation regulations of the Comptroller of the Currency, adopted in February 1962, reflect his own view that the adoption of disclosure requirements with respect to the outstanding securities of national banks is not necessarily dependent on the existence of comparable requirements with respect to public offerings of such securities. Nothing in the bills, however, would impair the Comptroller's existing authority to adopt, or diminish the feasibility of his adopting, such disclosure requirements with respect to public offerings of national bank securities as he deems appropriate.

THE AMERICAN BANKERS ASSOCIATION,
New York, N.Y., March 16, 1964.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: I am transmitting herewith a copy of a letter concerning S. 1642 which I have sent to the chief executive officers of all national banks, which is self-explanatory.

We would like to respond also to a proposed clarifying amendment with reference to the delegation of supervisory and rulemaking authority to the appropriate bank regulatory agencies. Our staff has discussed this with you and the Chairman of the Securities and Exchange Commission, and we are satisfied that the language of the Williams amendment makes a complete delegation of such

authority. However, if it is the desire of the committee to spell out such delegation with further emphasis, we would support such additional clarification.

Sincerely yours,

WILLIAM F. KELLY, *President.*

(Enclosure.)

THE AMERICAN BANKERS ASSOCIATION,
New York, N.Y., February 28, 1964.

To the Chief Executive Officers of All National Banks:

On February 20, 1964, the Comptroller of the Currency addressed a letter to the president of each national bank, enclosing a copy of a letter and an accompanying statement concerning S. 1642 which he had sent under date of February 19, 1964, to Congressman Oren Harris, chairman of the House Committee on Interstate and Foreign Commerce. S. 1642 is the legislation requested by the Securities and Exchange Commission which proposed to extend to larger issuers of stock traded in over-the-counter markets the provisions of the Securities Exchange Act of 1934 relative to public disclosure proxy solicitation, and insider trading.

Because the Comptroller's letter has generated anxiety and concern among national bankers across the country, it is the purpose of this letter to present a report on S. 1642—the actions taken by American Bankers Association and our understanding of its provisions as they would relate to banks—and hopefully in so doing to allay any fears which may have been aroused by the Comptroller's letter.

S. 1642 was introduced in the Congress in early June of last year. This bill presented the initial legislative recommendations of the Securities and Exchange Commission stemming from a special study authorized and directed by the Congress.

The primary objective sought by the SEC in S. 1642 is the application for the first time of the public disclosure, proxy solicitation, and insider-trading requirements of the Securities Exchange Act of 1934 to corporations whose stock is traded outside the national exchanges in the over-the-counter markets. Under the terms of the bill a corporation would become subject to the aforementioned requirements of the 1934 act if it has assets of $1 million or more and 500 or more shareholders (750 shareholders for the first 2 years after enactment). Heretofore, the 1934 act had applied only to those corporations whose stock was listed on the national securities exchanges. Historically, bank stocks have not been listed on the exchanges and, therefore, banks have not been concerned with the 1934 act.

It became apparent almost immediately after this legislation was introduced that it was destined for passage by the Congress. It enjoys strong support from the administration and from influential Members of Congress and unanimous backing from the stock exchanges and the securities industry. Thus, the question has never been, "Will S. 1642 pass?" but rather, "In what form will it pass?" Because of the widespread support in the Congress for this legislation and because the bill was aimed at all types of corporations, the American Bankers Association did not believe it was either wise or proper that this association should seek to have banks exempted from the bill. This position was approved by the Federal legislative committee and administrative committee of the association. The association was, however, concerned as to how this bill would be applied to and would affect banks. We were, and have continued to be, intensely interested in this matter of application, and it is to this aspect of the legislation that we have devoted our time and our energies.

As originally introduced, the provisions of S. 1642 relating to banks were phrased so as to provide that the "powers, functions, and duties" of the Securities and Exchange Commisison under the 1934 act would be delegated "in whole or in part" to any of the three Federal banking regulatory agencies to exercise with respect to the banks normally supervised by that agency provided that the Federal banking agency affirmatively requested such a delegation of authority from the SEC. The American Bankers Association was not at all satisfied with this provision. It was our conviction that the regulation of bank stock proposed by S. 1642 should be administered by the Federal banking agencies and not by the SEC. Since S. 1642 placed the regulatory power in the SEC, unless specifically requested by the Federal banking agencies, we concluded that this provision could only to confusion and complication for banks and might well result in certain banks being regulated, as to the trading of their stock, by the SEC while other banks would be regulated by one of the three Federal banking agencies.

We determined, therefore, that it was vitally important that S. 1642 be amended so as to provide clearly and unequivocally that its provisions as to banks would be administered by the Federal banking agencies and not by the SEC.

It was my privilege to present the position of the American Bankers Association on S. 1642 to the Securities Subcommittee of the Senate Banking and Currency Committee on June 25, 1963. In my statement to the subcommittee I described at considerable length the nature and extent of regulation, supervision, and examination to which banks are presently subjected by both Federal and State banking agencies. I pointed out that while this extensive regulation and supervision of banks is aimed primarily at protecting depositors and assuring the bank's soundness and stability, it nevertheless had a secondary effect of protecting the investing public in general and bank stockholders in particular. With this background I then suggested that S. 1642 should be amended so as to provide that with respect to bank stock, banks should be regulated not by the SEC but intsead, by the three Federal banking agencies; and further, to provide that the banking agencies be given the administrative flexibility to determine the manner in which they would carry out the statutory responsibilities of the 1934 act. The following two paragraphs from my prepared statement to the Securities Subcommittee will give you the primary thrust of the ABA's recommendations for amendments to that bill.

"Thus, the arrangement proposed in S. 1642 seems to be highly undesirable in practice. Moreover, we question whether, as a matter of principle, the Congress should leave this matter more or less 'up in the air.' We would instead urge that S. 1642 be amended so as to place with the appropriate bank supervisory agencies full and final regulatory authority over disclosure and related matters insofar as bank stock is concerned. The Congress would thereby direct the bank supervisory agencies to establish, pursuant to and consistent with the provisions of this legislation, appropriate legislation to provide for adequate disclosure on the part of banks. Those agencies are, of course, the Comptroller of the Currency in the case of national banks; the Federal Reserve Board in the case of State member banks; and the Federal Deposit Insurance Corporation in the case of insured nonmember banks.

"The different nature of banks from other business corporations, especially as a result of the strict regulation now applicable to banks, clearly indicates that enforcement of the provisions of S. 1642 relating to banks might well involve different techniques and procedures than the enforcement of similar provisions for nonbanking corporations. Consequently, we would strongly urge that the high degree of administrative flexibility now contemplated for SEC be granted to the banking agencies."

It is a matter of gratification to the association that the Senate committee adopted an amendment to S. 1642 which carried out the recommendations of this association. This amendment was proposed jointly by Senator Williams of New Jersey, chairman of the Securities Subcommittee, and Senator Javits, of New York. With respect to the amendment the Senate committee had this to say in its report which accompanied the bill to the Senate:

"The committee's opinion is that the provisions of S. 1642 relating to banks should be amended, as recommended by the American Bankers Association and the U.S. Chamber of Commerce, so that the powers, functions, and duties of the Commission to administer and enforce sections 12, 13, 14(a), 14(c), and 16 of the Exchange Act would be vested directly in the respective Federal bank regulatory agencies.

"It finds most persuasive the reasons advanced by the association, which directly represents the institutions most directly affected."

The Williams-Javits amendment was accepted by the Senate without objection and with that amendment S. 1642 was passed by the Senate on July 30, 1963.

From the very date of its enactment it has seemed entirely clear to the American Bankers Association that the effect of the Williams-Javits amendment was to directly and unqualifiedly transfer to the Federal banking agencies all of the powers, functions, and duties of the SEC under the 1934 act as to bank stock with respect to public disclosure, proxy solicitation, and insider trading. However, it is apparent from the Comptroller's letter to Chairman Harris of the House Interstate and Foreign Commerce Committee, that he has not shared our interpretation of the Williams-Javits amendment. His letter raises many questions concerning interpretation and application of this amendment.

It is our belief that all of these questions are very satisfactorily answered by either general or specific statements contained in the report of the Senate Com-

mittee on Banking and Currency. By way of example, let me cite one or two questions raised by the Comptroller and then refer to language in the Senate committee's report which I believe clearly answers these questions. In his letter the Comptroller asks: "Would the sponsors expect the banking agencies to follow the same general standards of disclosure as does the SEC?" On page 36 of its report the Senate committee had this to say:

"The committee also notes that the disclosure, proxy solicitation, and insider-trading provisions of the Securities Exchange Act of 1934 now provide, and would continue to provide under S. 1642, great discretionary authority for the administering agency to make appropriate rules, classifications, and exemptions. Under these provisions, the Federal bank regulatory agencies could adopt rules and forms differing from those of the Commission relating to companies, other than banks, whenever the bank regulatory agencies deemed it appropriate."

Also the Comptroller has asked in his letter to Chairman Harris, "Would the banking agency have the discretion to designate any reports it might require under the bill as nonpublic files?"

Regarding this question, the Senate committee had this to say on page 63 of its report:

"For the purpose of exercising the functions vested in them by this section, these designated Federal banking agencies would have the authority vested in the Commission under any provision of the Exchange Act. This would include, but would not be confined to, the power to define technical, trade, and accounting terms under section 3(b) of the act; the power to adopt rules and regulations necessary for the execution of their functions under the act pursuant to section 23(a) of the act; *and the power, under section 24 of the act, to extend confidential treatment to information filed with them pursuant to the provisions of the act.*" [Emphasis added.]

These two examples demonstrate and typify the thoroughness and clarity with which the Senate committee has described and interpreted the meaning and effect of the Williams-Javits amendment. In our opinion the Senate report leaves no room for questioning the intent of this amendment, which is to make total and unqualified transfer of the SEC's authority to the Federal banking agencies with respect to the regulation of bank stock.

To protect against any dilution of this amendment during the consideration of S. 1642 by the House Committee on Interstate and Foreign Commerce, a letter was sent to Congressman Staggers, chairman of the subcommittee holding hearings on S. 1642, reiterating the position of the American Bankers Association with respect to S. 1642 and the Williams-Javits amendment. Our letter to Congressman Staggers was sent under date of February 11, 1964.

On February 19, the day before the Comptroller's letter to the national bank presidents, a colloquy occurred in the House hearings between Chairman Oren Harris and William Cary, Chairman of the Securities and Exchange Commission, which should lay to rest any and all questions concerning the intent of the Williams-Javits amendment. The question raised by Chairman Harris was doubtless prompted by the Comptroller's letter and statement to him. The colloquy is as follows:

Mr. Harris: "Apparently the way it (the Senate amendment) is analyzed by some that I have discussed it with, any rules or regulations that you (the SEC) might issue would be binding on them (the Federal banking agencies) unless there was some provision here to make it very clear. Would you object to a provision in this (S. 1642) that would make it abundantly clear?"

Mr. Cary: "I would not object at all, sir. *That is what we contemplate, and when we said delegate, we meant it.*"

(Emphasis and parenthetical expressions have been added for purposes of clarity.)

It is therefore abundantly clear from the above-quoted colloquy that the Chairman of the SEC has interpreted the Williams-Javits amendment as having the effect of removing the SEC completely from the administration of the 1934 act with respect to the regulation of banks in connection with the trading of their securities.

I apologize for the length of this letter, but I did feel it necessary to set forth in detail the legislative record to date on S. 1642. I sincerely hope that this letter will answer any questions which may have arisen in your mind as a result of the Comptroller's letter, and I hope that it will additionally satisfy you that the American Bankers Association has been endeavoring to serve the best interests of the banking community.

Sincerely yours,

WILLIAM F. KELLY.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., March 13, 1964.

Hon. OREN HARRIS,
Chairman, Interstate and Foreign Commerce Committee, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: We are writing you concerning the Commission's legislatvie program (S. 1942, H.R. 6789, and H.R. 6792). As you well know, the bill has passed the Senate and is now pending before your committee in the House of Representatives. The President has specifically endorsed this legislation in his consumer message to the Congress dated February 15, 1964. The Comptroller of the Currency has repeatedly opposed this bill as it relates to national banks. He has now made public an attack (in the form of a letter dated March 6 to each national bank president) which is not only unwarranted but misleading. In an earlier letter on the same subject, dated March 3, 1964, the comptroller attacked the president of the American Bankers Association, which supports the bill, in an attempt to arouse opposition to the bill and to the views of that association. The Commission has until this time refrained from replying to the Comptroller but believes that it is now under a duty to state the facts.

In connection with our bill, which requires disclosure of information concerning all companies having wide public ownership, including banks, we have scrupulously avoided taking jurisdiction over banks. The bill vests authority over banks and bank securities in the appropriate banking regulatory agencies, including the Comptroller of the Currency as to national banks. Indeed, the bill would divest the Commission of its present jurisdiction over bank securities which are or may be listed on a stock exchange.

In answer to a question in the House hearings from you whether the Securities and Exchange Commission would object to a provision making it abundantly clear that no rules or regulations of the SEC would be binding upon the Federal banking agencies, I replied: "I do not object at all, sir, that is what we contemplate, and when we said delegate, we meant it." Pursuant to your suggestion, an amendment to the bill is being prepared which excludes SEC jurisdiction in even more explicit language.

In his letter of March 6 containing seven pages of selected summary of statutory provisions, the Comptroller has attempted to convey an impression of incredibly burdensome and technical requirements flowing from the bill. He totally omits the fact that administration of the law is exclusively in his hands and that he has ample authority to carry it out, in a reasonable way. His letter, to the contrary, carries the implication that he will be and must be an unreasonable administrator. The Comptroller has apparently overlooked, or chosen to ignore, those provisions of the bill which grant to the banking regulatory agencies broad powers to exempt banks, classify them and generally relate rules to particular situations where necessary. In the words of the Senate Report the bill provides "[a] great discretionary authority for the administering agency to make appropriate rules, classifications, and exceptions."

In the sum the Comptroller has chosen to overlook the ample authority to be granted him by the Congress to tailor the requirements of the bill to the special needs and problems of national banks.

In closing, I would point out that our legislative program is the end product of a 2-year examination of the securities markets directed by the Congress; that this program has received almost universal support of the securities industry; that the application of the bill to banks, to be administered by the banking authorities, has been approved by the Federal Reserve Board, the American Bankers Association, and the U.S. Chamber of Commerce; and that the complete and exclusive power of the Federal banking regulatory authorities to deal with bank stocks has been already spelled out in the legislative history of the bill and it will be further reemphasized in the proposed amendment.

Very truly yours,

WILLIAM L. CARY, *Chairman,*
(For the Commission.)

EXECUTIVE OFFICE OF THE PRESIDENT,
BUREAU OF THE BUDGET,
Washington, D.C., March 13, 1964.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: It has come to our attention that in a letter to your committee, dated February 19, 1964, and in a statement of the same date, the Comptroller of the Currency expressed strong opposition to certain provisions of H.R. 6789 and S. 1642 which affect the Nation's banks. As you may have noted, neither the letter nor the testimony contained the usual advice from this Bureau as to relationship to the President's program. The views expressed, therefore, were the Comptroller's own views and they were in fact contrary to the administration position with respect to these provisions of the bill.

To summarize the record on this matter:

1. The provisions of the bill affecting banks and insurance companies were extensively discussed before the legislation was transmitted to the Congress, and the decision to include them under the full disclosure and certain other provisions of the bill was a carefully considered one.

2. Your committee was advised on June 3, 1963, and November 14, 1963, that enactment of this legislation would be in accord with the program of the President.

3. President Johonson's 1965 budget document (pp. 106 and 107) reaffirmed this position as follows:

"Pending legislation should be enacted to help protect millions of small investors by extending the present disclosure safeguards to all companies whose securities are widely owned, and by otherwise strengthening the securities laws."

4. The President's consumer message of February 5, 1964, also recommended its prompt enactment.

We would appreciate your making this letter a part of the record on S. 1642 and H.R. 6789 in order that there may be no doubt as to the administration position on this matter.

Sincerely,

KERMIT GORDON, *Director.*

Mr. STAGGERS. I would like to take this opportunity to thank you, Mr. Cary, and your whole staff. This has been a hard day; you have been here many days and have spent a lot of time here. We appreciate it, because we feel this is serious business. We needed your help, and you have been helpful, you and all of your staff.

I wish to thank the members of the staff of this committee because they have certainly been tolerant in all of their time and giving of not only their free time but their time to be helpful. We do appreciate your help very much. I was impressed with you and your Commission's presentation on the things you intend to do.

Mr. CARY. Thank you, Mr. Chairman. We certainly want to say as I did at noontime that I think that the probing questions and the encouragement and sometimes the stimulus that this committee has given to us will stand in good stead for the investor.

Thank you very much.

(The following letters were later received from Mr. Cary:)

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., February 28, 1964.

Hon. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance,
Committee on Interstate and Foreign Commerce,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: Thank you for your letter dated February 24, 1964, concerning certain aspects of my statement before your committee on safeguards respecting customers' funds and securities.

As I mentioned in my statement, we have circulated to industry groups a proposed Commission rule requiring broker-dealers holding free credit balances to notify customers on a periodic basis of the status of customer free credit balances and of the fact that they are being used by the broker-dealer holding them and thus may be vulnerable in the event of insolvency. For your information, I am enclosing a copy of this rule, which incorporates one of the recommendations of the Special Study relating to financial responsibility. (Recommendation 1, ch. III. D.) We are now discussing this proposal with the industry.

In addition to the above rule, the Commission is now preparing a substantial revision of the Commission's net capital rule (rule 15c3–1 under the Exchange Act) which will contain, among other things, a provision to require that broker-dealers maintain a certain percentage of customers' free credit balances in liquid form. The primary purpose of this amendment is to provide a certain amount of liquidity in the event that customers wish to withdraw these balances. Moreover, by in effect restricting the investment of free credit balances, this proposal can also serve to limit the risks a firm might otherwise incur. This proposed rule has not yet been circulated to the industry but we expect to do so within the very near future.

I should point out, as I did in my statement before the committee, that the Commission regards complete segregation of free credit balances as a last resort. The need for protection of free credit balances and the added benefits that would be afforded by segregation must be balanced against the added cost which might have to be absorbed by customers. We have concurred with the conclusion of the study that on the basis of prior loss experience, there does not appear a need to require complete segregation at this time.

If I can be of further assistance to you on this or any other matter, by all means let me know.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

[Staff draft. Feb. 6, 1964]

PROPOSED RULE 15c3–2 UNDER SECTION 15(c)(3) OF THE SECURITIES EXCHANGE ACT OF 1934

No broker or dealer shall use any funds arising out of any free credit balance carried for the account of any customer in connection with the operation of the business of such broker or dealer, unless such broker or dealer has established adequate procedures pursuant to which (A) each customer will be informed in writing, when such customer opens an account with such broker or dealer, that such customer may request repayment of such funds without prior notice; that such funds may be commingled with assets of such broker or dealer and may be used in connection with the operation of any business of such broker or dealer; and that interest will (or will not) be paid on such funds and, if so, the rate or other basis of computation; and (B) each customer for whom a free credit balance is carried will be given or sent, not less frequently than once a month, (i) a written statement informing such customer of the exact amount due to the customer by such broker or dealer on the date of such statement, and (ii) a written notice that such funds may be commingled with assets of such broker or dealer and may be used in connection with the operation of any business of such broker or dealer; and that such customer may request withdrawal of such funds without prior notice. The notice required by clause (B) (ii) above shall be in type at least as large as 8 point modern type. For the purpose of this rule the term "customer" shall mean every person other than a broker or dealer.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., March 3, 1964.

HON. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: Thank you for your letter dated February 24, 1964, concerning the activities of specialists on the American Stock Exchange.

The Commission has not made a specific study of the activities of American Stock Exchange specialists following the assassination of the President on November 22. As I stated in my letter transmitting the staff's study of the

New York Stock Exchange specialists, under present circumstances reconstruction of the market is a difficult and painstaking process, requiring considerable clerical and analytical work.

In line with the recommendations of the Special Study, we have instituted a broad and regular inspection program of all national securities exchanges. Members of the Commission's staff are now inspecting on a routine basis various aspects of the American Stock Exchange's regulatory activities, including that exchange's oversight of its specialists.

It would appear from our inspections that the exchange has made a considerable effort to improve its supervision and surveillance of specialists' activities, including the development of new tests for judging specialists' performance. In another step, the exchange has recently reorganized its market surveillance functions to improve their effectiveness. However, there remain a number of important areas where the exchange can improve its surveillance of specialists and their financial arrangements, particularly in the areas outlined in the Special Study Report. We expect to discuss these matters in the near future with the American Stock Exchange when we commence discussions on the Special Study recommendations relating to specialists.

In answer to your last question, we are not aware of any disciplinary actions taken by the exchange against specialists relating to failure to meet exchange capital rules on November 22, 1963. Since members of the American Stock Exchange, as well as members of other major exchanges, are exempt from the provisions of the Commission's net capital rule, the Commission cannot take disciplinary action against them for violations of that rule. The Commission has found that the rules and settled practices of the exchange are more comprehensive than the requirements of the Commission's net capital rule.

In view of the fact that your letter concerns the self-regulatory activities of the American Stock Exchange, I have taken the liberty of sending a copy of your letter, together with our reply, to that exchange. If I can be of any further assistance to you on this or any other matter, by all means, let me know.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., March 2, 1964.

Hon. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance,
Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: Thank you for your letter dated February 24, 1964, concerning the specialists in American Photocopy stock.

We understand that depriving the specialists of the "book" in this stock was the extent of the disciplinary action taken by the exchange as a result of the events of November 22, 1963. As I mentioned in my statement before your subcommittee, the president of the New York Stock Exchange has informed me that dealer and brokerage activity in American Photocopy stock accounted for almost three-fourths of the income of these specialists. The Commission has no reason to believe, on the basis of the available facts, that this disciplinary action was inadequate.

In this connection, the Commission cannot take disciplinary action under exchange rules against specialists for failure to maintain fair and orderly markets. The Commission has recently proposed a rule under the Exchange Act to the New York exchanges which sets forth the basic obligation of specialists to maintain a fair and orderly market. Its general purpose would be to reinforce self-regulation by the exchanges and it would be invoked by the Commission in cases of egregious misconduct by specialists.

If I can be of any further assistance to you on this or any other matter, by all means, let me know.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

Mr. STAGGERS. With those remarks the committee stands adjourned.

(The following material was submitted for the record:)

HOUSE OF REPRESENTATIVES,
Washington, D.C., March 5, 1964.

HON. OREN HARRIS,
Chairman, Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: I respectfully request permission to submit the following statement opposing S. 1642, a bill which would place certain national banks under the provisions of the Securities and Exchange Act of 1934.

TEXT OF STATEMENT BY CONGRESSMAN BOB WILSON ON S. 1642

It is public knowledge that national banks already suffer from burdensome overrgulation. They are subject to the National Bank Act, the Federal Reserve Act, the Clayton Act, and the laws of the State wherein their principal office is located. The proposed legislation, S. 1642, would bring under the act of 1934 banks with 750 or more shareholders and with $1 million or more assets. They would thus be required to provide the Federal Government with registration statements, periodic reports, proxy statements, and insiders trading reports, all of this in addition to data they are already required to supply, much of it duplicative of what the proposed legislation contemplates.

I would remind the committee that the Comptroller of the Currency opposes this legislation for just the reasons I have cited and has stated that it would place new and wholly unnecessary burdens upon the banks affected, which might well be "the straw that broke the camel's back."

There is the additional consideration that banks are less free than other business firms to disclose the kind of information sought under this bill. Bank funds are largely deposits and the depositors are justifiably sensitive about the release of information which might be interpreted in an unfavorable light by the public. The terms of this bill provide no guarantee that the Federal Government would not be free to make such data widely available.

For these reasons, I oppose the legislation.

I respectfully request that this statement be made a part of the committee's records.

Sincerely,

BOB WILSON, *Member of Congress.*

THE AMERICAN BANKERS ASSOCIATION,
New York, N.Y., February 11, 1964.

HON. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance, House Committee on Intrastate and Foreign Commerce, Washington, D.C.

DEAR MR. CHAIRMAN: The American Bankers Association supports and urges favorable action by the Subcommittee on Commerce and Finance on S. 1642, as amended by the Senate extending to the issuers of stock traded in over-the-counter markets the provisions of the Securities Exchange Act of 1934 relative to public disclosure, proxy solicitation, and insider trading. Because the only provision in this legislation, as introduced, to which the American Bankers Association takes strong exception has been cured by amendment in the Senate, we are presenting our views by letter rather than formal appearance in an effort to economize on the valuable time of your subcommittee.

From the very outset the American Bankers Association has supported the general purposes and objectives of S. 1642 and the companion bill, H.R. 6789. However, our association does have one specific objection to this legislation as it was originally introduced in the House and the Senate. It is to those provisions appearing at page 11 of the original bill, which define the manner in which banks are to be regulated under the Securities Exchange Act of 1934. The bill provides that as to banks the requirements of the 1934 act shall be administered by the Securities and Exchange Commission unless a Federal banking regulatory agency requests a delegation of authority from the SEC so that it might exercise all or any of the powers, functions, and duties of the Commission under the 1934 act with respect to those banks which the banking agency normally supervises or examines. We view this provision as being unneces-

sarily complicated and feel it could give rise to needless confusion and uncertainty in the field of bank regulation.

For example, it is conceivable that one agency, such as the Federal Reserve Board, might not request that any power be delegated to it, or might request only a part of the powers granted by the legislation, thereby leaving substantial authority to the SEC, while another agency, such as the Office of the Comptroller of the Currency, might request complete delegation. This would mean that a State member-bank of the Federal Reserve System, would be regulated in whole or in part by a nonbanking agency—the Securities and Exchange Commission—while a national bank operating in the same community, and perhaps in the same city block, would be regulated by a banking agency—the Comptroller of the Currency. Much confusion could arise under this type of arrangement, and the confusion might be compounded over time as requests for delegation were rescinded or amended. Such changes might well occur with changes in management of the banking agencies.

We feel that the language of this provision gives tacit acknowledgment to the view that the proposed securities regulation so far as it applies to banks should be administered by the Federal banking agencies rather than the SEC. Our concern over the potential for confusion and complication caused the American Bankers Association to recommend to the Securities Subcommittee of the Senate that this particular subsection of the bill be amended so as to provide for the direct and unqualified delegation of this regulatory authority to the three Federal banking agencies. On the joint motion of Senator Williams of New Jersey, chairman of the Securities Subcommittee, and Senator Javits, S. 1642 was amended by the Senate committee in accord with our recommendation. This action, which had the approval of the Securities and Exchange Commission, was accepted by the Senate at the time it considered and adopted S. 1642. We were pleased to note that Chairman Cary of the SEC, in appearing before this subcommittee, stated "The Commission has no desire, and is, indeed, reluctant, to take direct responsibility over bank disclosures in any respect. It is only the principle of adequate disclosure which we assert."

It is our earnest hope that the Subcommittee on Commerce and Finance will see fit to approve this particular Senate amendment. Virtually all commercial banks are subject to Federal supervision by reason of their National charter or, if State chartered, because of membership in the Federal Reserve System or the Federal Deposit Insurance Corporation. In addition, State banks are subject to further supervision by State authorities.

Unlike most other businesses, entry into banking is strictly regulated, with careful attention given to such things as community needs, proposed management, capital adequacy, and earnings prospects. Once established, banks must furnish reports of condition to both State and Federal authorities and, with few exceptions, must publish them. Detailed reports of earnings and dividends must also be furnished and, though generally not required to be published, are subject to regular verification by examiners. Thorough examinations are made of every bank—usually at least once a year—for the primary purpose of appraising the assets of the bank and determining its net sound capital. Any developing capital impairment must be arrested or rectified, or the bank is closed.

Operating limitations are likewise extensive. Without permission of a Federal agency— and in some cases of a State agency—no insured commercial bank may open a branch, change its home office or branch location, employ a person convicted of dishonesty or a breach of trust, or retire capital. In addition, banks generally are subject to specific operating restrictions such as limitations on the amount loaned to a single borrower, limitations on the volume of real estate loans, and maximum interest rate ceilings on deposits.

It should also be noted that Federal supervision extends to bank holding companies and to bank mergers. In each case Federal authorities possess broad powers designed to protect the public and to assure bank soundness and stability in these two essential areas.

The extensive and stringent supervision presently given commercial banks is due primarily to the fact that the commercial banking industry holds, in the form of deposits, the bulk of the Nation's money supply. We are aware that this supervision is not directed solely, or even primarily, at the protection of stockholders. Instead, it is to protect depositors and to guard the money supply by assuring bank soundness and stability. However, it should be obvious that bank stockholders also benefit from this strict supervision. When, for example, supervisory authorities deny a bank charter because of the speculative nature

of the enterprise, the specific reason for doing so may not be that of protecting the investing public, but the end result is the same.

The extensive scope and detailed nature of existing regulation of commercial banks by Federal and State banking agencies provides—we believe—a justifiable basis for differentiating banks from other business corporations when considering the imposition of additional governmental regulation on banks. For the reasons indicated we very strongly urge that the application of the new regulatory requirements contained in the instant legislation be achieved through the Federal banking agencies rather than a nonbanking agency such as the Securities and Exchange Commission.

We have also noted that during Chairman Cary's appearance on November 20, 1963, the subcommittee made some initial inquiries into the difference of views involving appropriate Federal regulation and supervision of bank-maintained collective investment funds. If banks are to effectively carry out their responsibilities as trustees under the provisions of the Self-Employed Individuals Tax Retirement Act of 1962 (the Smathers-Keogh Act), it is essential that the Congress resolve the dispute between the Comptroller of the Currency and the Securities and Exchange Commission concerning the Federal regulation of bank collective investment funds.

Because the Federal banking agencies have been regulating and supervising bank common trust funds (organically identical to the proposed pooled funds of Smathers-Keogh trust assets) for over 25 years in a manner wholly consonant with the public interest, it is the view of the American Bankers Association that regulation and supervision of bank collective investment funds should continue to be vested exclusively in the Federal banking agencies. This is the approach adopted in H.R. 8499 by Congressman Anderson, of Illinois, and H.R. 9410 by Congressman Fascell, of Florida, both of which have been referred to the Committee on Interstate and Foreign Commerce for consideration.

These two bills—identical in their requirements—carefully define the capacity in which a bank must hold assets in order that it may commingle those assets for investment purposes without being subject to the Federal securities laws. Statutory standards are established for the operation of common trust funds and similar pooled funds, which will assure full public disclosure for those seeking and employing bank trust services. These standards are drawn so as to give full recognition to the uniqueness of banking procedures and to the distinctive nature and scope of existing bank regulations, just as the Investment Company Act of 1940 was carefully drafted to accommodate well-established practices in the investment company field. (See S. Rept. 1775 of the 76th Cong., 3d sess., p. 1.) The authority to promulgate rules and regulations implementing these statutory requirements is vested solely in the Comptroller of the Currency, with added authority granted the Comptroller to issue such other regulations as may be necessary to assure proper protection for those individuals who have an identifiable interest in these funds. To avoid any possible impairment of our dual banking system the Anderson and Fascell bills very wisely provide that supervision of compliance with the Comptroller's regulation shall be divided among the three Federal banking agencies along the traditional jurisdictional lines. These provisions are similar to the Senate amendment to S. 1642. In short, H.R. 8499 and H.R. 9410 establish both the pattern and the procedure for the Federal regulation of three clearly defined classes of collective investment funds operated by banks in the conduct of trust business.

Should the Subcommittee on Commerce and Finance desire to consider this matter in conjunction with its deliberations on S. 1642, the American Bankers Association is prepared to cooperate in the development and presentation of any materials and information needed by the subcommittee. If, on the other hand, it is the subcommittee's decision to consider the collective investment fund legislation separately, we do hope that it will be possible to commence consideration by your subcommittee in the near future. Only the Congress can effectively resolve this dispute between the SEC and the Comptroller of the Currency, and until it is resolved the vast majority of banks will not be able to provide their customers with the full range of fiduciary services which they are well qualified to perform.

We appreciate this opportunity to express the views of the American Bankers Association on S. 1642 and the pending legislation relating to bank collective investment funds, and we hope that this letter may be included in the public record of your hearings.

Sincerely yours,

WILLIAM F. KELLY, *President.*

STATEMENT OF NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

The National Association of Independent Insurers is a trade association of 350 casualty and fire insurance companies located and doing business in all parts of the United States. Two hundred and eighteen of these companies are capital stock companies.

Our association strongly urges that H.R. 6789 and H.R. 6793 and S. 1642 pending before your committee be amended to exempt securities issued by insurance companies subject to State regulation from their scope. The extension of SEC authority over securities issued by insurance companies would duplicate the efforts of the individual States and thus impose on those companies a costly burden which is both watseful and unnecessary.

Through the efforts of individual State insurance commissioners and their central organization, the National Association of Insurance Commissioners, a comprehensive body of regulation has been developed in the 50 States which imposes on insurance companies close supervision concerning the interests of both the insuring and investing public. Illustrative of these is the annual statement required to be filed with State regulatory officials and made a matter of public record. This statement provides a detailed analysis of insurance company activities. Its contents are used by various financial analysts, insurance writers, and other interested parties to determine the soundness of insurance company finances.

In addition, the NAIC has just recently inaugurated a program designed to better aid the insurance investor. A stockholder information supplement to the annual statement will require companies to provide information on financial reports to stockholders, insider trading, and compensation and stock holdings of management and directors. There is also an interrogatory in the existing annual statement dealing with conflicts of interest.

Other reports of losses and expenses are required by the various States, and the results published frequently. Insurance companies are given thorough periodic examinations by State examiners. The report of these examinations is generally a matter of public record.

Thus there can be no doubt that the information readily available to the investing public at the present time is most extensive and duplicates most of the ground covered by the proposed amendments. To require insurers in addition to become subject to SEC regulation would be an unwarranted addition to insurance company expenses. Extension of the regulatory jurisdiction of the Federal Government would not replace State regulation but would be added to it. Compliance with dual regulation would be costly, burdensome, and confusing. This was not the object of Congress when it passed Public Law 15 delegating the power to regulate insurance companies to the States. It was the judgment of Congress that the States were in a better position to regulate the industry than the Federal Government.

The SEC filed its report with the Congress on April 3, 1963, which contained recommendations for broadening its jurisdiction over many stock insurance companies, alleging certain inadequacies of State regulation. The NAIC has now promulgated further requirements in its annual statement (as outlined above) in order to better inform the investor public. These requirements would seem to answer the SEC's criticism and clearly fulfill the prerequisites for exemption as outlined in the SEC report. It is certain that, should other purported inadequacies be brought to the attention of the NAIC and/or individual States, if need be, they will be rectified.

For the above reasons, we earnestly request your subcommittee to amend H.R. 6789 and H.R. 6793 and S. 1642 so as to exempt any securities issued by insurance companies which are subject to supervision by the insurance commissioner or any agency or officer performing like functions for any State or territory of the United States or the District of Columbia.

Respectfully submitted.

VESTAL LEMMON,
General Manager.

STATE OF OHIO,
OFFICE OF THE GOVERNOR,
Columbus, December 10, 1963.

Hon. PAUL F. SCHENCK,
U.S. House of Representatives,
Washington, D.C.

DEAR PAUL: Carl Shipley has written me and called my attention to S. 1642, a bill to amend the Securities Act of 1933 and the Securities Exchange Act of 1934. This bill would extend disclosure requirements to the issuers of additional publicly traded securities, and would provide further for improved qualification and disciplinary procedures by registered brokers and dealers. According to Mr. Shipley the bill is currently being heard by the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce.

I have asked Ralph A. Winter, superintendent of securities in the department of commerce here in Ohio, to give me his recommendation on this bill. It is his view—a view which I adopt—that enactment of S. 1642 would encroach upon Ohio's rights in the field of broker-dealer regulation. I believe that, at the State level here in Ohio, there is now adequate control and regulation of the activities embraced by S. 1642. Enactment of that bill would susbtantially duplicate Ohio's efforts and would be a step toward the ultimate taking over of the entire field of securities regulation by the Federal Government.

I am sending a duplicate of this letter to your colleague, Congressman Devine.

Sincerely,

JAMES A. RHODES, *Governor.*

THE FIRST NATIONAL BANK OF DOTHAN,
Dothan, Ala., February 24, 1964.

Congressman GEORGE GRANT,
Washington, D.C.

DEAR CONGRESSMAN: It would be appreciated if you would deliver this letter to someone on the House Banking and Currency Committee whom you may know, or to the chairman.

We refer to Senate bill 1642, which, among other things, would subject every bank having assets of a million dollars or more, or 500 or more stockholders to the major provisions of the Securities and Exchange Act of 1934.

The Comptroller of the Currency has been supervising the national banks from the beginning of the system. We are carefully examined and make many reports to the Comptroller of the Currency as to practically every detail of our operation. We are required to publish a detailed financial statement four times a year and have the same printed in newspapers.

I cannot see any benefit to anyone which may be gained by putting a certain class of banks under the SEC regulation and it would be just one more annoyance and would be rather a useless one.

This bank would not come under the present proposal, as passed by the Senate, but we can easily see the burden and hardship on the banks who will come under it. I hope the House committee will exempt banks from the provisions of S. 1642.

Very truly yours,

W. D. MALONE,
Chairman of the Board.

NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT FUNDS,
February 12, 1964.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR CHAIRMAN HARRIS: I enclose a copy of a statement of policy recently adopted by the National Association of Real Estate Investment Funds concerning various pending proposals in connection with the conduct of the securities markets and, specifically, supporting the adoption by Congress of H.R. 6789.

Our association, whose members own the greater part of funds invested via the real estate investment trust medium, was formed in 1960 shortly after sections 856 to 858 were added to the Internal Revenue Code. Since our formation we have taken an active industry-Government liaison role with the Internal

Revenue Service (in connection with the regulations and various rulings under secs. 856 to 858 of the code), the Securities and Exchange Commission (in connection with prospectus and shareholder reporting requirements under the existing securities laws), and with various State securities commissions and associations (with respect to the application of their respective blue-sky laws to real estate investment trust securities). We have also, since our organization, been actively working toward the formulation and adherence of high standards of conduct and public responsibility to be maintained by our own members.

As you are undoubtedly aware, the requirements for qualification as a real estate investment trust under the code and Treasury regulations are extremely complex and rigid. In addition, real estate investment trusts must frequently meet rather strict State requirements. And, because they are running trusts, it is generally felt that the trustees of real estate investment trusts owe a higher degree of fiduciary duty to their beneficiaries-shareholders than officers of other types of business organizations. As a result of these factors, our association, which represents businesses already subject to a high degree of public duty and public control, strongly backs your bill to increase the standards and the protection of the public in the securities markets generally.

We feel that the public deserves full and accurate information about the securities not only that it is being asked to buy, but also that it already owns; and for that reason we strongly support the continuing shareholder reporting requirements, presently expected of listed companies, being made applicable to companies whose securities are traded over the counter, as indeed are the securities of most of our members. Some of our members have fewer than 300 or 500 shareholders and might therefore not technically be subject to the requirements of the bill. You will observe, however, that the enclosed statement of policy urges that those of our members with fewer than the requisite number of shareholders nonetheless give to their shareholders the same detail of information that would be required of trusts subject to the new law. In this respect, I think the proposed legislation will have an important side effect, for the investing public will, I believe, come to expect being continually kept informed by their companies, whether or not these companies must give the required information, with the result that most publicly owned companies will voluntarily submit the desired information to their shareholders notwithstanding that they may not be required to do so.

As pointed out in part 1, subchapter IV.E.4.b(2), at page 588, of the Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, some real estate securities have been sold to the public by people who are not adequately trained or informed concerning securities. To the extent that this leads, as it would appear that it must, to investment by the public on the basis of inadequate information and understanding of what is being bought, we deplore this practice. We believe that most of the problems of this sort have arisen in connection with the sale of real estate limited partnership interests. Although every offering of real estate investment trust securities of which I am aware has been handled by a member firm of the National Association of Security Dealers, Inc., and has been made under a registration statement filed under the Securities Act of 1933, nonetheless some of the tar that has been spread as a result of sales of other real estate securities has brushed off on the sale of all real estate securities, including real estate investment trust securities. Several commentators and on occasion a few State officials criticizing and proposing drastic "reform" in the sale of real estate securities have failed to distinguish between the various types of real estate securities involved, and where this has happened real estate investment trusts have been unfairly tarnished. The proposed bill presently before Congress, if enacted, should go a long way toward eliminating this problem by removing the unqualified salesman from the real estate securities market.

One of the inherent problems with sales of real estate limited partnership interests is their relative lack of marketability. In other words, once a person buys in it is difficult for him to sell out. Many investors are not aware of this fact when purchasing limited partnership interests, and it is largely the inherent difficulty of transferring a partnership interest and of maintaining an active market in them that accounts for the fact that so few of the established underwriting and brokerage houses either handle the initial offering or maintain a secondary market in these limited partnership interests.

Real estate investment trust shares, on the other hand, by their inherent nature, are as freely transferable as corporate securities. Indeed, one of the reasons given in the report of the Committee on Ways and Means in 1960 for

recommending the addition of sections 856 to 858 to the Internal Revenue Code was that this vehicle would allow investors to obtain the same tax benefits afforded limited partnership interest holders while at the same time giving them easily transferable interests. Real estate investment trusts, by the requirements of the tax law itself, must have at least 100 shareholders, and most have substantially more. For this reason, they have attracted the interest of well-established general underwriting and brokerage houses who are subject to the rules and requirements of the NASD, and most of whom are also members of national securities exchanges. Consequently the initial offerings of real estate investment trust securities, and also the maintenance of secondary markets in these securities, have been handled by reputable, qualified firms and salesmen on the same basis as other industrial or commercial offerings.

As other responsible segments of the securities industry have done, therefore, our association heartily endorses the legislation presently before your committee and hopes that it will help eliminate unqualified brokers, dealers, and salesmen from the securities industry and thereby further increase the protection and confidence of the investing public.

I might add that our association firmly believes that, to the greatest extent feasible, the standards and qualifications for all persons dealing in any kind of securities should be made uniform. We would therefore not favor any proposal which would result in the adoption of such special rules with respect to real estate securities as would appear to stigmatize them generally, any more than I imagine banks, savings and loan associations, insurance companies, oil and gas producers, or other specialized industries would favor such specialized rules with respect to their securities. Although there are, of course, unique factors relating to the real estate industry, this can be said equally of every industry, and it would make no more sense to require that a securities salesman have a special grounding in real estate matters before he could sell real estate securities than it would be to require that he have special grounding in oil or automotive matters before he could sell securities of Standard Oil of New Jersey or General Motors. It would be especially unfortunate, from our point of view, if rules were adopted establishing separate qualifications for brokers and dealers in real estate securities which might effectively result in the established underwriting and brokerage firms ceasing to handle the securities of our members, or, indeed securities of any other industry. While there appears to be room within the proposed legislation for the National Association of Securities Dealers and the Securities and Exchange Commission to promulgate rules which might have such unfortunate effects, we nonetheless count on their continued intelligent administration of the securities laws as we trust they will shortly be amended.

Sincerely,

JOHN H. GARDINER,
President, National Association of Real Estate Investment Funds.

NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT FUNDS STATEMENT OF POLICY

Whereas a principal purpose of this association is to educate the public concerning the advantages to the economy and to investors of investments in securities of real estate investment trusts; and

Whereas this association is committed to the goal that all matters concerning and affairs of real estate investment trusts must be conducted in a manner warranting the highest degree of public confidence; and

Whereas this association is committed to the further goal that investors and potential investors in securities of real estate investment trusts be reliably, accurately, and meaningfully informed concerning the affairs of the issuer both prior to their making of an investment in such securities and while they remain holders of such securities; and

Whereas abuses recently disclosed in the sale of some real estate securities and in the conduct of the affairs of a few issuers of real estate securities, while not numerous and not relating to the securities or affairs of real estate investment trusts, nonetheless tend to undermine public confidence in the securities and affairs of the issuers of real estate securities generally including to some extent real estate investment trusts; and

Whereas the association believes that it is desirable and beneficial both to the investing public and to real estate investment trusts that persons acting as dealers or brokers of real estate securities be subject to the same degree and

not to a greater or less degree, of supervision, regulation, and control as persons acting as dealers or brokers of securities generally and that investors buying securities need the same measure of meaningful, accurate, and reliable information in connection with a purchase of securities whether such purchase is technically in interstate or intrastate commerce: Now, therefore, this association—

(1) Supports and urges the enactment by Congress of pending legislation, embodied in S. 1642 and H.R. 6789, to amend the Securities Act of 1933 and Securities Exchange Act of 1934, which is designed, among other things, to require increased continuing disclosure by issuers of securities not listed on a national securities exchange and also to require the registration with the Securities and Exchange Commission and membership in a registered securities association of all securities brokers and dealers;

(2) Urges all of its real estate investment trust members to comply with the applicable standards for proxy statements and reports to shareholders established by the Securities and Exchange Commission notwithstanding that such members are not now, or after the enactment of pending legislation before Congress may not be, required by law to comply with such standards; to the end that all shareholders of real estate investment trusts be furnished with the same degree of information, whether or not the securities of a real estate investment trust are listed on a securities exchange, and without regard to the number of shareholders it may have; and

(3) Urges that the National Association of Securities Dealers, Inc. (or other registered securities association) adopt, and the Securities and Exchange Commission approve, rules as to membership in such association and conduct which will establish certain minimum qualifications for any person acting as broker or dealer in any security but which will not unduly stigmatize brokers and dealers in real estate securities or prevent established brokers and dealers from continuing to handle securities of real estate investment trusts.

THE CENTRAL NATIONAL BANK OF RICHMOND,
Richmond, Va., February 24, 1964.

HON. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. HARRIS: It is our understanding that H.R. 6789 is now under consideration by the House Committee on Interstate and Foreign Commerce under your chairmanship. It seems to me that my comments can be more meaningful if I talk about the Central National Bank rather than banking generally.

We have no objection to a full disclosure to the public of any of the facts of our operations which do not involve individuals' or businesses' confidential relationships. To amply demonstrate our point of view, there are enclosed herewith the following data.

1. A copy of our latest annual report. Similar reports have been made annually since the early 1930's.
2. A copy of our latest statement to shareholders soliciting proxies.
3. A copy of our financial statement which is published quarterly throughout the year.

We are already subject to the regulations of the Comptroller of the Currency, the regulations of the Federal Reserve Board, the regulations of the Federal Deposit Insurance Corporation, and, in many cases, to the regulations comprised in the statutes of Virginia and the banking department of the State of Virginia.

We submit that placing national banks in our position under the regulation of the SCC will accomplish nothing for either investors of citizens of the United States. It will add gratuitously to the increasing burden of the cost of operations.

Sincerely yours,

W. HARRY SCHWARZSCHILD, Jr., *President.*

INVESTORS DIVERSIFIED SERVICES, INC.,
Minneapolis, Minn., January 24, 1964.

Hon. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, Washington, D.C.

DEAR MR. CHAIRMAN: This letter has reference to H.R. 6789 and H.R. 6793 and related Senate bill 1642, which propose amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934 as amended, and which have been the subject of recent hearings before your subcommittee on Commerce and Finance. This letter will constitute the statement of Investors Diversified Services, Inc. (IDS) with respect to the proposals contained in that proposed legislation.

BACKGROUND OF IDS

IDS is a Minnesota company, which was incorporated in 1894. Until 1941 it sold instruments commonly referred to as "face amount certificates" under which stated amounts were paid to the holders of the certificates at maturity, in consideration of periodic payments made by the holder during the accumulation period of the certificate. The proceeds of the payments were invested in government, corporate, and mortgage obligations in order to produce the funds necessary to discharge the obligations of the certificate at maturity. Since 1941 this operation has been continued through a wholly owned subsidiary, Investors Syndicate of America, Inc. Commencing in 1941 IDS also entered into the mutual fund industry with the formation of Investors Mutual, Inc. and, thereafter, Investors Stock Fund, Inc., Investors Selective Fund, Inc., Investors Inter-Continental Fund, Ltd. (formerly known as Investors Group Canadian Fund, Ltd.), and finally, Investors Variable Payment Fund, Inc. By contract, IDS acts as the investment adviser and exclusive distributor for these open-end mutual funds.

I believe it is acurate to say that from almost any point of reference, the investors group of companies is preeminent in the face amount certificate and the mutual fund industry. Investors Mutual, Inc., is the world's largest mutual fund, having assets currently in excess of $2 billion. Investors Stock Fund, Inc.'s assets at the present time are a little in excess of $1 billion. Assets under the management of, or for which IDS acts as investment adviser, exceed $4 billion. The face amount certificate business conducted by Investors Syndicate of America, Inc., represented certificate liabilities of approximately $575 million as of May 31, 1963, which represented scheduled maturities of over $2 billion. IDS maintains a nationwide sales organization of approximately 3,400 sales representatives, district managers, and divisional managers. There are approximately 160 divisional offices throughout the country. The five mutual funds for which IDS is the investment adviser and exclusive distributor represent approximately 15 percent of the assets of all such funds reporting to the Investment Company Institute, which in turn represents approximately 95 percent of all open-end mutual fund assets. For the past several years IDS has produced about 15 percent of annual gross sales in the open-end fund industry, and because of its favorable redemption rate, this represents closer to 20 percent of all sales net of redemptions. There are presently over 780,000 shareholder accounts in the mutual funds distributed by IDS, and there are almost 400,000 holders of face amount certificates issued by Investors Syndicate of America, Inc., or IDS.

IDS POSITION

In view of this tremendous participation in the investment industry and in view of its responsibilities to the welfare of its many customers, IDS is vitally interested in the legislative proposals you are considering and particularly in the proposal that any broker-dealer registered under the Securities Exchange Act of 1934 must be a member of a securities association which is registered pursuant to section 15A of that act.

We are pleased to observe that as proposed, the legislation would not require membership in the National Association of Securities Dealers, Inc., which is the only securities association now registered under the Securities Exchange Act of 1934, but on the other hand is cast in terms which recognize the right of a broker-dealer to belong to any association which might be formed and so registered. We are also pleased to note that the legislation would give the Securities and Exchange Commission the power, unconditionally, or upon specified condi-

tions, to exempt any broker or dealer or any category thereof from this requirement.

We feel that the opportunity to join or form an association other than the National Association of Securities Dealers or perhaps not to join any association is salutary for many reasons. Primarily, we believe that the National Association of Securities Dealers was conceived and is operated with the general securities business in mind and was not and is not geared to the distribution of mutual fund shares. We believe that the problems attendant upon the distribution of mutual fund shares are in most respects unique to that type of operation and need separate and distinct treatment from that generally afforded to the public distribution and trading of securities, whether traded over the counter or listed on national exchanges.

Secondly, the distribution of mutual fund shares is effected in one of two basic patterns. In one case, sales are effected through a selling organization of regular broker-dealers, members of the National Association of Securities Dealers, who are offered price concessions by a wholesaler of the shares of the fund in question and who ordinarily conduct their operations along the lines of the traditional broker-dealer. The other method of distribution is that employed by IDS, where it built and operates its own independent sales organization composed of sales representatives who distribute the securities of the Investors Group exclusively and do not engage in the securities market in any other fashion as would a normal broker-dealer. There is a natural competition and rivalry between representatives of these two different types of distribution and it seems extremely doubtful that one association can be chartered and can devise rules equally and fairly applicable to both types of operations, and it seems even less likely that the government of such an association can be fairly apportioned so as to give proper presentation to both types of operation. This last observation is underscored by the traditional dominance of the National Association of Securities Dealers by representatives of what might be termed the normal broker-dealer engaging in general securities business.

Thirdly, the self-enforcing and disciplinary procedures of the National Association of Securities Dealers seem largely oriented to the problems of the general securities business, and subjects such as markup policies, free-riding, transactions between members and nonmembers, and other problems of that nature. We do not believe that anywhere else is there a detailed and specific program of good standards and practices in the distribution of mutual funds which is coupled with an effective mechanism for the enforcement of these standards and practices which comes even close to comparing with these elements of the IDS program. The practices and standards, the enforcement thereof, and the methods of selection and training of sales representatives which IDS has developed over the years and which it vigorously enforces at a cost of in excess of $500,000 per year is, we feel, unique. We cannot believe that in any alteration of its existing rules or in any new rules that it might adopt the National Association of Securities Dealers would make applicable to all of its members training and selection requirements, standards, and practices of conduct and policies of enforcement which would even approximate those presently in effect at IDS.

Finally, membership in the National Association of Securities Dealers would saddle IDS with excessive and wholly unnecessary entrance, membership, and examination fees. We estimate that these fees and expenses would be in excess of $100,000 the first year of IDS' membership. As I have indicated IDS already spends large sums each year to insure compliance with its operating and sales standards which, as we have stated, we feel far exceed any imposed by the National Association of Securities Dealers upon its members. This needless duplication of expense, with no possible benefit to the customers of IDS or its fund companies seems completely unjustified.

If the effect of this legislation would be to require membership in the National Association of Securities Dealers and if alternative arrangements, either by way of a new association independent of the National Association of Securities Dealers or by other means, were not available, IDS would be forced to take a position in opposition to this feature of the proposed legislation.

May I express the appreciation of my company for this opportunity to state its views to your subcommittee? We hope that they will be constructive and helpful to you in recommending sound and salutary legislation. We are deeply involved in the mutual fund industry, and we believe most sincerely that our industry furnishes an efficient and effective way for the people of our country to participate in our economic system. In turn, this participation stimulates

the system to work for the benefit of all of our citizens. Good and thoughtful legislation designed to encourage the mutual fund industry and good practices and high standards in its operation cannot produce anything but beneficial results.

If you or your committee feel that any further information or expansion of the views expressed herein would be helpful, we would be most happy to cooperate in any way whatsoever.

Cordially,

THOMAS W. MOSES.

NORTH & JUDD MANUFACTURING CO.,
New Britain, Conn., December 23, 1963.

Hon. HARLEY O. STAGGERS,
Chairman Subcommittee on Commerce and Finance,
House Office Building, Washington, D.C.

DEAR SIR: We wish to present our objections to H.R. 6789, H.R. 6793, and S. 1642 pertaining to an enlargement of the scope and activities of the Securities and Exchange Commission.

We feel that the proposed legislation is an unwarranted distortion of the original purpose of the Securities and Exchange Commission Act of 1934 which was to protect investors in securities listed on national exchanges and offered to the Nation at large.

We don't feel that the recent investigation of the securities market by the SEC indicated a pressing need for the expansion of its regulatory activities into the field of the small unlisted corporation.

It is our understanding that the collection and filing of the various financial reports now required of companies covered by the SEC is a staggering and extremely expensive proposition. It is also our understanding that these records which are available to the public are seldom, if ever, looked at and then usually by investment counselors, brokers, etc. To require thousands of small companies to file similar financial statements which will gather dust at a cost to the taxpayers of millions of dollars, from which they will receive absolutely no benefits, seems to us to be extremely foolish and very wasteful. The little good that might come from further expansion of SEC as contemplated by this legislation is not worth the price the taxpayer will have to pay.

Further, the reporting requirements regarding financial statements and the filing of proxy statements puts an added burden and expense on the smaller companies which are hard-put today to operate at a profit, and which are already overcontrolled by State and Federal authority.

North & Judd Manufacturing Co. has been in business over 150 years, and a Connecticut corporation since 1863. We have over 2,000 stockholders and have never beeen listed on any exchange and have no present intention of so doing. Dividends have been paid by us continuously since 1863.

We are strongly opposed to this legislation and request your support to defeat it.

Very truly yours,

W. H. JUDD, Jr., *Secretary.*

SKINNER PRECISION INDUSTRIES, INC.,
New Britain, Conn., January 14, 1964.

Hon. HARLEY O. STAGGERS,
Chairman, Commerce and Finance Subcommittee, House Interstate and Foreign Commerce Committee, Washington, D.C.

DEAR CONGRESSMAN STAGGERS: I am writing this letter to call your attention to the SEC control bill (S. 1642) which, I understand, has been passed by the U.S. Senate and is now under consideration by your subcommittee.

It is our understanding that this bill would put all unlisted corporations having $1 million in assets and 500 stockholders under SEC supervision. As an officer of a corporation, and as an individual citizen, I wish to record my strong protest against the passage of this bill.

At the present time, our company would not be affected since although we exceed $1 million in assets, we do not have 500 stockholders at the present time. However, it seems obvious that if this bill is passed, the further extension to companies with a lesser number of stockholders will be only a matter of time.

In any event, it will only be a matter of time before our company will have more than 500 stockholders.

The requirements of the SEC will impose onerous burdens for small unlisted corporations if this bill becomes law. Moreover, this bill appears to be an entirely unwarranted distortion of the original purpose of the Securities Exchange Act of 1934 which was to protect investors in securities listed on national exchanges and offered to the Nation at large. This bill appears to be merely a step in the direction of Federal regulation of local corporations, a subject which has always been a matter to be determined by the States which created them.

Corporation law in the State of Connecticut is very clear in its control of corporations which are chartered by our State and therefore, this additional burden of bureaucracy seems completely unnecessary.

We ask that careful consideration be given to the additional burdens which this law would impose upon small companies without accomplishing anything which is not now available particularly in States such as Connecticut where State corporation law performs the same service.

Very truly yours,

ROBERT D. TWOHIG,
Executive Vice President.

DUNCAN ELECTRIC CO., INC.,
Lafayette, Ind., December 6, 1963.

Re S. 1642 and H.R. 6789, Securities Acts Amendments of 1963.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House Office Building, Washington, D.C.

DEAR CHAIRMAN HARRIS: Enclosed is statement which our company desires to file with your committee, on behalf of its 550 employees and 1,374 shareholders, in opposition to requiring companies whose stocks are traded over the counter to comply with SEC disclosure regulations. As your Subcommittee on Commerce and Finance has been holding hearings on this legislation, we request that our statement be included in the record and given consideration in connection with the committee recommendations.

May I emphasize our objection mainly centers on the requiring of full financial disclosure, particularly sales data which could give competitive advantages to larger firms. We do not object, of course, to reasonable regulations on insider trading nor would be object to full financial disclosure to SEC if a way were provided for confidential treatment.

You may be interested in knowing that although our company never has had a public offering of its stock, annual reports have been issued to shareholders since 1939. We issue the conventional form of financial statements except that sales income is not published for competitive reasons. As indicated in our statement, it appears manifestly unfair to compel a small- or medium-sized company, built around a special product line, to publish specific information which its larger competitors do not have to do when they are multiproduct companies. Our company has been in business over 60 years and we are perfectly willing to take our chances against the larger and more powerful electrical manufacturers in our field as long as we can compete on even terms. Despite all the talk about Government wishing to help smaller businesses, we seem to be subjected to more and more Federal regulations and restrictions which either add to our cost or handicap our competitive position in other respects.

Please know your earnest consideration of our statement indeed will be appreciated.

Very truly yours,

J. E. BIXLER, *President.*

STATEMENT BY DUNCAN ELECTRIC CO., INC.

On behalf of our company and its 550 employees and 1,374 shareholders, we wish to make you aware of the harmful effects certain provisions of this bill could have on small- and medium-sized businesses, especially those firms which are built around a single product line. If a single product company is compelled to publish its sales volume and, if its competition consists wholly or for the most part of larger companies selling multiple products, the smaller firm is placed in a precarious position. Not only can larger competitors deter-

mine the exact share of the market held by the smaller company but with such information they would be in a position to alter their pricing policy and subsequently determine exactly the effect on a smaller one-product company.

For example, our principal competitors in the watt-hour meter industry, General Electric, Westinghouse Electric, and Sangamo Electric make other products. Since the stocks of those companies are traded on the New York Stock Exchange, they comply with SEC disclosure regulations but show only the total sales of all the products they make. Under the proposed bill we would be compelled to release our meter sales, yet our larger competitors are required to disclose only the sales total of all their products. We believe there are similar situations in other product lines and therefore urge your committee to exempt such companies from SEC jurisdiction. To require single product companies, which do not release sales or other operating information for competitive reasons, to make full financial disclosure certainly cannot help but work at cross purposes with the purported intent of this legislation. In such instances, instead of protecting shareholders the law could jeopardize their investments, and in addition be detrimental to the job security of many workers.

For your further information, although our company never has had a public offering of its stock, annual reports have been issued to shareholders since 1939. Our reports include the conventional financial statements except that sales data is not released for competitive reasons. We would have no objection to any reasonable regulations on insider-trading. Moreover, we would be willing to make full financial disclosure to SEC provided a satisfactory way could be established to give confidential treatment to sales and other data which could be harmful to the submitter's competitive situation.

While there is much talk by Congress and Federal Government agencies about helping and protecting smaller businesses, it seems that new legislation and new regulations by various Federal bureaus make it increasingly difficult for small and medium-sized business to compete against bigger competitors.

Some 1,500 over-the-counter companies already come under SEC's jurisdiction due to issuing new securities. Thus, we respectfully ask you to consider if the added cost for SEC to administrate the new proposals which would mean increasing its annual budget at least $600,000 (and probably $1 million before long) is justified? Certainly a much greater figure will be added to the operating costs of the companies which would be brought under SEC jurisdiction by the proposed legislation. Experience has shown fraud cases can occur involving companies which have securities listed on national exchanges or are subject to reporting requirements of the Security Exchange Act of 1934. Consequently, it would appear adherence to reporting requirements, per se, will not protect investors from loss through fraud or misrepresentation.

STATE OF KANSAS,
OFFICE OF THE SECURITIES COMMISSIONER,
Topeka, Kans., February 26, 1964.

Hon. OREN HARRIS,
Committee on Interstate and Foreign Commerce,
House Office Building, Washington, D.C.

DEAR CONGRESSMAN HARRIS: As Secretary of the Midwestern Securities Commissioners Association, I was instructed at the February 1964 meeting of that association to forward to each member of the Interstate and Foreign Commerce Committee of the House of Representatives a certified copy of a resolution adopted by the association in November of 1963 with regard to Senate bill 1642. A copy of this resolution was previously forwarded to the Honorable Harley Staggers, chairman of the Subcommittee on Commerce and Finance, on November 15, 1963. It was the desire of the membership of the Midwestern Securities Commissioners Association that the secretary send a copy to each member of the committee individually, in order that they would be apprised of the sentiment of the member States. Accordingly, I enclose herewith a certified copy of the resolution.

Very truly yours,

RICHARD E. PRINGLE,
Secretary, Midwestern Securities Commissioners Association.

I, Richard E. Pringle, duly elected and acting secretary of the Midwest Securities Commissioners Association, do hereby certify that the following is a true copy of a resolution adopted at the November 3, 1963, meeting of the

Midwest Securities Commissioners Association in New Orleans, La.; the States of Arizona, Illinois, Iowa, Kansas, Missouri, North Dakota, Oklahoma, South Dakota, Tennessee, and Wisconsin voting in favor; the States of California and Michigan voting "No"; and Texas abstaining:

RESOLUTION

"Whereas the Midwest Securities Commissioners Association believes that the report of the Special Study of the SEC demonstrates the existence of a serious problem with respect to the functioning of brokers and dealers and that remedial legislation, State and Federal, is necessary: Now, therefore, be it

"*Resolved*, That the Midwest Securities Commissioners Association go on record as opposed in principle to the portion of the proposed legislation submitted to Congress by the SEC, which would require membership in a trade association by a broker-dealer; and be it further

"*Resolved*, That the Midwest Securities Commissioners Association recommends that the SEC and/or the several States regulate directly broker-dealers properly under their respective jurisdiction, whether or not members of the NASD or similar trade association."

Witness my signature as secretary of the Midwest Securities Commissioners Association, this 15th day of November 1963.

RICHARD E. PRINGLE, *Secretary.*

DENVER, COLO., *January 17, 1964.*

HON. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.:

In view of the already indicated hostility of the NASD and its members toward our industry, it would be impossible for our company to secure a fair hearing before an NASD judge and jury. This company has no basic objection to a properly established system of self-regulation by a representative association organized by its own industry.

HAMILTON MANAGEMENT CORP.,
A. R. TYRONE, *President.*

OLYMPIA, WASH., *November 29, 1963.*

HON. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
House Office Building, Washington, D.C.:

As administrator of securities for State of Washington, I desire to go on record as opposing that portion of H.R. 6789 requiring compulsory membership in NASD.

BERNARD G. LONCTOT,
Administrator, Securities Division, State of Washington.

STATEMENT OF LOUIE PALUMBO, PRESIDENT, FRANKLIN NATIONAL LIFE INSURANCE CO., FORT WAYNE, IND.

It is with grateful appreciation that I acknowledge on behalf of the officers, directors, shareholders, and policyholders of Franklin National Life Insurance Co., of Fort Wayne, the privilege afforded me in filing with your honorable committee this statement in opposition to House bill 6789.

Our opposition to the proposed legislation is not filed for the sake of opposition, but is filed for the purpose of placing in the records sound and logical reasons for our opposition to this bill.

Our company was founded in February of 1960 and is, therefore, a new company, but a sound company and one that is fast growing. This company brings to the insurance industry a new force, a new idea, a new policy, and a new work force in the community.

We respectfully suggest that the proposed legislation will burden this new company with excessive expense in filing reports with the Securities Exchange Commission, subject its work force to duplicate regulations already in effect under the regulatory powers of the Indiana Insurance Department and now as proposed under the Securities Exchange Commission as well. All of the informa-

tion which this bill seeks to impose upon the work force of this company for the Securities Exchange Commission is readily available from the Indiana Insurance Department and can be easily supplied or acquired between the governmental agencies without further disrupting our daily affairs.

The insurance industry, as the honorable committee already knows, is probably the most highly regulated of all the industries and is effectively administered through the insurance departments of the respective States, and the burden sought to be placed on this company could, because we are a young, vigorous company, hamper productive efforts in the field of our routine service to our shareholders, policyholders, and the public.

LOUISVILLE, KY., *February 6, 1964.*

HON. OREN HARRIS,
Chairman, Interstate and Foreign Commerce Committee,
House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: Deep concern for the preservation of our Federal system of securities regulation, and for our Kentucky local and regional markets for unlisted securities including restoring honest and proper quotation systems for our Kentucky securities, dictates my desire to address my views to your committee in the hope that they may be helpful.

There is little, if any doubt in my mind that the imposition by the Congress of the controls contained in the Securities Acts Amendments of 1963 quickly and effectively will destroy the traditional dual system of securities regulation. There is no more reason to destroy this system than the dual banking system of our country. The States once more will find themselves preempted by Washington from a field in which they obviously are capable of performing the necessary duties required to protect their own citizens. The trend toward further centralization of all governmental functions in Washington would be accelerated to a point harmful to both the listed and unlisted markets and especially local markets such as our own.

It would seem to be simple logic that such drastic proposals as those contained in the amendments now under study should be supported abundantly by hard facts leading to a single conclusion. The burden of proof is squarely upon the Securities and Exchange Commission and the special study of the securities markets. To insist upon less would be a grave disservice to the preservation of our listed market system and to our local and regional unlisted system.

There may be a need for this legislation, but nowhere in the record is there any significant indication that the SEC has proved its case. Spokesmen for the SEC continually brought up the single question: "Why shouldn't holders of securities traded over the counter enjoy the same protections as those owning listed securities?" This is much like the old question, "When did you stop beating your wife?"

Reference to the Federal securities laws and cases readily shows that holders of unlisted stocks do, indeed, enjoy substantially the same protection as holders of listed securities. In that regard, please refer to the question posed by Senator Williams (p. 12 of the record of the Senate hearings on S. 1642):

"Senator WILLIAMS. Mr. Chairman (Cary), I wonder if your studies indicate, perhaps generally, the extent to which the securities fraud cases involve companies with more than 500 shareholders? Can you give a sample of fraud cases involving over-the-counter companies?"

This indicates Senator Williams' interest in learning to what extent this bill as presently written, with its 500 shareholders and $1 million asset standards, would have applied to past over-the-counter stock frauds if it had been in effect at that time.

The Commission's answer (beginning on p. 288 of the hearing record) is disappointing in that it is not responsive to the Senator's question and is misleading in that it implies that this bill would have applied to the sample cases and probably would have prevented these stock frauds.

Of the 13 cases described in appendix A (representative sampling of fraud cases before the Commission concerning companies which are not subject to the disclosure requirements of the Securities Exchange Act of 1934), only 1 case involves a company which the Commission represents as having as many as 500 shareholders. Could this part of the bill be so wide of its mark? Analysis of these cases cited reveals a rather remarkable consistency which

questions further the soundness of the SEC's position. Of the 13 cases, 6 were basically broker-dealer revocation actions under the act of 1934, involving unscrupulous stock salesmen. All 13 involved violations of the criminal and civil liabilities provisions of the act of 1933, which apply to interstate (or use of the mails) stock sales, unlisted as well as listed. In all these cases, defrauded investors had available to them the effective, court-tested private remedies provided by the 1933 act. Also, a private right of action is further provided to holders of unlisted stocks by section 10(b) of the act of 1934 when fraudulently induced to buy from or sell stock to company "insiders."

This represents no slight measure of investor protection, but the sample cases minimize the availability of these investor-oriented laws. Furthermore, even assuming that the reporting requirements of this bill would have been applicable to the companies of the size involved in the sample fraud cases, it is wholly unrealistic to conclude and misleading to suggest that these unscrupulous brokers would have made the information contained in the SEC files in Washington available to their customers, or that such stock operators would have been inhibited in their promotional schemes by the mere existence of such public information.

If the threat of the severe criminal sanctions contained in section 17 of the act of 1933 fails to inhibit frequent fraudulent misrepresentations involving over-the-counter and listed securities, it is unreasonable to assume that the imposition of reporting requirements with respect to all companies with more than 500 shareholders or $1 million in assets will really change things?

I firmly believe the Special Study manifestly indicates a clear and present need for corrective action in some of these areas. If, afterward, it appears to the Congress that the States are not competent, or are reluctant, to provide the needed regulations, if in fact, any is needed, then a modicum of Federal action may be the only resort.

It would seem, however, that a preferable alternative would be a tightening and more vigorous application of existing Federal laws and regulations, and at the same time providing an opportunity to the States to administer on a uniform basis any additional regulation of the more localized securities markets. The public interest would be served twofold: (1) investors would be protected without needless expansion and intervention of the Washington bureaucracy, and (2) the Federal system would be preserved.

From a practical standpoint, the SEC already has its hands full with regulating the listed market. That market is growing all the time. There is a recent trend of mergers of New York Stock Exchange firms, and of such firms going public, in order to amass more capital to meet the needs in that area. This is putting the small, local securities firm at a greater and greater disadvantage, and ultimately will bring about virtual obsolescence of main street investment banking firms. I do not believe this will prove politically wise, and the votes come from "Main Street" not "Wall Street."

It certainly would seem the better part of wisdom and practicality to leave the area of regional and local unlisted stock transactions under the jurisdiction of the securities commissioners of the States including the quotation systems, with the National Association of Securities Dealers continuing in its role as the policing arm and the liaison agent with the SEC. Only in this way can the integrity of the quotation system of the grassroots unlisted market be preserved. The most pressing problem for investor protection is the unlisted market quotation system which needs revision. A broader financial base for local and regional banking investment firms—those wholesale investment banking concerns doing business only with other dealers and not with the general public, as well as the small dealers doing business with the public—should be encouraged and preserved.

It should be of critical concern to all of us interested in preserving the local securities market that the Dow-Jones industrial average is now at an alltime high, while the unlisted stocks have not nearly recovered their declines of almost 2 years ago. The so-called blue chip listed securities have an increasingly abundant support from pension and welfare trusts and mutual funds. No such support is available to the local unlisted market. That support can only rise from the grassroots level by local securities firms, wholesale and retail. Finally, the number of local and regional companies whose securities are being listed is growing. Kentucky Utilities Co., of this area, is a good example. Its shares will begin trading on the New York Stock Exchange February 17. The Small Business Administration is attempting to help revive small local enter-

prises by its lending authority. These firms need local support to help maintain liquidity of their shares, and the shareowners themselves need it. (I have been a member of the National Small Business Administration Advisory Council for 3 years and chairman of District No. 6 Advisory Committee, Kentucky and Ohio. I have seen the impact of this local market situation at first hand and it is harmful to the effectiveness of this program.)

The job of regulating both the listed and unlisted local securities markets is simply too stupendous for the SEC to do it alone. Commonsense would seem to dictate that the Federal and the local market systems be maintained as they are, with the State commissioners of securities regulating, and the NASD acting as coordinating agent between State securities commissioners and the SEC.

The SEC and staff and the various State security commissioners are dedicated to our American system, and I believe this situation can be worked out by full cooperation to the best interests of all parties concerned. I know the State administration at Frankfort will cooperate fully as they are pledged to an expanding industry program. The problems in Arkansas and Kentucky are one and the same.

Respectfully submitted.

THOMAS GRAHAM.

P.S.—The Honorable Keith Funston said in a recent talk that one of his objects was to bring Main Street and Wall Street closer together. This could be the first project of togetherness.

BROOKLYN, N.Y., *December 19, 1963.*

Hon. OREN HARRIS,
U.S. House of Representatives,
Washington, D.C.

DEAR MR. HARRIS: Since your committee is considering legislation in the securities field I am taking this opportunity to comment on certain aspects of that business.

SEC AND NASD

At the present time the SEC, in its regulatory activity, does not distinguish between large firms active in all phases of the securities industry and small firms who specialize in one activity, generally mutual funds. All are required to maintain voluminous records, many of which are completely inapplicable to the small mutual fund dealer. All are required to file lengthy reports which are meaningless but quite expensive. One is tempted to shrug this off as another example of bureaucratic stupidity if it did not make it so difficult and expensive for the small firm to exist in the securities industry.

The role of the NASD is particularly objectionable. This organization, sanctioned by law and regulations, is supposed to exist as a purely voluntary organization providing some measure of self-regulation for its members. The NASD, however, does not permit any of its members to give nonmember firms the financial consideration which business firms normally give to each other. This has led to a situation in which any firm that wishes to execute a sales agreement with a mutual fund can do so only if the firm joins and pays tribute to the NASD. To refrain from doing so is to be out of business before one commences.

It is for this reason that I was forced to join the NASD. As one who deals in mutual funds exclusively, I derive absolutely no benefit from my membership. Moreover, the regulatory activities of the NASD do not apply to my limited activity. Certain things are, however, evident. Most large securities firms are happy with regulation by the NASD, their own creation. Forcing small firms to join against their will, and to pay increasingly large fees, permits the NASD to supervise the activities of those firms requiring supervision without requiring these firms to pay the whole cost.

The most distressing aspect of the whole situation is that this unethical, undemocratic, and transparent scheme has been sanctioned by the Congress. Since we already have an SEC which is sustained by taxes, why is it necessary to have an NASD supported by separate fees. Perhaps you can also explain why a "voluntary organization" is permitted to require membership at the risk of being unable to transact business? Does the Congress countenance such an approach to free enterprise in other industries?

MINIMUM CAPITAL REQUIREMENTS

Your firm is considering the creation of minimum capital requirements for firms in the securities business. This has long been a favorite NSAD project, for obvious reasons. Creation of a $5,000 or $10,000 capital requirement will make it impossible for many small firms to remain in business. Thus removing considerable competition for the large firms.

Here again there is a need to distinguish between firms and the business transacted. There is no particular amount of capital needed by a mutual fund dealer. Credit is not extended to the customer, the dealer merely transmits investment orders or redemptions to the fund. Rarely does the dealer see the investor's money.

Creation of a minimum capital requirement would indicate that the Congress is ready to equate the possession of money with honesty, integrity, and competence. Anyone who has made even a cursory investigation of the lives and careers of some of our wealthiest citizens recognizes such an equation to be contrary to fact.

It seems particularly unfitting that in this country, the champion of the free enterprise system, the Congress should consider reserving certain occupations for persons of wealth. It would seem that the statutes under consideration and the activities of the NASD are turning supervision of the securities industry into regimentation and restriction of anyone with an interest in the field.

Respectfully yours,

MORTON WEINBERG.

CHAMBER OF COMMERCE OF THE UNITED STATES,
Washington, D.C., December 6, 1963.

Hon. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance, House Committee on Interstate and Foreign Commerce, Washington, D.C.

DEAR MR. STAGGERS: The chamber of commerce of the United States supports, with some reservations, that portion of H.R. 6789 which would amend existing law to extend disclosure requirements relating to issuers of unlisted publicly held securities sold over the counter. Our reservations, explained below, are related to provisions concerning banks and insurance companies.

These proposed requirements would apply initially to firms with $1 million or more in assets and 750 or more shareholders; after 2 years, the requirements would apply likewise to firms with 500 or more shareholders.

According to information compiled by the Securities and Exchange Commission, in recent years the over-the-counter market has increased considerably. Thus, in our opinion, the market is now of such dimensions as to suggest the advisability of minimum regulations intended to provide reasonable and proper disclosure of certain information as being in the public interest.

The chamber believes that as a matter of principle investors and potential investors should be furnished adequate information as a suitable basis for intelligent decisions. In recent years, Congress has endeavored to set a pattern of basic requirements for the disclosure of essential information to those who contemplate investment, and H.R. 6789 contains provisions in support of this action.

We do have two major reservations to the bill in its present form, however.

One type of business which does not require additional regulation is the insurance business. We urge its exemption from the disclosure requirements of H.R. 6789.

The insurance companies which would be affected by the SEC proposal are now subject to extensive and detailed regulation, examination, and reporting requirements by the various States. The addition of Federal regulation on top of State regulation should be undertaken only if a pressing need is clearly demonstrated. This need has not been demonstrated.

In the process of examination by the States, all records of insurance companies are open, including stock records, board and stockholder minutes and notices, and records of compensation, including pension and similar plans. In annual statements, subjects such as loans to officers, compensation of officers, and conflicts of interest are covered by interrogatories. The financial transactions and condition of individual companies are presented in detail.

It is a basic misconception that the financial reporting in the annual statements of insurance companies does not meet the needs of the investors and that the information required by the SEC would meet this need. We are sure that

the SEC recognizes that the mass of reporting required by the States provides policyholders great protection and that, collaterally, the reports required by the States also afford protection to the stockholders against questionable business practices and company insolvency.

In this regard, it should be noted that the National Association of Insurance Commissioners has appointed a subcommittee of its laws and legislation committee to examine the SEC proposal to determine whether there is any void in State legislation and, if so, what steps should be taken by the State regulatory authorities. Congress should have the benefit of this study before considering regulatory legislation affecting insurance companies.

For these reasons, we urge the exemption of insurance companies from the relevant provisions of H.R. 6789.

One other reservation regards the language of H.R. 6789 which applies directly and specifically to banks. Section 3 of the bill should be amended to make it mandatory that authority for disclosure of information by banks be assigned to the various existing Federal banking agencies (Federal Reserve System, Comptroller of the Currency, Federal Deposit Insurance Corporation). It is not necessary to add another Federal agency to the group now regulating banks.

In conclusion, we want to emphasize that we favor self-regulation by individuals and companies insofar as this is feasible. We urge that any legislation you propose encourage such self-improvement.

We ask that these recommendations be given consideration and this letter be made part of the hearings on H.R. 6789.

Sincerely yours,

THERON J. RICE.

STATE OF CONNECTICUT,
INSURANCE DEPARTMENT,
Hartford, Conn., February 4, 1964.

HON. WILLIAM L. ST. ONGE,
U.S. House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN: I would like to call to your attention H.R. 6789, H.R. 6793, and S. 1642 Securities and Exchange Commission omnibus bill which is up for consideration at this time. I would like to state that the Connecticut Insurance Department is opposed to these bills because the regulatory auhorities of each State in which the companies are licensed already require this type of reporting.

The National Association of Insurance Commissioners during their semiannual meeting, December 2 to 6, 1963, adopted as a requirement for the annual statement of all insurance companies for the 1964 business and thereafter a set of general interrogatories inquiring into financial reporting to stockholders, insider trading, management salaries, proxy solicitations, beneficial ownership of securities, and related financial information.

What is significant about the NAIC action is that in addition to the long-standing financial detail required of insurance companies in their annual statements, there is now a set of interrogatories which in substance is similar to the information insurers would be required to supply in the event S. 1642 is enacted into law as presently written. In addition, you will note that the NAIC requirements as drafted extend to all stock insurers and not just to those with $1 million in assets and 750 stockholders as required in S. 1642. As you can see, the NAIC requirements are more sweeping than the SEC bill.

Over the years, the NAIC has continually reviewed the annual statement form and enlarged and improved it to meet the requirements of the various States. The companies have adhered to its form completely. It is my considered opinion that the NAIC is a most effective instrument in this respect. Any assistance you can give in this matter would be gratefully appreciated.

Sincerely,

ALFRED N. PREMO, *Commissioner.*

KEY BISCAYNE, FLA., *February 3, 1964.*

Hon. HARLEY O. STAGGERS,
Committee on Interstate and Foreign Commerce,
U.S. House of Representatives, Washington, D.C.

GENTLEMEN: Thank you for the privilege of making a brief statement regarding your hearing on Senate bill 1642 as pertains to revision of the Securities and Exchange Act of 1934, as amended.

Your committee has the authority and obligation to correct deficiencies in this act which tacitly permit considerable subversion of the democratic process in corporate ownership.

In no State is the power of apportionment so invidiously discriminatory as it is in U.S. corporations—with inadequate regulatory or punitive power in the hands of the Securities and Exchange Commission.

S. 1642 offers mostly quantitative extension of SEC regulatory power, but no significant qualitative advancement.

The subcommittee could improve vastly upon the proposed legislation by recommending that the following two steps be incorporated in the proxy rules of SEC:

I. Democracy in corporate nominations: The number of shares of corporate stock required to place one name in nomination for director shall be determined by dividing the number of shares held by management by the number of directors.

II. Democracy in corporate elections:

A. In contested elections, only the cost of the first full solicitation of proxies shall be borne by the corporation; and proxies shall be filed directly with a special election referee appointed by the Securities and Exchange Commission.

B. No corporation may discriminate against any nominee in publicizing an election.

C. All nominees shall be listed alphabetically with their qualifications in the proxy statement of the corporation.

D. Promotion on behalf of a single nominee or group of nominees within the entire slate shall be borne by private individuals or groups at no expense to the corporation; however, all proxy forms must carry the full list of nominees.

I am aware that complete implementation of these two recommendations will not solve all the problems faced by small corporate shareholders.

They will, however, give the vast majority of owners of American business an opportunity to challenge self-perpetuating management when it is inept or unscrupulous.

Moreover, they should guarantee unconditionally the right of disclosure—the abortion of which at present effectively disenfranchises millions of individual shareholders and discourages millions of others from participating in the growth of our Nation and its resources.

Sincerely,

SERGEI V. KIRPATOVSKY.

THE TERRY STEAM TURBINE CO.,
Hartford, Conn., December 26, 1963.

Subject: H.R. 6793 and S. 1642 (Securities and Exchange Commission).

Hon. EMILIO Q. DADDARIO,
House Office Building,
Washington, D.C.

DEAR SIR: We have been very appreciative of the concern which you have shown for small business by sponsoring the bill which would prevent State taxation of interstate commerce. It will be a great relief to us if this bill is successfully passed.

I am writing you this time to express the deep concern which our company and many other small businesses feel regarding the subject bill and to urge that you vote against it.

We are particularly worried that the public disclosure of full information will make it much easier for unscrupulous persons to find profitable situations and to raid small companies. I hardly need elaborate on the irreparable damage which has been done to the employees and their communities by the raiding and

subsequent liquidation of small companies. More than one company in our own city has been grieviously hurt by outside financial manipulators.

In addition we feel that the reports required will be onerous and expensive for a small business. We have only 200 employees so that the addition of only one "nonproductive" employee to compile reports is a substantial increase in our costs. Worse yet is the amount of executive time which might be taken from the critical task of trying to improve our products and remain competitive. We are now shipping over a third of our production overseas. I hope we can continue to devote our attention to this vital export business.

Very truly yours,

A. LINDSAY THOMSON, *President.*

STATE OF NEVADA,
DEPARTMENT OF COMMERCE,
INSURANCE DIVISION,
Carson City, November 4, 1963.

Hon. WALTER BARING,
House Office Building,
Washington, D.C.

DEAR CONGRESSMAN BARING: I am writing with reference to H.R. 6789 and S. 1642 and the statement of the Securities and Exchange Commission with respect to proposed amendments to section 12, 13, 14, 15(c), 15(d), 16, 20(c), and 32(b) of the Securities Exchange Act of 1934 and section 4(1) of the Securities Act of 1933, dated November 19, 1963.

I wish to object generally to the passage of H.R. 6789 and/or S. 1642 as each of these bills will include many hundreds of small insurance companies that are presently exempt.

As a whole the regulation and supervision of insurance companies by the several States is entirely adequate for the protection of both the policyholders and the stockholders. Also the additional cost to the companies is not necessary nor warranted and the result, in many instances, would be a financial burden at a time when the young and small companies are striving to become a financial success. In addition I object as a matter of principle of additional regulation of the insurance companies being taken from the States where it now primarily rests by such legislation.

With specific reference to the content of the SEC statement dated November 19, 1963, on page 46 the third paragraph reads, and I quote, "The Special Study's examination of proxy and financial disclosure policies of insurance companies shows that their shareholders need the investors protections afforded by the bill just as much as do shareholders of other companies."

The correctness of this statement is a matter of opinion. No agency of local, State, or Federal Government is, or ever will be, perfect. So the fact that there have been a few instances of stockholders in insurance companies that have lost part or all of their investment in the past does not necessarily warrant dual regulation and additional financial burden that is here proposed.

Page 49, paragraphs 2 and 3 read as follows: "The existing State regulation of insurance companies is aimed almost entirely at policyholder protection and is not an adequate substitute for investor-oriented protections of the type that would be provided by the bill.

"State regulation furnishes nothing comparable to the proxy and insider trading protections that would be provided by the bil. The seriously deficient proxy practices of insurance companies that would be covered by the bill have been pointed out." This is only a partially correct statement. State regulation and supervision does consider its primary duty the protection of the policyholder but in so doing it also protects the investor in many ways. Not les often than every 5 years and normally each 3 years every company is given a thorough examination which includes checking to ascertain that the stockholders' rights and interests are also being protected. In most States a new or small company is oftentimes checked as often as quarterly and seldom less often than annually.

Page 50, paragraph 2 reads as follows: "Moreover, the bill would require certain nonfinancial information not now generally available under State insurance regulation to be filed with the Commissioner. For example, a State report, in comparison with the Commission's rules, typically contains only limited data concerning material transactions of insiders. Also, there is no provision in State regulation for current disclosure of events of major significance to investors such as mergers, acquisitions, and the issuance of substantial amounts

of stock, whereas the Commission's form 8–K, the filing of which would be required by the bill, must be filed soon after the occurrence of any of these material events. This is information that is readily available and inexpensive to file, but which is of great value to investors."

I must question the accuracy of the thought expressed here that the States do not know about or control the "issuance of stock," "mergers," and "acquisitions." I cannot, of course, speak for all jurisdictions but I do know that in most States no "merger," "acquisition," or stock issue is possible without the written approval of the insurance supervisory authority.

Paragraph 1 of page 53 reads as follows: "The Commission's annual report form under the Securities Exchange Act, form 10–K, requires no information, except for certain supplementary reconciliations and explanatory notes, from insurance companies that is not contained in the annual statement to State regulatory officials; indeed any deviation therefrom must be specifically noted. The main difference between form 10–K and the annual statements submitted to State regulatory officials is that the former is more simplified and, in general, contains less information than the latter." Paragraph 2 on page 54 reads as follows: "Article 7A will, in the main, codify the above-described practices of the Commission with respect to life insurance companies. It will not prescribe any method of reporting that is inconsistent with the methods prescribed in the annual statement blank adopted by the National Association of Insurance Commissioners. Consistent with the Commission's present practices, the proposed article does not require the reporting of any financial information to the Commission which cannot be obtained out of the uniform NAIC annual statement or which is not otherwise readily available."

The above statements, if they mean what I believe them to, verify the fact that requirements proposed will be mostly a "duplication" and are therefore, unnecessary.

I trust that the majority of the Members of Congress will see fit to include in H.R. 6789 an exemption of insurance companies.

Sincerely yours,

PAUL A. HAMMEL,
Insurance Commissioner.

THE AMERICAN DRUGGISTS' INSURANCE CO.,
Cincinnati, Ohio, November 13, 1963.

Hon. OREN HARRIS,
House Office Building,
Washington, D.C.

DEAR REPRESENTATIVE HARRIS: We write to you as chairman of the House Interstate and Foreign Commerce Committee, to whom Senate bill 1642 has been referred since it has now passed the Senate.

We wish to register our objection to this Senate bill 1642 which would extend the jurisdiction of the Securities and Exchange Commission to all transactions involving over-the-counter securities, including the stocks of insurance companies.

Insurance companies should be excluded from the provisions of Senate bill 1642 because they are already adequately regulated by the various State insurance departments.

This bill would impose a very difficult burden on small insurance companies and would increase their cost of operation substantially. This is an unfair burden since it affects only capital stock insurance companies, when it is a fact that mutuals already have serious and substantial other advantages.

Capital stock companies are already having a difficult time making a profit and further regulation and burdens upon their operation is wholly unnecessary and uncalled for.

We hope you will express our opposition to Senate bill 1642 and please understand that we are very active in the State of Arkansas and now insure most of the retail drugstores there.

Thank you very much.

Yours truly,

DAVID P. PICKREL, *President.*

GREAT NORTHWEST LIFE INSURANCE CO.,
Spokane, Wash., February 20, 1964.

HON. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
Washington, D.C.

DEAR SIR: We wish to put this letter on record with you as the official opposition of this company to S. 1642, which is a bill to amend the Securities Exchange Act of 1934 by extending the reporting requirements, proxy rules, and "insider training provisions" of the 1934 act to stock life insurance companies having more than 500 stockholders and assets in excess of $1 million. This bill is pending before your committee in the Subcommittee on Commerce and Finance.

While we have assets considerably in excess of $1 million, we do not have more than 500 stockholders. Indeed, the number of our stockholders is considerably less than that. We would not be affected by this legislation, and you might feel that therefore we have no concern with it. We nevertheless oppose it for the following reasons.

The result of this measure will be regulatory confusion. The National Association of Insurance Commissioners will require that all stock life companies furnish for 1964 the very information which S. 1642 would require. In our report to our State insurance commissioner therefore we will give this information, although we would not be included in the proposed Federal legislation. We are perfectly willing to give this kind of information and, indeed, have furnished both the financial and proxy information to our stockholders for many years.

In our opinion however the critical issue here is that we firmly believe that the requirement of Federal reporting and regulation in addition to the State requirements will inevitably lead to a breakdown of efficient regulation. If the Federal Government waits for State action in regulatory matters, or the States wait for Federal action, critical problems can be allowed to drift and confusion of leadership develop. Moreover, the State regulation of insurance is well removed from politics and is well accepted throughout the industry. It works, and it works efficiently.

Unless State regulation is eventually to be abandoned entirely, we submit that there is no need for S. 1642 or legislation of like kind.

Yours very truly,

C. ROBERT OGDEN, *President.*

WESTERN INDUSTRIAL SHARES, INC.,
Salt Lake City, Utah, March 3, 1964.

Representative HARLEY O. STAGGERS,
Chairman, Subcommittee of Commerce and Finance, Committee on Interstate and Foreign Commerce, Washington, D.C.

DEAR REPRESENTATIVE STAGGERS: Western Industrial Shares, Inc., a mutual fund, and its management company, Investment Management Corp., are so small as to be inconsequential in the industry. We have chosen not to belong to the National Association of Securities Dealers which we view even now as a restraint of trade. The association has conspired not to do business with nonmembers and since the control of the securities business rests in their hands we are already deprived of the single major source of doing business with the public. Had we chosen to join the NASD it would have been of no value since the member firms would have naturally sold mutual funds whose history and size facilitated a ready sale.

Specifically I refer to section 6(a) of S. 1642 which your subcommittee is now considering. This amendment to section 15(a) of the Exchange Act would compel a broker dealer such as Investment Management Corp., to become a member of a national securities association or to be put out of business.

With individual freedom comes individual responsibility. We absolve this responsibility partly by a 30-day money back return regardless of reason; and, a return within a year in case of misrepresentation, etc. It has not been proven that either membership or nonmembership in any association alters standards of ethics. To compel a small firm to join an association is to legislate away our constitutional rights and to leave us to the discretion and mercy of larger and stronger competitors and, to a group not judicial in training which might not be impartial in judgment.

As a small firm we already quake under the ominous shadow of the SEC, somewhat frightened and afraid to voice ourselves for fear of reprisal. In my opinion, the industry is already stultified in being able to develop new and progressive ideas by which the free enterprise system is advanced. Are we further to restrict liberty by compulsory membership in a trade association with life or death powers over its members when in this day of mass-media even the slightest censure is the kiss of death?

We are a small minority; it is easy to deprive us of our liberty.

Restpectfully yours,

INVESTMENT MANAGEMENT CORP.,
EDWARD M. MABEY, *President.*

STATE BOARD OF INSURANCE,
Austin, Tex., March 5, 1964.

Re S. 1642

Hon. OREN HARRIS,
Chairman, House Interstate and Foreign Commerce Committee,
Washington, D.C.

DEAR CONGRESSMAN HARRIS: This summary of the convictions of the State Board of Insurance, State of Texas, is respectfully submitted for inclusion in the hearing record of the House Interstate and Foreign Commerce Committee on S. 1642.

As a first consideration the Texas board requests exemption of all insurance companies from SEC regulation. As a second consideration, in those areas where similarity of operation exists, to wit: financial condition and proxy solicitation, the board opposes SEC regulation of one type of insurance company (stock) and nonregulation of mutual, reciprocal, Lloyd's assessment, stipulated premium, and other types of competing organizations.

Subjects of concern and extant circumstances are briefly discussed below:

State regulation is more exacting and comprehensive

Public disclosure could hardly be more complete or detailed. Annual statement requirements of insurance companies are searching and voluminous. They contain more data than is required by SEC. They are public records in each State of license. Their contents are published in several services of wide national distribution.

Annual statement blanks for 1964 contain "stockholders information supplements" as prescribed for use in all States by the National Association of Insurance Commissioners. These stockholder disclosure requirements equal those of SEC. Texas authority to enforce compliance is clear and absolute.

Texas insurance companies are required to be examined every 6 months until 3 years old and every 2 years thereafter. This work is done at the offices of the companies by a large staff of trained examiners and actuaries. Financial condition, competency of management, and compliance with law are determined. SEC authority stops well short of this State authority.

S. 1642 authorizes Federal regulation of insurance

The possibility of Federal insurance regulation is a very real one. The Securities Exchange Act of 1934, subsection (b) of section 13 provides in part: "The Commission may prescribe * * * the methods to be followed * * * in the appraisal or valuation of assets and liabilities * * *." Further, authority is granted to issue "such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors * * *."

These grants of authority are vast. They are comparable in extent to that under which State supervision functions.

Mutuals will have a competitive advantage

It has been the policy of Congress for 50 years and of the States for longer periods to make no difference in application between stock and mutual companies. The common purpose has been to preserve competition in a severely competitive business.

Stock insurance companies, particularly the small stock companies, translating the rather substantial expenses imposed by S. 1642 into premiums charged to policyholders, could be at a severe, even disastrous, disadvantage.

There is evidence that some insurance people, seeking reduction of competition, support SEC entrance into insurance supervision:

"* * * some persons in the life insurance business would welcome (SEC) intervention." Page 227, Michigan Law Review, December 1963.

"The large number of companies now operating in the United States, and the rapid rate at which the number has grown in recent decades, suggests that some restrictions upon access to the market would do no harm and might possibly be desirable." Page 253, Michigan Law Review, De.ember 1963.

"Every thoughtful life insurance executive must necessarily feel some concern about the number of companies being formed." T. A. Sick, chairman, Life Insurance Association of America, as quoted in January 20, 1964, United States Investor.

Such concern may be misplaced. Best's Weekly News Digest, February 10, 1964, reports there to have been a net increase of only 21 life companies (stock and mutual) in the United States in 1963, less than one-half company per State, and a net decrease of 47 fire and casualty companies (stock and mutual). This would not appear to warrant Federal legislation.

At apparent odds with the restraint theories of SEC and Mr. Sick, is James J. Saxon, Comptroller of the Currency, who, administering to a rapidly expanding number of banks and branches, is quoted:

"It is a bleak future we would have to paint for the future of our banking system, if our efforts were to be centered on safeguarding the markets for any segment of that system."

"* * * banks ought to be left free to compete for the available pool of savings without the Government's intervening." January 20, 1964, United States Investor.

The policy of the Legislature of Texas is to permit incorporation of soundly financed insurance companies to the limits demanded by an expanding economy and to permit competition within limits neither jeopardizing to policyholders nor beyond normal risk to stockholders, and, in the application of that policy, not to discriminate as between stock or mutual companies, or large or small companies.

Small companies will be damaged

It is undisputed that young insurance companies operate at substantial losses for years. Such companies would be further burdened by the substantial expense imposed by S. 1642. Even the established companies would be put to expense not inconsequential in amount.

While Mr. Cary has stated that the added burden on life companies would be tempered by his willingness to accept annual statement forms, plus supplemental data, the statement may have obscured the fact that fire and casualty companies were excluded from his offer and will be subject to the full impact of added expense.

Furthermore, subsection (2) of section 13(a) of the present act and as amended by section 4 of S. 1642 specifically authorizes requirement of certified reports by independent public accountants to be filed annually and as often as quarterly.

Eighty-three Texas companies would immediately come within S. 1642. As secondary sales of stock add to stockholder numbers and as assets increase in the next few years the number should reach 150.

Proxy solicitation

If there be a need for disclosure with proxy solicitations, such need exists in mutual as well as stock companies.

Solicitations, in both instances, are of "owners" and for the purpose of electing management.

The Texas Supreme Court has held that the State of Texas, if it were a policyholder in a mutual fire insurance company, would occupy the position of a "stockholder." (*Lewis* v. *Austin I.S.D.*, 161 S.W. 2d 450)

The Wisconsin Insurance Department has been upheld by the trial court in its position that in an insolvency of a mutual fire insurance company its policyholders have no claim for unearned premiums since the policies are, in effect, similar to stock owned in a corporation. (Insurance Guide, January 1964)

Conclusion

To avoid burdening the record, comments on conflicts of S. 1642 with congressional policy as established in the McCarran Act and on other subjects amply developed in hearings have been omitted.

Very truly yours,

WM. HUNTER MCLEAN, *Chairman.*
NED PRICE, *Member.*
DURWOOD MANFORD, *Member.*

LOS ANGELES, CALIF., *December 5, 1963.*

Hon. WILLIAM CARY,
Chairman, Securities and Exchange Commission,
Washington, D.C.

Because of newspaper reports that a State securities commissioner has questioned the constitutionality of pending legislative proposals to expand controls exercised by Securities and Exchange Commission over securities brokers and dealers and securities markets, I wish to advise that in my opinion there is no question as to the constitutionality or desirability of the proposals in question. The California securities law and the office I hold were established in 1913. Citizens of California are probably the ultimate purchasers of more securities than citizens of any other State. Between 1959 and 1962, according to the census of shareholders published by the New York Stock Exchange, more Californians became, for the first time, shareholders in publicly held corporations than citizens of any other State, by a wide margin. Our securities regulatory staff is considerably larger than that of any other State. Consequently the proposed Federal legislation has necessarily received our attention.

The constitutionality of the proposals appears beyond question for several reasons. A basic reason in my opinion is that the securities markets are primarily national markets. Elaborate systems of interstate electronic, telephonic, telegraphic, and other communication devices connect the offices of most securities brokers, the public's money is primarily invested in securities sold in interstate commerce. Most of the public's funds are invested through brokers doing an interstate business. There are hardly any corporations whose shares are held by the public which do not have shareholders residing in more than one State.

Those securities which are not sold in interstate commerce are ordinarily sold in competition with securities which are sold in interstate commerce and therefore have a direct effect upon securities sold in interstate commerce. If a securities broker is to render proper service to his customers he should, to the best of his ability, sell the securities best suited to the needs of his customers, therefore, in the ordinary situation if the broker is to properly serve his customers he must understand, to a substantial extent, securities which are sold in interstate commerce, as well as securities sold purely locally. The desirability of the current legislative proposals is demonstrated by the careful study made by the SEC pursuant to congressional authorization.

In the past the Securities and Exchange Commission have successfully coordinated their regulatory efforts in California with those of the California Division of Corporations. I see no reason for supposing that such coordination will not be continued in the future. In the event Congress should grant additional authority to the SEC, I would anticipate that the coordination between the SEC and various State commissioners would grow even closer since we all have the same general objectives—that of protecting the investing public. I see no basis for assuming that any regulatory authority granted the SEC by the proposed legislation will not be as wisely and efficiently administered as in the past. On the contrary, the proposed increased powers should permit greater protection to the public with better coordination with the securities industry so that in this area the national growth can expand even more rapidly and with even greater protection to the public. You are authorized to make any use which you deem proper of this telegram.

Although, as you know, I am commissioner of corporations of California, I feel this legislation does not directly affect my official duties and therefore am sending this telegram in my private capacity and at my own expense. With best wishes for the success of your fine legislative proposals, cordially

JOHN G. SOBIESKI.

STATEMENT OF JOHN C. WILLIAMSON, DIRECTOR OF GOVERNMENTAL RELATIONS, NATIONAL ASSOCIATION OF REAL ESTATE BOARDS

Mr. Chairman and members of the subcommittee, I appreciate this opportunity to present the views of the National Association of Real Estate Boards in regard to H.R. 6789, a bill to amend the Securities Act of 1933 and the Securities Exchange Act of 1934.

Our association, consisting of approximately 75,000 realtors in more than 1,450 local real estate boards, is interested in the pending legislation primarily because of its effect on real estate securities—a relatively new but fast-growing segment of both the real estate and securities industries.

The real estate security is a unique security in that shares in real estate investment trusts and limited partnerships convey interests in real estate. There is some reported judicial opinion to the effect that one who sells a certificate of beneficial interest in a real estate investment trust or a limited partnership unit in a syndicate is selling real estate and is therefore subject to appropriate State licensing laws.

Be that as it may, our association is concerned with preventing abuses in the sale of real estate securities and in improving investor protection. We are motivated by the same considerations which inspired realtors to bring about enactment of real estate licensing laws in all 50 States.

A portion of the Report of the Special Study of the Securities Market, submitted to the Congress on April 3, 1963, is devoted to real estate securities and refers to this segment of the securities business as a "phenomenon new to the last decade."

The first real estate syndicate was filed with the Securities and Exchange Commission on February 11, 1952. Since then approximately 300 syndicates, investment corporations, and real estate investment trusts have filed registration statements representing total offerings of more than $1.5 billion.

This, while impressive, is only part of the picture. Real estate syndicates, particularly in New York, rely heavily on the intrastate exemption from SEC requirements. We believe that a major portion of syndicate public offerings have been made within this intrastate exemption. Unofficial estimates of all public offerings in real estate exceed $10 billion. We are therefore talking about a significant segment of the securities market.

Of the three real estate security issuers, the real estate investment trust is subject to a substantial degree of regulation by the Internal Revenue Service as well as State laws governing trusts. This, coupled with the relatively recent revival of the trust as a real estate investment vehicle, has left the real estate investment trust untouched by the recent highly publicized disclosures of irregularities in the operation of real estate syndicates and "cash flow" corporations.

DISTRIBUTION OF REAL ESTATE SECURITIES

A substantial number of the sellers of real estate securities are not licensed to sell real estate and, because of the intrastate exemption, are not subject to the self-policing requirments of the National Association of Securities Dealers.

To quote from the report of the Special Study:

"The salesman of real estate securities is purveying a commodity more intricate than most securities. Even a sophisticated investor may have difficulty in evaluating the tax aspects of an offering, or the factors of risk and promoters' benefits, and the best investment analysts and counselors have little if any expertise in the real estate securities field.

The report cites an extremely active underwriter of real estate syndicate shares which gives its salesmen total training of from 8 to 10 hours.

The interests of the investing public as well as the real estate industry require, in our opinion, approval by the Congress of the proposal in the pending bill requiring all broker-dealers and registered representatives, who make use of the mails, or an instrumentality of interstate commerce, to register with the Securities and Exchange Commission and belong to a registered securities association which at present means the National Association of Securities Dealers.

We endorse the provision in H.R. 6789 (sec. 7(a)(3)) which would require registered securities associations to adopt rules establishing standards of training, experience, and competence for members and their employees. We also have recommended that the National Association of Securities Dealers revise its testing requirements to require that broker-dealers and salesmen of real estate securities

possess adequate knowledge of real estate investment and the real estate business.

Perhaps NASD members and persons associated with members dealing exclusively or principally in real estate securities could be classified as such and be subject to specialized training and qualifications. This, we believe, is contemplated in the new section 15A(b)(3) which would be added to the Securities Exchange Act of 1934.

We have advised NASD of our views on the subject and have offered our cooperation in developing appropriate professional standards and qualifying examinations for applicants who propose dealing in real estate securities. I am pleased to advise that the officials of NASD have accepted our offer of cooperation in this matter.

ADEQUATE REPORTING TO INVESTORS

I will now turn to another aspect of the Report of the Special Study and the pending legislation. This relates to adequate reporting of information to investors by promoters of syndicates, trusts, and corporations.

Quoting from the report:

"Issuers of real estate securities seem to share a general reluctance to send regular reports to their securityholders with information adequate for an informed appraisal of the issuers' operations including distribution policy, although they may be required to submit an annual balance sheet and profit and loss statement of income to each participant."

However, even these annual balance sheets and profit and loss statements sent to investors fall short of our view of "adequate reporting" because such statements as a rule are not certified.

In the language of the report:

"Holders of real estate securities rank high among those in need of protection that can be provided by legislation extending certain reporting provisions of the Exchange Act of 1934."

Section 4 of the bill (amending sec. 13(a) of the act) would remedy this deficiency in reporting to investors by providing for the filing of annual reports containing certified financial statements, semiannual reports of uncertified profit and loss and earned surplus statements, and current reports whenever events of immediate interest to investors occur.

We endorse section 5(c) of the bill (adding sec. 14(c) to the act), which provides that a company not soliciting proxies would nevertheless be required to furnish shareholders with information equivalent to that contained in a proxy statement.

We also endorse the provision requiring an issuer having total gross assets in excess of $1 million to file a registration statement with the Commission for any class of its equity security held of record by 500 or more persons. This requirement would cover issuers whose securities are traded by use of the mails or any means or instrumentality of interstate commerce.

Earlier in my testimony I refered to estimates of approximately $10 billion in real public offerings, although only about $1.5 billion represented filings under the Securities Act of 1933. The balance of $8.5 billion represents intrastate exemptions. The proposed section 12(g) will reach a substantial portion of these exempt offerings and result in a measure of disclosure and regulation both necessary and desirable in the public interest.

Another desirable change flowing from section 3(c) of this bill (adding sec. 12(g) to the act) would require issuers to file information with respect to material contracts not made in the ordinary course of business. With respect to real estate this would include, for example, management contracts, leases, and mortgages not covered in the initial disclosure. We concur in SEC Chairman Cary's statement in his testimony that "a company which goes to the public for funds should not subsequently be free to seal off its operations from disclosure."

We appreciate the administrative requirements that necessitate limiting the application of section 12(g) to issuers whose shares are held by 500 persons or more (750 or more persons until July 1, 1966). However, we hope that the Congress and the SEC, after further study, will find it practicable to reduce this minimum to perhaps 300 shareholders in order to bring within the requirements of section 12(g) a greater number of real estate syndicates.

In closing, I want to submit for the record a copy of a resolution entitled "Real Estate Securities" adopted by the annual convention of the National Association of Real Estate Boards earlier this month.

We hope that the Congress will complete action on this legislation during the current session of the Congress.

REAL ESTATE SECURITIES

We pledge our cooperation with the Securities and Exchange Commission in the development of adequate regulations, including regulatory power, directed at preventing abuses in the sale of real estate securities and in the operation of real estate investment companies engaged in the public offering of real estate securities.

We urge that the National Association of Securities Dealers, a self-policing trade association recognized as such by the Securities and Exchange Commission, develop appropriate qualifying examinations for broker-dealers and salesmen who are engaged in the sale of real estate securities. We pledge to the National Association of Securities Dealers the cooperation and assistance of this association in the development of appropriate professional standards and qualifying criteria for those engaged in the sale of real estate securities.

(Statement of policy adopted by the delegate body of the National Association of Real Estate Boards, New York, N.Y., Nov. 14, 1963.)

ARKANSAS LIFE CONVENTION,
Little Rock, Ark., November 6, 1963.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. HARRIS: The membership of the Arkansas Life Convention is comprised of domestic life insurance companies that were organized and incorporated by bona fide residents of the State of Arkansas. Generally, all member companies are legal reserve life insurance stock companies and are qualified to do business in States other than Arkansas. As such, these companies all comply with the National Association of Insurance Commissioners uniform accounting procedures and file their annual statements with the proper regulatory bodies in all States in which they are qualified to do business. These financial statements are a matter of public information and are readily available for inspection in detail by any interested parties. We do not believe that is any other industry in the United States so carefully regulated as is the life insurance industry. We do not believe there is any other industry whose operations are so fully disclosed to the public as the life insurance industry.

There now appears public hearings to be held by your subcommittee on H.R. 6789 and H.R. 6793 and S. 1642—Securities and Exchange Commission omnibus bill. The members of this convention wish to go on record as being against this legislation. Because of a great many valid and technical reasons in addition to those mentioned above, we can see no useful purpose to be served in the public interest for including life insurance companies in this omnibus bill. On the other hand, we believe that the inclusion of life insurance companies in this omnibus bill will seriously impair the ability of small stock companies to participate in the highly competitive life insurance industry. It may in truth and in fact cause many small dedicated life insurance companies to withdraw as business organizations.

There is no question that the requirements as promulgated by the Chairman of the Securities and Exchange Commission would be expensive, needless duplications of the reporting requirements already set forth by the National Association of Insurance Commissioners and complied with by all qualified life insurance companies.

We urge your most serious consideration of the opinions of the businessmen represented by the member companies of the Arkansas Life Convention.

Respectfully,

HERBERT L. THOMAS, Jr., *President.*

ARKANSAS LIFE CONVENTION MEMBERS

Frank Whitbeck, president, American Foundation Life Insurance Co., 1150 Tower Building, Little Rock, Ark.
J. H. Leggett, president, Arkansas National Life Insurance Co., 1000 West Fifth Street, Little Rock, Ark.
Rhett Butler, president, Empire Life Insurance Co., Post Office Box 2116, Little Rock, Ark.
G. Bert Ward, Sr., president, Investors Preferred Life Insurance Co., Post Office Box 3704, Little Rock, Ark.
Gardner McNabb, president, NcNabb Insurance Co., Post Office Box 207, Pocahontas, Ark.
W. E. Darby, president, National Old Line Insurance Co., Post Office Box 2900, Little Rock, Ark.
W. M. Ritter, president, Preferred Risk Life Insurance Co., Post Office Box 410, Fayetteville, Ark.
J. H. Mize, president, Riverside Life Insurance Co., 401 West Third Street, Little Rock, Ark.
E. M. Arnold, president, Union Life Insurance Co., Union Life Building, Little Rock, Ark.
Lawrence Primm, president, American Life & Annuity Insurance Co., Post Office Box 7157, Little Rock, Ark.
Frank Shamburger, president, Christian Foundation Life Insurance Co., 2101 Main Street, Little Rock, Ark.
Herbert L. Thomas, Jr., president, the First Pyramid Life Insurance Co. of America, Pyramid Life Building, Little Rock, Ark.
W. J. Bryden, Jr., president, Jackson Life Insurance Co., 1101 Falls Building, Memphis, Tenn.
Jess Odom, president, National Investors Life Insurance Co., 124 Main Street, Little Rock, Ark.
I. F. Jones, president, Ozark National Life Insurance Co., 501 North University, Little Rock, Ark.
Tony Christello, president, Professional Life Insurance Co., Professional Life Building, Fort Smith, Ark.
Harry Crow, president, Southern Equitable Life Insurance Co., Third and Center Streets, Little Rock, Ark.
Paul Chambers, president, Washington Independent Life Insurance Co., Independent Life Building, North Little Rock, Ark.

INVESTMENT COMPANY INSTITUTE,
New York, N.Y., November 18, 1963.

Re Securities Acts Amendments of 1963 (H.R. 6789, H.R. 6793, and S. 1642).

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce.
Longworth House Office Building,
Washington, D.C.

MY DEAR MR. HARRIS: The purpose of this letter is to urge that (1) if the bill embodying the Securities Acts Amendments of 1963 is reported favorably by your committee that this be done with the inclusion of the word "natural," as explained below, thus following the version adopted by the Senate in S. 1642, and making it clear that the bill is not intended to confer on the NASD or another registered securities association any power or jurisdiction over a registered investment company or an investment adviser of such company or with respect to standards or qualifications for the personnel of such registered company of investment adviser; and

(2) The bill be amended to provide that its provisions relating to reports, proxies, and insider trading in the case of bank stocks should be administered by the Securities and Exchange Commission and not by bank supervisory agencies.

There is presently pending before your committee three related bills; namely, H.R. 6789, H.R. 6793, and S. 1642. The texts of H.R. 6789 and H.R. 6793 appear to be the same and they differ in minor respects from S. 1642 because of certain amendments to S. 1642 adopted by the Senate prior to its passage.

One of the amendments which the Senate adopted was proposed by the Investment Company Institute (and approved by the Securities and Exchange Commission) and consisted of adding the word "natural" before the words "persons associated with" in clause (A) in the seventh line from the top of page 34 of S. 1642 as originally introduced, being in the paragraph amending section 15A(k)(2) of the Securities Exchange Act of 1934. The word "natural" now appears at such place in S. 1642 as adopted, and is missing from such place in H.R. 6789. The purpose of adding the word "natural" was to make it clear that despite the breadth of certain technical definitions in the bill, the bill is not intended to confer upon a registered securities association any power or jurisdiction over an investment company registered under the Investment Company Act of 1940 or an investment adviser of such company, or with respect to standards of qualifications for personnel of such investment company or investment adviser.

The reasons for our position with respect to the desirability of adding the word "natural" as above stated is set forth in a memorandum dated June 19, 1963, submitted by us to the Subcommittee on Securities of the Senate Committee on Banking and Currency. A copy of such memorandum is attached hereto. This position was endorsed in the Report No. 379 of the Senate Committee on Banking and Currency which accompanied S. 1642, which stated at page 87:

"S. 1642 contains several amendments to section 15A relating to discipline and qualifications for membership, and the proposed amendment to subdivision (A) of section 15A(k)(2) would be needed to insure that the Commission retains ultimate control in these areas, consistent with the philosophy of the Maloney Act. The word 'natural is used before 'persons associated with' to make it clear that a registered securities association is not to prescribe qualifications for nonmember investment adviser corporations or partnerships or investment companies controlling or controlled by a member. See, however, the analysis of section 7(a)(3) of S. 1642 for the effect of the use of this word in relation to sections 15A(b)(3) and 15A(b)(4) of the act."

H.R. 6789 presently provides (sec. 3(e), bill, p. 11) that in respect of securities issued by banks the powers and duties of the Securities and Exchange Commission relating to reports, proxies, and insider trading shall be "delegated" to an appropriate bank regulatory agency upon request of such agency. The same section of S. 1642 provides that in respect of such securities the powers and duties of the Securities and Exchange Commission relating to such activities shall be "vested" in various bank regulatory agencies.

We strongly support the statement by Mr. William McC. Martin, Chairman of the Board of Governors of the Federal Reserve System, to the Senate Committee on Banking and Currency on June 24, 1963, relating to S. 1642, in which Mr. Martin expressed the view that the provisions of the bill relating to reports, proxies, and insider trading should in the case of bank stocks as well as other stocks be administered by the SEC and not by bank supervisory agencies.

Respectfully yours,

ROBERT L. AUGENBLICK, *General Counsel.*

MEMORANDUM ON BEHALF OF INVESTMENT COMPANY INSTITUTE REGARDING NEED FOR CLARIFICATION OF THE SECURITIES ACTS AMENDMENTS OF 1963 (S. 1642)

The Investment Company Institute submits this memorandum in order to point out the need for clarification of certain portions of S. 1642 so as to make it plain that such proposed legislation does not confer upon a registered securities association any power or jurisdiction over an investment company registered under the Investment Company Act of 1940 or an investment adviser of any such investment company, or with respect to personnel of such investment company or investment adviser.

The Investment Company Institute is an association composed of 169 open-end investment companies (popularly called "mutual funds") and also the 89 investment advisers to, and 80 principal underwriters for, such investment companies. The investment company members of the Investment Company Institute, all of which are registered under the Investment Company Act of 1940 and are subject to extensive regulation by the Securities and Exchange Commission under that act, have aggregate assets constituting approximately 95 percent of the assets of all domestic registered open-end investment companies. These companies provide a medium by which investors may pool their resources and

have the funds invested collectively in the securities of other corporations. They offer the investor of moderate means an opportunity to obtain diversification of risk and experienced investment management which might otherwise be available only to persons of substantial means. These companies have approximately 6 million shareholder accounts. The average size of these accounts is about $3,600.

Investment advisory services are usually furnished to an investment company by an investment adviser which is a separate corporation or partnership. In the case of an investment company organized as a trust, investment advisory services may be performed by the trustees of the trust. Most investment companies employ principal underwriters for the sale of their shares, and the principal underwriter may be a corporation or partnership separate from the investment adviser. As a result of stock ownership, there is often a "control" relationship between the investment adviser and the principal underwriter of an investment company.

An underwriter to an investment company is a "dealer" under the Securities Exchange Act of 1934 and would, under proposed section 15(a) of such act (bill, p. 14), be required to be a member of a registered securities association.

The need for clarification of S. 1642 arises because of the breadth of the definition of "person associated with a broker or dealer" contained in the proposed amendment of section 3(a) of the Securities Exchange Act of 1934 (bill, p. 2). Such definition of "person associated with a broker or dealer" includes any person "directly or indirectly controlling or controlled by" a broker or dealer, and thus might include those corporate investment advisers, whose majority stock is owned by, or who own the majority stock of, a principal underwriter. Moreover, since the word "control" is essentially vague and is not defined in the 1934 act, there is no certainty that an investment company itself might not in some circumstances be claimed to be a person "directly or indirectly controlling or controlled by" the principal underwriter.

If an investment adviser or investment company were found to be a "person associated with a broker or dealer" under proposed section 3(a)(18), it would also be a "person associated with a member" under proposed section 3(a)(21) (bill, p. 2) since the definition of "person associated with a member" includes a "person associated with a broker or dealer which is a member of such [registered securities] association."

If an investment adviser or investment company were a person "associated with a member," it is not clear whether the proposed amendments to section 15A of the 1934 act might not for the first time subject the personnel of an investment adviser or investment company to regulation in certain areas by a registered securities association.

More specifically, proposed paragraph (5) of section 15A(b) (bill, pp. 26, 27) states that the rules of the registered securities association must, unless the Commission directs otherwise, provide that no "natural person" shall become a "person associated with a member" unless such person meets standards prescribed by the association, and further states that for the purpose of defining such standards the association may classify "persons proposed to be associated with members" and may require them to be registered with the association. Proposed amended paragraphs (9) and (10) of section 15A(b) (bill, pp. 28, 29) require the rules of the association to provide disciplinary measures and procedures for persons "associated with members."

Although the mandatory direction to the registered securities association to set standards and qualifications is limited in the case of a "person associated with a member" to a "natural" person, this might, taken literally, be interpreted to include an officer or director of an investment adviser or investment company, a partner of an investment adviser partnership, or a trustee of a trust-type investment company, all of which individuals are "natural" persons. The uncertainty is increased by the fact that proposed amended section 15A(k)(2) (bill, p. 34) provides that the Commission, if an association fails to alter or supplement its rules upon the Commission's request, may by order alter or supplement the association's rules with respect to, among other things, the "qualifications required for * * * persons associated with members * * *," and in this case the word "persons" is not qualified by the word "natural."

The technical statement of the SEC submitted in connection with the bill points out clearly that the bill is not intended by the SEC to subject registered investment companies, investment advisers, or their personnel, to regulation by a registered securities association. Thus, the SEC technical statement says in this connection (p. B–22):

"Under the proposed amendment, the NASD could not prescribe qualifications for persons associated with a member unless such persons were natural persons. This would mean, for example, that the NASD could not prescribe qualifications such as training, experience, and capital for a nonmember corporation or partnership acting as investment adviser to an investment company, or for an investment company itself, even if such investment adviser or investment company controlled or was controlled by a member of the NASD which acted as underwriter for the investment company."

Such technical statement is consistent with the fact that registered securities associations are associations of "brokers and dealers" under section 15A of the Securities Exchange Act of 1934. Investment companies, and to some extent their advisers, are subject to regulation by the carefully drawn provisions of the Investment Company Act of 1940, and their functions are fundamentally different from those of a broker or dealer concerned with the sale of securities.

Because of the importance to investment advisers and investment companies of certainty of exclusion from regulation by an association of brokers or dealers, we respectfully suggest that clarification of the bill in this respect is needed.

In aid of such clarification, we suggest that the word "natural" should be inserted before the word "persons" in clause (A) in the seventh line from the top of page 34 of the bill, and additionally that the committee report on the bill affirmatively adopt the substance of the SEC technical statement and state clearly that the bill is not intended to confer upon a registered securities association any power or jurisdiction over an investment company registered under the Investment Company Act of 1940 or an investment adviser of any such company, or with respect to standards or qualifications for personnel of such investment company or investment adviser.

Respectfully submitted.

ROBERT L. AUGENBLICK,
General Counsel, Investment Company Institute.

TALLAHASSEE, FLA.,
November 14, 1963.

HON. HARLEY STAGGERS,
Chairman, Subcommittee on Commerce and Financing,
House of Representatives, Washington, D.C.:

Regret I cannot personally appear at November 19 hearing by Subcommittee on Commerce and Financing. However, would like to be put on record as strongly opposing that part of S. 1642 requiring mandatory membership in trade association known as NASD. In my opinion this would be further usurpation of a State right and responsibility.

DANNITTE H. MAYS III,
Director, Florida Securities Commission,
Chairman, Southern Securities Administrators.

THE RESPONSE OF THE REAL ESTATE SYNDICATION INDUSTRY TO THE REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION

Presented by Harry G. Silverstein, president, the Association of Real Estate Syndicators, New York, N.Y.

In the opinion of the officers, the board of directors, and the membership of the Association of Real Estate Syndicators, "The Report of the Special Study of Securities Markets," of the Securities and Exchange Commission, is a major contribution toward the construction of a more secure foundation of investor protection for the more than 17 million shareholders of our Nation. The Special Study Report, which was promulgated with special regard for the welfare of the investment markets as well as the overriding interest of the investor public, has added a new dimension to the traditions of the outstanding public service achievements of the Securities and Exchange Commission and has notably increased the Nation's basic understanding of the operations and problems of the investment markets in the United States.

The authors of the 793-page, part I of the SEC Special Study Report, in their letter of transmittal to the Securities and Exchange Commission, declare that

if the securities industry is to operate on the level of ethical standards, it is important that the public's understanding should not be clouded by illusions and misconceptions.

"Mere lipservice or exaggeration in these matters," the authors of the SEC's Special Report say, "may do more harm than good, because the investing public may be led to expect too much in the way of protection; may fail to appreciate the risks inherent in investment, and may not exercise the vigilance and care required of the investor, even under a statutory philosophy that emphasizes 'caveat vendor' instead of 'caveat emptor.' Perhaps the most pressing need of all * * * is to foster accurate and realistic public understanding."

The Association of Real Estate Syndicators, therefore, in the interests of realistic public understanding, wishes to make its support of the objectives of the Securities and Exchange Commission's Special Study of the Securities Markets, a matter of public record.

Without reservation, the association offers its cooperation in fulfilling the following safeguards for the real estate securities and public investment industry of which it is an integral part:

THE ASSOCIATION OF REAL ESTATE SYNDICATORS

1. Pledges implementation of all measures for greater and more effective protection for public investors in real estate equity securities.

2. Endorses the establishment of higher qualifications of character and training; standards and criteria for syndicators, broker-dealers, and their representatives in the real estate securities investment industry.

3. Supports full disclosure of all material facts and figures in all real estate public investment presentations.

4. Affirms and supports the need for regular uniform certified reports to investors and Government agencies.

5. Recommends compliance to the discipline of governmental and self-regulatory controls and all other necessary steps which may be in the public interest in the conduct of the real estate equity securities industry.

In his foreward to Congress, William L. Cary, Chairman of the Securities and Exchange Commission declared that "Government regulation * * * must continue to be directed against practices * * * which can only be harmful to the economic growth of this country and to the investors who furnish the funds for that growth." With open clarity and irrefutable logic, Mr. Cary states:

"The report begins where regulations must begin—the point of entry into the business. It is self-evident that the standards of conduct of the securities industry are vitally dependent on the integrity and the competency of its personnel. Obviously, no system can be devised which eliminates all potential wrongdoers. But the Report of the Special Study concludes that the minimal controls furnished by existing regulation are inadequate * * *. With the exception of the major exchanges, significant standards of character, competence, and minimum capital have not generally been imposed. Furthermore, certain sectors of the industry * * * are not subject to the discipline of self-regulation." In conclusion, Mr. Cary then goes on to make the following recommendations:

"We shall, therefore, recommend to the Congress, legislative proposals, in the following direction:

"1. Authorizing standards of character, competence, and financial responsibility and conditions for entry into the business, to be established and administered by the national securities associations, notably the NASD, which will complement similar regulations by the exchanges of their members.

"2. Requiring all firms and individuals to be subject to the authority of one of the self-regulatory agencies;

"3. Granting the Commission direct disciplinary controls over individuals and perfecting NASD controls in this area; and

"4. Providing the Commission with intermediate sanctions over firms and individuals."

Mr. Cary also told Congress that he had provided that:

"To secure the benefit of industry views of our legislative proposals, we shall immediately request leaders of the financial community to form liaison committees."

DIGEST OF THE REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS AS IT RELATES TO "REAL ESTATE SECURITIES" IN CHAPTER IV, SECTION E

A phenomenon of the last decade, the SEC special study declares, has been the widespread public distribution of real estate equity securities. It is impossible to estimate accurately how much the public has invested in this field. However, in New York State, the center of such real estate offerings, 400 offerings were made totaling $1.3 billion in 1961. In 1962, 302 such offerings were made which totaled over $500 million * * * Unofficial estimates of all such syndication sales place them well above the $10 billion mark in the past 10 years.

Like real estate investment trusts, both the limited partnership and the corporate entities in the real estate area are carefully designed to take maximum advantage of relevant Internal Revenue Code provisions on the deductibility of depreciation of real property. Indeed, continues, the SEC report, there is no doubt that the entire real estate syndication business is essentially the product of the accelerated depreciation deduction permitted by the Federal income tax laws. The importance of the present Federal tax laws to the structure of real estate syndication is in many respects far greater than securities regulation.

Another significant and unusual aspect of the real estate syndication business is its primarily local nature and its historical concentration in the New York City area. To some extent, the syndicators have carried on their activities elsewhere, but the SEC report points out, New York is the center of the syndication universe.

As might be expected of a new phenomenon, the SEC report avers public real estate offerings have brought special problems which have been intensified by the recent spectacular expansion of public participation. The principal problems according to the SEC report relate to the speculative nature of some of the real estate securities being offered to the public; the extent of the compensation of the promoters; and the manner in which such securities are sold to the public.

The SEC report makes the following severe criticisms of the real estate securities industry:

"Selling practices need improvement. The absence of an effective self-regulatory securities association with jurisdiction over the industry and the lack of adequate qualifications training and supervision of many of the salesmen engaged in the business are matters of concern * * * A special problem relating to real estate securities involves extensive reliance by their offerors on the intrastate exemption from Federal regulation."

The SEC report is also critical of the use of depreciation allowances for tax shelter purposes as well as the exemption of the limited partnership entity from Federal corporate taxes.

The SEC report's section dealing with real estate securities concludes:

"The Special Study concludes and recommends that:

"1. The Commission should propose to the Congress that section 15A of the Exchange Act be amended to provide that all distributors and dealers in real estate securities in interstate commerce shall be required to be members of a registered securities association having such rules relating to the business in real estate securities carried on by its members as shall appear to the Commission to be necessary or appropriate in the public interest or for the protection of investors. Also all individuals engaged in selling or distributing real estate securities should be subject to registration requirements recommended generally in chapter II for persons engaged in selling or distributing securities.

"2. The Commission should further study the problems of speculative offerings, promoters' benefits, insider transactions, distributions, and the information furnished to security holders, and the adequacy of its power to deal with such problems."

Therefore, at the instance of Mr. William L. Cary, Chairman of the Exchange Commission, the Association of Real Estate Syndicators, pledges, that through the consultative operations of its joint SEC-Syndicator Liaison Committee, it will maintain a constant channel of communications so that the best interests of the public and the industry can be served and maintained in an atmosphere of mutual cooperation and trust in accordance with the highest principles of governmental and business joint endeavors.

STATE OF MARYLAND,
OFFICE OF THE INSURANCE COMMISSIONER,
Baltimore, Md., September 9, 1963.

Re S. 1642, H.R. 6789 and 6793 Securities and Exchange Act of 1934, extension to over-the-counter securities.

Hon. CARLTON R. SICKLES,
Member of Congress,
Washington, D.C.

DEAR CONGRESSMAN SICKLES: As insurance commissioner for Maryland, I have just had an opportunity to review the above proposed bills, and am directing this letter to you, calling your attention to what I believe would be undesirable consequences should this legislation be enacted. My comments regarding the bills relate to insurance companies and not to corporations other than insurers.

Insurance companies are regulated by the several States under Public Law 15 in that it is in the public interest that the business of insurance shall continue to be regulated by the respective States.

The administration of State insurance laws has functioned efficiently and effectively for many years and the various State insurance commissioners, through the National Association of Insurance Commissioners, have effectively coordinated the supervision of insurance companies in their respective States.

I respectfully solicit your opposition to the enactment of the above legislation. In my opinion the enactment of these bills would extend Federal regulation of the insurance business. I am confident Public Law 15 controls this situation effectively in the public interest.

Any assistance you can give in opposition to the enactment of this legislation will be appreciated.

With kind personal regards, I am,
Sincerely,

F. DOUGLASS SEARS, *Commissioner.*

OFFICE OF SECRETARY OF STATE,
Indianapolis, Ind., November 15, 1963.

Re S. 1642, Securities and Exchange Commission omnibus bill.

Hon. HARLEY STAGGERS,
Chairman, Subcommittee on Commerce and Finance, House Interstate and Foreign Commerce Committee, Washington, D.C.

DEAR SIR: Pursuant to the notice of public hearing, dated October 18, 1963, regarding the above cited bill, I am forwarding herein a statement for the record in opposition to said bill.

As a State securities administrator I forward this statement representing the best interests of the citizens of the State of Indiana.

I have made a study of the proposed bill as well as the accompanying reports. I feel that the two taken together have a tendency to greatly confuse the issues.

The study poses great criticism at an established trade association. These criticisms appear to have been acquired from one area of the country.

The bill, S. 1642, seeks to give this trade association greatly increased powers under the closer control of the Securities and Exchange Commission. The key to the bill is the elimination of intrastate securities houses, intrastate securities markets, intrastate securities and ultimately means of financing for small business which still stands as the backbone of our economy.

It should also be noted that the means provided in this bill to solve problems of one part of our country are not necessarily sufficient or adequate to solve problems in other areas of the country.

It is my opinion that portions of this proposed bill deprive brokers nad dealers in the industry of rights without due process of law which is unconstitutional.

Further, I would cite three key words in the preamble to the Constitution of the United States of America; namely "We the People." It is my opinion that legislation such as this violates every intention of the founders of this country and the makers of the Constitution. Such legislation seeks to place control of a local problem in the hands of the Federal Government. This violates our very way of life and existence.

I very respectfully submit that this bill in its present form is a direct encroachment on States rights, a detriment to the economy of our country and an unrealistic approach to the problem.

In behalf of the citizens of the State of Indiana, I respectfully submit this statement in opposition to the proposed bill, S. 1642.

Very truly yours,

MARTIN K. EDWARDS,
Securities Commissioner.

NATIONAL COUNCIL OF FARMER COOPERATIVES,
Washington, D.C., January 24, 1964.

Re status of farmer cooperatives under H.R. 6789 (S. 1642)—Securities acts amendments of 1963

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House Office Building, Washington, D.C.

DEAR MR. HARRIS: Section 3(c) of H.R. 6789 proposes to add a new subsection (g) to section 12 of the Securities Exchange Act of 1934, which would subject the issuers of securities with total assets exceeding $1 million and a class of equity security held of record by 750 or more persons to the reporting, proxy, and insider trading provisions of the Securities Exchange Act of 1934. A small number of the approximately 9,000 farmer marketing, purchasing and farm business service cooperatives in the country no doubt would be subject to the new subsection under the statutory test, even some that are now exempt from the registration requirements under the Securities Act of 1933.

We called this matter to the attention of officials of the Securities and Exchange Commission last July and furnished them the most current and complete information available on a nationwide basis concerning the types of securities issued by farmer cooperatives, as contained in General Report 32, issued June 1957 by the Farmer Cooperative Service, U.S. Department of Agriculture, entitled "Methods of Financing Farmer Cooperatives." A copy of that report is enclosed for reference.

Thereupon, Philip A. Loomis, Jr., General Counsel of the Securities and Exchange Commission addressed a letter under date of July 17, 1963, to Hon. A. Willis Robertson, chairman, Committee on Banking and Currency, U.S. Senate, Washington, D.C., with respect to the application of S. 1642 to farmer cooperatives. In that letter Mr. Loomis pointed out that securities of farmer cooperatives differ in various ways from the common and preferred stock issued by conventional corporations, but they might nevertheless constitute equity securities within the meaning of section 3(a)(11) of the Securities Exchange Act of 1934. Mr. Loomis expressed the view that if any farmer cooperatives should turn out to fall literally within the sections of the bill referred to, it would be *appropriate* for the Commission to exempt them pursuant to the powers provided in section 12(h) of the act as added by section 3(d) of the bill. (Emphasis supplied.)

I understand that a copy of Mr. Loomis' letter of July 17, 1963, to Senator Robertson, above referred to, has been incorporated in the record of the hearings on this legislation before the subcommittee.

When Chairman William L. Cary of the Commission testified before the subcommittee on November 20, 1963, he stated in part in reply to your interrogation concerning the status of farmer cooperatives under this legislation, as follows:

"The premise in Mr. Loomis' letter is that he would not anticipate that farmer cooperatives would be covered, and, if covered, we can exempt them. We can state that much more precisely if you would wish that in the record."

Subsequently, Chairman Cary has submitted for the record letters under dates of November 29, 1963, and January 17, 1964, which in substance state that the Commission believed it highly unlikely that any farmers' cooperatives will meet the test of H.R. 6789 and that if *any* cooperative does meet these tests, it is our *intention* to exempt it (Emphasis supplied)

Chairman Cary makes clear in his letter of January 17, 1964, that this intention refers to the application to farmers' cooperatives of the amendments contained in section 3(c) of the bill and related sections which would subject larger companies in the over-the-counter market to the reporting, proxy and insider trading provisions of the Securities Exchange Act.

It seems clear, therefore, that the Securities and Exchange Commission as presently constituted agrees that it is not their recommendation or intention that *any farmer cooperatives* should be subject to the regulatory requirements imposed on issuers of securities meeting the test set forth in section 3(c) of H.R. 6789 even though it might be determined that some farmer cooperatives might literally meet that test. If your committee concurs in that conclusion it appears to us that the only question is how best to achieve that result—by subsequent administrative action by the Commission in individual cases as they might arise or by a specific exemption in the bill itself. We believe the latter course is highly preferable and fully justified. We believe that on the basis of economical and effective administration and the underlying purpose of this legislation namely, to protect the investing public, and in view of the fact that the intention of the present Commission on this point might not be followed by future Commissions, a specific exemption for farmer cooperatives should be included in the bill itself.

RECOMMENDATION NO. 1

Section 3(c) of the bill provides that the proposed new subsection (g) to be added to section 12 of the Securities Exchange Act of 1934 shall not apply to the securities in certain categories enumerated in subparagraphs (A) through (B) inclusive.

We recommend a new subparagraph in the new subsection (g)(2) (p. 8 of the bill), preferably following subparagraph (D), reading as follows:

"Any security of an issuer which is a 'cooperative association' as defined in the Agricultural Marketing Act, approved June 15, 1929, as amended, or a federation of such cooperative associations, if such federation possesses no greater powers or purposes than cooperative associations so defined."

I am enclosing a copy of the definition of "cooperative association" as contained in the Agricultural Marketing Act of 1929, as amended. This same definition is the basis for exemption from economic regulation of transportation by motor vehicles controlled and operated by cooperative associations as contained in section 203(b)(5) of the Interstate Commerce Act, part II, and is the same definition for cooperative associations to be eligible for loans under the Farm Credit Act of 1933 which authorized the organization of 12 regional banks for cooperatives and the Central Bank for Cooperatives.

To avoid any questions of interpretation in the future we herein recommend that the exemption specifically include federation of such cooperatives. As is generally known, many farmers today are direct members of a cooperative association at the county or community level and these local associations of farmers make up the direct membership of the federated cooperative operating on a statewide or regional basis.

Adoption of the recommended language would assure that only farmer cooperatives (1) which are operating on a nonprofit basis for the mutual economic benefit of their farmer members, (2) which are primarily engaged in marketing farm products or furnishing farm supplies or farm business services, and (3) which permit only one vote for each member, or limit the dividends on stock or membership capital to 8 percent per annum, would be exempt. Organizations purporting to be farmer cooperatives but which do not actually qualify as such thus could not take advantage of this exemption.

RECOMMENDATION NO. 2

Although H.R. 6789 would principally amend the Securities Exchange Act of 1934, it is noted that section 11 of the bill would amend section 4 of the Securities Act of 1933. It occurs to us, therefore, that this bill offers an appropriate opportunity and legislative vehicle to effectuate a desirable change in the basis for exemption of securities of farmer cooperatives under the Securities Act of 1933.

The latter part of section 3(a)(5) of the Securities Act of 1933 provides that the provisions of that act shall not apply to:

"* * * [or] any security issued by a farmers' cooperative association as defined in paragraphs (12), (13), and (14) of section 103 of the Revenue Act of 1932;".

The tax treatment of farmer cooperatives as prescribed in the Internal Revenue Code does not, we believe, furnish the most logical or proper basis for the exemption of securities of farmer cooperatives under the Securities Act of 1933. Since 1932 there have been at least three changes in the tax treatment of

farmer cooperatives—a minor one in the Revenue Act of 1934, a major change in the Revenue Act of 1951 adding section 522 to the Internal Revenue Code of 1954, and a major change in the Revenue Act of 1962, repealing section 522 and adding a new subchapter T to chapter 1 (relating to normal and surtaxes) of the Internal Revenue Code prescribing a substantially different tax treatment for all cooperative organizations and their patrons than has existed heretofore. Although the definition of a so-called tax-exempt farmer cooperative has not been substantially modified by these changes, we submit that any sound reason which may have existed in 1933 for basing the exemption in the Securities Act of 1933 on the definition of farmer cooperatives as contained in the Internal Revenue Code at that time has been invalidated by the pertinent changes in the law and experience of the past 30 years.

Qualification under section 521 of the Internal Revenue Code which prescribes the present requirements in the definition of a so-called tax-exempt cooperative is not contingent upon the size of the cooperative from the standpoint of assets, number of members or stockholders, volume of business, or amount or type of securities issued. Some large farmer cooperatives are so-called tax exempt, others are nonexempt. Some small farmer cooperatives are so-called tax exempt, others are nonexempt.

We believe that the basic requirements in the definition of a farmer cooperative as contained in the Agricultural Marketing Act of 1929, as amended, as explained herein under our recommendation No. 1, furnish a sound and more appropriate basis for exemption of the securities of such organizations from the registration requirements under the Securities Act of 1933. Under that definition the cooperative must be an association of farmers; they must act together in marketing farm products, purchasing farm supplies or farm business services; the association must be operated for the mutual benefit of the members as such producers or purchasers; voting must be limited to one vote per member regardless of the amount of stock or membership capital owned or dividends on stock or membership capital must be limited to 8 percent; and the amount of business transacted with nonmembers cannot exceed that transacted with members.

In the majority of cases today the securities issued by farmer cooperatives are held by their farmer members or other patrons who use the services and there are usually restrictions upon the transfer of these securities.

We believe it is clear that in the case of farmer cooperatives which meet the requirements of the Agricultural Marketing Act of 1929, as amended as summarized above there is no practical need for the imposition of any additional requirements on those few which may issue securities available for purchase by other than their farmer patrons in order to protect any part of the general public who, in exceptional cases, might have an interest in purchasing such securities. It is well known as a practical matter that any members of the public who manifest a trading interest in the securities of those few farmer cooperatives which issue marketable securities have access to full information concerning the organization, operations and capital structure of the cooperative. They are often persons who want to strengthen the cooperative for its potential contribution to the economy of the area rather than from a purely invesment-for-profit motive.

Therefore, we recommend that the present exemption in section 3(a)(5) of the Securities Act of 1933 be amended to read as follows:

"* * * [or] any security issued by a 'cooperative association' as defined in the Agricultural Marketing Act, approved June 15, 1929, as amended, or by a federation of such cooperative associations if such federation possesses no greater powers or purposes than cooperative associations so defined."

We further recommend that such amendment be included as an amendment in section 11 of H.R. 6789.

We respectfully request the incorporation of this letter in the record of the hearings before the subcommittee and the favorable action of the subcommittee and thereafter the Committee on Interstate and Foreign Commerce on these recommendations. We would also appreciate your including in the record the enclosed definition of "cooperative association" as contained in the Agricultural Marketing Act of 1929, as amended. The enclosed report on "Methods of Financing Farmer Cooperatives" in view of its length is submitted only for reference purposes.

If any additional information is desired by members of the subcommittee or the full committee, or staff, in their consideration of these recommendations, we shall be glad to furnish it in written or oral form as may be requested.

Sincerely,

L. JAMES HARMANSON, Jr.,
General Counsel.

SECTION 15(a) OF THE AGRICULTURAL MARKETING ACT

Approved June 15, 1929, as amended (49 Stat. 317, 12 U.S.C.A. 1141j(a))

As used in this act, the term "cooperative association" means any association in which farmers act together in processing, preparing for market, handling, and/or marketing the farm products of persons so engaged, and also means any association in which farmers act together in purchasing, testing, grading, processing, distributing, and/or furnishing farm supplies and/or farm business services: *Provided, however,* That such associations are operated for the mutual benefit of the members thereof as such producers or purchasers and conform to one or both of the following requirements:

First. That no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own therein; and

Second. That the association does not pay dividends on stock or membership capital in excess of 8 per centum per annum.

And in any case to the following:

Third. That the association shall not deal in farm products, farm supplies, and farm business services with or for nonmembers in an amount greater in value than the total amount of such business transacted by it with or for members. All business transacted by any cooperative association for or on behalf of the United States or any agency or instrumentality thereof shall be disregarded in determining the volume of member and nonmember business transacted by such association.

PHOENIX SOCIETY OF FINANCIAL ANALYSTS,
Phoenix, Ariz., November 15, 1963.

Re Securities Acts Amendments of 1963, H.R. 6789.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR CONGRESSMAN HARRIS: The Phoenix Society of Financial Analysts is 1 of 34 local societies of the national association, Financial Analysts Federation. Our Phoenix society has a current membership of 61 analysts primarily engaged in the valuation of securities and formulation of investment advice, both for individual investors and financial institutions.

The executive committee of our society, at its meeting of November 13, 1963, voted to favorably endorse H.R. 6789 insofar as it tends to further the disclosure of adequate information as a basis for security valuation and promotes the professional qualifications of security and financial analysts. Our executive committee directed that a letter advising of this action be forwarded to Congressman Harris, with copies to the Arizona congressional delegation.

Sincerely,

GEORGE F. GERMAN, JR., *President.*

THE FINANCIAL ANALYSTS FEDERATION,
November 4, 1963.

Re Securities Acts, Amendments of 1963, H.R. 6789.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

MY DEAR CONGRESSMAN HARRIS: The Financial Analysts Federation, a national association of 34 local societies having an aggregate membership of approximately 8,250 professional financial analysts, is vitally interested in the proposed legislation entitled "Securities Acts Amendments of 1963" and desires to express its views as to certain provisions of the bill.

The analysts represented by the federation are primarily engaged in the evaluation of securities and the formulation of investment advice for individual investors and for financial institutions. More and more the analyst is the medium through which financial information is being channeled and, in recognition of this increasing responsibility, the federation has pursued a program designed to further the disclosure of adequate information as a basis for security evaluation and to promote the professional qualifications of its members. The pending legislation has a direct bearing in both of these areas.

This organization has always favored in principle the extension of disclosure requirements applicable to listed coroporations to the larger companies having unlisted securities held by the public and has endorsed legislation proposed in

past years to accomplish this end. Full and continuing disclosure of essential facts is a necessity for the determination of security values, and for many issues in the over-the-counter market the information available has been inadequate. We strongly favor those provisions of the bill extending reporting requirements and proxy rules to the corporations specified therein, and the extent of the coverage is believed to be reasonable on the basis of the information contained in chapter IX of the Special Study of Securities Markets of the Securities and Exchange Commission. Concern has been expressed that the requirements would be unduly burdensome for the smaller corporation, but it is felt that due regard for this is reflected in the administrative flexibility provided in the bill. We are in accord with the provision that corporations disclose their "material contracts" on a continuing basis subsequent to registration. It is felt that banks and insurance companies, under whatever governmental agencies may be designated to have jurisdiction, should conform with the requirements applicable to other corporations.

Because the federation has been engaged in a program to establish improved standards of performance of its members, we are interested in those aspects of the bill dealing with qualification standards and controls over those in the securities business. Many of the individual societies have had codes of ethics for many years and a federation code of ethics was approved at the 1962 national convention. It has since been adopted by substantially all of the local societies. In 1959 a department of the federation known as the Institute of Chartered Financial Analysts, Inc., was activated after 10 years of study and development to conduct examinations leading to the professional designation of "chartered financial analyst." The first charters were issued in September to 268 analysts who passed examinations given in June.

It is recognized that the strengthening of standards in the securities business generally requires the establishment of reasonable controls over those engaged in the business and we favor the principle of self-regulation as set forth in the bill. We are in accord with the general plan proposed and we would be willing to cooperate with designated self-regulatory organizations and governmental authorities in the formulation of standards applicable to those who may be classified as financial analysts.

We agree with the proposal to extend the period for the delivery of a prospectus for offerings of companies filing a registration statement for the first time. While an analyst would normally secure a prospectus as a basis for his evaluation without the requirement that one be delivered, this measure is definitely in the public interest and should be adopted.

Many aspects of the bill do not directly affect the specialized interests of financial analysts and we have therefore refrained from commenting upon them. We are in accord with the general purposes of the legislation and we feel that it is in the best interest of the investing public and hence of the financial analysts. We favor adoption of the bill.

Very truly yours,

WILLIAM C. NORBY, *C.F.A., President.*

NATIONAL ASSOCIATION OF MANUFACTURERS,
New York, N.Y., November 27, 1963.

Hon. HARLEY O. STAGGERS,
Chairman, Commerce and Finance Subcommittee, Interstate and Foreign Commerce Committee, House of Representatives, Washington, D.C.

DEAR MR. STAGGERS: The purpose of this letter is to file a written comment with your subcommittee in connection with the hearings being held on H.R. 6789, which incorporates important proposals regarding Federal regulation of securities and exchanges.

The National Association of Manufacturers primarily represents the issuers of securities; therefore, our comments will be directed only to the provisions of H.R. 6789 which would affect issuers. These provisions would extend the requirements presently applying to listed companies—as to the making of reports, furnishing of certain information on proxy solicitations, and being subjected to certain restrictions on insider trading—to unlisted companies meeting specific criteria as to number of stockholders and size of assets.

Our association believes in the right of stockholders to proper and adequate disclosure of information and in reasonable and proper safeguards to protect and assure that right. Companies whose stock is not listed on an exchange

are increasingly responding to the need of shareowners for adequate information. All evidence points to the voluntary acceleration of this trend which would lessen any need for Government action in this respect.

Our association endorses the desirability of advancing the education of the American investor and expanding the number of shareholders in American business. Nevertheless, we must express our concern about the bill's proposals which would directly affect unlisted companies. The burden of keeping up to date on, and complying with, SEC requirements is not light nor insignificant. It necessitates the employment of specialized legal and accounting personnel schooled in Federal regulation of the securities field. The complex and detailed requirements of this measure would require that many smaller concerns file registration statements setting forth:

(1) The organization, financial structure and nature of their business;

(2) The terms, position, rights and privileges of the different classes of securities outstanding;

(3) The terms on which securities have been issued in the preceding 3 years;

(4) The directors, officers, and underwriters, and each security holder of record holding more than 10 percent of any class of any equity security of the issuer, their remuneration and their interests in the securities of, and their material contracts with, the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common contol with, the issuer;

(5) Bonus and profit-sharing arrangements;

(6) Management and service contracts;

(7) Options existing or to be created in respect of their securities;

(8) Material contracts, not made in the ordinary course of business;

(9) Balance sheets for the 3 preceding fiscal years;

(10) Any further financial statements which the Commission may deem necessary or appropriate.

All this is to be supplied in such detail as the Commission may require by rules and regulations as necessary and appropriate.

In addition, the bill would necessitate filing with the Commission such information and documents as the Commission shall require to keep reasonably current the information and documents required to be included in or filed with the registration statement, and such annual and quarterly reports as the Commission may prescribe. This, too, to be done in accordance with such rules and regulations as the Commission may prescribe as necessary and appropriate.

Additionally, compliance would be required with such rules and regulations as the Commission may prescribe as necessary and appropriate in regard to information contained in proxy solicitations. If no solicitation is made prior to a meeting of securities holders, the issuer nevertheless would be required, in accordance with rules and regulations prescribed by the Commission, to file with the Commission and transmit to all such securities holders information substantially equivalent to the information which would be required to be transmitted if a solicitation were made. The Commission's rules and regulations on proxy solicitations as of January 10, 1958, consisted of 19 large printed pages and are much too lengthy and elaborate to summarize in this letter. They consisted of 14 rules numbered 14a–1 to 14a–11, a schedule 14A comprising 21 items, and a schedule 14B comprising 5 items.

So far as we know, the Commission has never made a study of the burden of time and cost imposed on issuers by reason of these legal requirements. It is obvious that the cost could be an unreasonable percentage of the net earnings of a smaller company with comparatively modest income. Up to now, the subjection of a company to these requirements has been a voluntary matter. A company seeking the advantages of listing on an exchange or a public offering of its securities knowingly and willingly subjected itself to Federal regulation. It is submitted that the decision as to listing on an exchange should be left optional and not be unduly influenced by the requirements of Federal law. Under this new bill, the requirements will be imposed on many companies which will be subjected to costly and burdensome procedures with no prospect of offsetting benefits.

Therefore, we respectfully urge your distinguished subcommittee to subject those provisions of H.R. 6789 which would extend Federal regulation to companies not seeking exchange listing or public financing.

Sincerely,

W. P. GULLANDER, *President.*

THE NATIONAL BOARD OF FIRE UNDERWRITERS,
New York, N.Y., February 20, 1964.

Re H.R. 6789, H.R. 6793, and S. 1642.

Hon. HARLEY O. STAGGERS,
Chairman of the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, House Office Building, Washington, D.C.

DEAR MR. STAGGERS: The hearings disclose that SEC believes the States and their insurance commissioners do not have the power to enforce compliance with their program of disclosure and stockholder protection. That belief is due, evidently, to a lack of understanding of the fundamental power of State governments over the insurance industry.

Before an insurance company may transact business, it must apply for a license from each State where it wishes to do business. The granting of the license by a State is permissive, and it is conditioned upon compliance by the company with the laws of the State and the rules and regulations of its department of insurance. The license must be renewed annually in most States and it may be suspended or revoked at any time for just cause in every State.

The power of a State to deny, suspend, or revoke an insurance company license—which means the power to put a company out of business—is far greater than any power possessed by the SEC, and the exercise of that power is more absolute than any remedy available to the SEC.

The choice given an insurance company, therefore, is to either comply with the disclosure and stockholder protection program of the insurance commissioners of the States or forfeit the right to do business. Certainly, no company is going to refuse the comply when the loss of the right to do business is the alternative.

The supervisory and enforcement powers of the States in regard to stockholders are superior to those of the SEC in many other important respects. I am attaching a memorandum in regard to them for your consideration.

We greatly appreciate the opportunity of presenting this material for the thoughtful consideration of your subcommittee and ask that it be included in the printed record.

Respectfully yours,

J. RAYMOND BERRY, *General Counsel.*

Enclosure.

STATE REGULATION IS PRESENTLY MORE COMPLETE, IN MANY RESPECTS, THAN SEC-PROPOSED REGULATION AND, SHORTLY, CAN BE MADE MORE COMPLETE IN ALL RESPECTS THAN SEC REGULATION

I

State regulation has the power of annual licensing. SEC does not. The power of licensing is coupled with the power of revocation and the language of the statutes with reference to licensing and revocation of license is extremely broad in all of the States. In substance, these broad provisions permit termination of a company's authority to do business when, in the opinion of the insurance commissioner, the business is being conducted in a manner which is not in the best interests of the public.

II

State regulation has the power of examination in every State at any time when, in the judgment of the insurance commissioner, examination is indicated. This examination is at the expense of the insurance company. The SEC does not have this power.

III

State regulation has 50 regulators—one in each State—where all information with reference to the companies under regulation is readily available. SEC does not have this.

IV

State regulation has overlapping regulation where a company does business in more than one State (and most companies do). Thus, a lapse in regulation in one jurisdiction may be corrected by alert regulation in another jurisdiction. As the number of States in which the company is doing business increases, the "may" in the preceding sentence comes close to the word "will."

V

The rulemaking power of the insurance commissioner is extremely broad. It permits the commissioner to make such reasonable rules and regulations as may be necessary for making effective the insurance laws of the State. An example of an exercise of this power, with reference to the sale of insurance stocks, is the proposed rule 9.13 to become effective March 17, 1964 in Illinois. SEC has proceeded on the assumption that regulation of proxy or insider trading would require action by 50 State legislatures. (Testimony of Chairman Cary, before Subcommittee on Commerce and Finance, House of Representatives, November 19, 1963.) This assumption is wide of the mark. Most, if not all, of SEC requirements can be imposed under the rulemaking power or under the licensing power. SEC does not have the broad power to enforce compliance which is comparable to the forfeiture of the right to do business.

VI

State regulation (in some States expressly—in other States implicitly) has the power to remove executives of insurance companies whose performance is not in the best interest of the insurer or the public. This power has been exercised when circumstances required. SEC does not have this power.

VII

State regulation reaches, and will reach, a far greater number of stock companies than SEC can or will under the proposed legislation.

VIII

State regulation of financial information and proxy information can go further than just the regulation of stock companies, for the powers of the insurance commissioners extend to mutual insurance companies as well.

IX

State regulation has a uniform annual statement for each type of insurer—life, fire, casualty. This annual statement is more conservative than SEC accounting requirements. Thus, the stockholder is better protected by State regulation, for there is less risk of overstatement of assets under State law accounting requirements. (Some States have been requiring quarterly statements. Among these are the important insurance States of New York and California.)

XII

State regulation is close to the people of each State. SEC regulation is not. This closeness is not merely a geographical closeness—the insurance commissioner and the members of his staff in each State are widely known—not only by the insurance people of the State, but also by financial interests and investor interests.

XI

It is repeatedly said in report of the special study and in the testimony of Chairman Cary that, "the keystone of the entire structure of securities legislation is disclosure." There is no limit to the disclosure which is required or can be required under State regulation. The power to enforce disclosure and to discipline for failure to disclose is more complete under State regulation than under the SEC statutes.

X

The cause of action given under SEC to force disgorgement of profits on prohibited insider-trading transactions goes beyond disclosure. If there is any doubt that the States cannot compel disgorgement of profits through its power to revoke an insurance company's license to do business, or under other State laws and the rules and regulations of State insurance departments, the States should be afforded the opportunity to enact law and regulations to do so. There is precedent showing that, if given the time and the opportunity, State regulation can and will act. (McCarran Act and subsequently enacted State rating laws.)

(Whereupon, at 5:10 p.m. the hearing was concluded.)

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