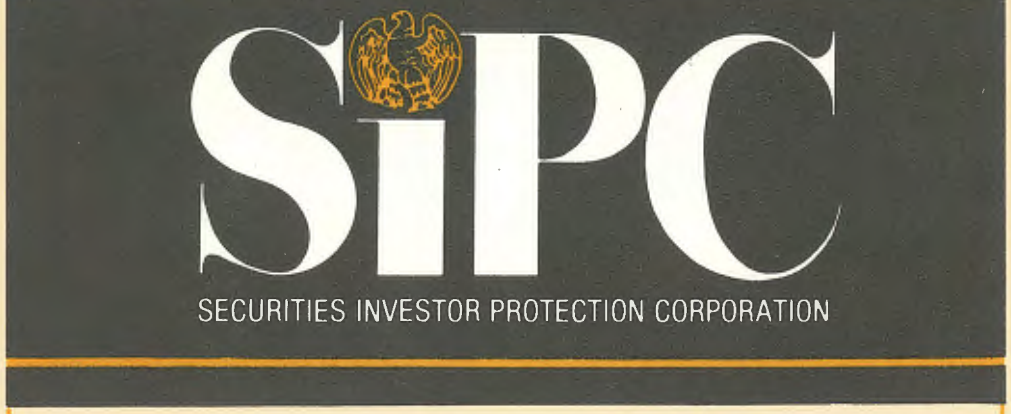

FIRST ANNUAL REPORT

1971

SECURITIES INVESTOR PROTECTION CORPORATION
485 L'ENFANT PLAZA, S.W. • SUITE 2150
WASHINGTON, D.C. 20024 • (202) 484-5400

LETTER OF TRANSMITTAL

SECURITIES INVESTOR PROTECTION CORPORATION

Washington, D. C.
April 28, 1972

The Honorable William J. Casey
Chairman
Securities and Exchange Commission
500 North Capitol Street, N. W.
Washington, D. C. 20549

Dear Chairman Casey:

On behalf of the Board of Directors I submit herewith the First Annual Report of the Securities Investor Protection Corporation pursuant to the provisions of Section 7(C)(2) of the Securities Investor Protection Act of 1970, approved December 30, 1970.

Respectfully,

Byron D. Woodside

Byron D. Woodside
Chairman

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SECURITIES INVESTOR PROTECTION CORPORATION

(SIPC)

Directors

		Term expires December 31
Byron D. Woodside	Chairman	1973
George J. Stigler, Vice Chairman	Professor of Economics, University of Chicago, Chicago, Illinois	1972
Glenn E. Anderson	President, Carolina Securities Corporation, Raleigh, North Carolina	1972
Henry W. Meers	Vice Chairman, White, Weld & Co., Incorporated, Chicago, Illinois	1974
J. Charles Partee	Adviser to the Board and Director, Division of Research and Statistics, Board of Governors of the Federal Reserve System, Washington, D. C.	1974
Samuel R. Pierce, Jr.	General Counsel, Department of the Treasury Washington, D. C.	1973
Donald T. Regan	Chairman, Merrill Lynch, Pierce, Fenner & Smith Inc., New York, N. Y.	1973

Bruce K. MacLaury, Deputy Under Secretary for Monetary Affairs, served as a director representing the Department of the Treasury from January to July, 1971.

Andrew J. Melton, Jr., Chairman, Executive Committee, Smith, Barney & Co., Inc., New York, N.Y., served as a director for the term expiring December 31, 1971.

Staff Officers

Theodore H. Focht
General Counsel—Secretary

Lloyd W. McChesney
Vice President—Finance

Wilfred R. Caron
Assistant General Counsel

485 L'Enfant Plaza, S.W., Suite 2150
Washington, D. C. 20024
Telephone: 202-484-5400

FOREWORD

The original members of the Board were appointed in January 1971. The Act specified that SIPC must have a fund of $75 million within 120 days of enactment. Accordingly, the first five months of 1971 were devoted principally to the preparation, organization and review of the assessment procedures and the establishment of the Fund. In addition, many hours and substantial sums of money were expended during this period in connection with anticipated problems—potentially of critical magnitude—should a large member of SIPC then experiencing serious financial difficulty fail to survive. For these and other reasons it was not until June that SIPC could concentrate on the problems to be met and the procedures to be developed in administering Sections 5 and 6 which govern the liquidation process. The activity under these two sections increased at a rapid rate as the year progressed and accelerated markedly after November.

It was decided, therefore, that accounting in this first report only for events occurring within the fiscal year, excluding developments through the first quarter of 1972, would result in the presentation of an incomplete picture of SIPC's activities. It should be noted, therefore, that although the financial statements relate to the fiscal year ending December 31, the text and other financial data reflect events occurring through March 31, 1972. It is anticipated that in the future the annual report will deal principally with events occurring within the fiscal year and will be issued shortly after completion of the required annual audit.

HIGHLIGHTS

This report by the Securities Investor Protection Corporation covers the period from its inception on December 30, 1970 through March 1972. In the space of 15 months, through the efforts of its members in providing financial support and the efforts of the entire industry and the regulatory and self-regulatory organizations in searching for and attempting to remedy some of the causes of failures of broker-dealer firms, SIPC has been established and substantially funded as a new instrument for the protection of customers of broker-dealer firms.

In the words of the report[1] of the Senate Committee on Banking and Currency, SIPC ". . . . is intended to serve several purposes: to protect individual investors from financial hardship; to insulate the economy from the disruption which can follow the failure of major financial institutions; and to achieve a general upgrading of financial responsibility requirements of brokers and dealers to eliminate, to the maximum extent possible, the risks which lead to customer loss."

SIPC was created by the Securities Investor Protection Act of 1970, a federal statute which became effective December 30 of that year. It is a non-profit membership corporation. While it is not an agency or instrumentality of the United States Government, it has authority to borrow from the United States Treasury (see page 17) and its directors are appointed by "government" (see page 12).

The membership of SIPC is composed of all brokers or dealers registered under the Securities Exchange Act of 1934 and all members of a national securities exchange (other than those whose business consists exclusively of one or more of four categories (see page 11). At the end of 1971 there were approximately 4,000 SIPC members.

SIPC's primary purpose is to provide financial protection within the limits specified in the Act for customers of failing brokers or dealers who are members of SIPC. The protective provisions of the Act work in various ways for the benefit of customers of failing firms. For example, if a customer's fully paid securities are held by a broker-dealer firm which fails, these securities, if they are on hand and identifiable as the customer's fully paid for property, are to be returned to the customer without limit as to their dollar value.

If a customer has a net equity claim on the date a liquidation proceeding begins (see "filing date," p. 22), SIPC shall, if necessary, advance funds through the trustee conducting the liquidation in amounts necessary to cover the customer claims up to a maximum of $50,000 for each customer except that in the case of claims for cash, as distinct from securities, not more than $20,000 may be paid with funds advanced by SIPC. It should be noted that SIPC does not protect a customer from the decline in price resulting from an unwise purchase or an adverse movement in market prices. It is intended to protect the customer, in the event his broker-dealer firm fails, against the loss of securities or cash balances owing to him on the filing date, based on the situation as it exists on that date, up to the above mentioned statutory limits. Customers also may receive certain benefits under the Act as a result of SIPC's advances if necessary to complete certain types of open contractual commitments which had been entered into by the failing firm in the ordinary course of business in which customers had an interest.

The funds for purposes of protecting customers of SIPC members are provided by assessments based on a percentage of the gross revenues from the securities business of the SIPC member firms. These assessments are currently at the rate of ½ of 1 percent of each member's gross revenues from the securities business. SIPC receives no appropriation of government funds.

It is expected that the SIPC fund will be accumulated until it approximates $150 million exclusive

[1] Report No. 91–1218 at p. 4.

of lines of credit. The rate at which this can be accomplished, of course, depends upon many circumstances, including the health of the securities industry, the demands upon the fund for the liquidation of SIPC member firms, and the flow of assessments. As the fund increases in size, SIPC may vary assessment rates based on various considerations, including the type of business done and risk and experience factors. It is expected that it will be several years before varying rates can be established.

The SIPC fund at any time consists of cash, United States Government or agency securities and confirmed lines of credit. At the end of 1971 the fund amounted to approximately $91 million, exclusive of approximately $5.7 million received after January 1, 1972, representing assessments on 1971 fourth quarter revenues. $65 million of the fund consisted of a confirmed line of credit expiring October 1976 with a group of 29 banks. Under the terms of the agreement the amount of the available credit declines each year, and on April 1, 1972 the credit was reduced to $55 million.

If necessary for the protection of the Nation's securities markets, presumably only in the event of a crisis of extreme severity, SIPC may borrow from the Securities and Exchange Commission which, in turn, will issue notes to the United States Treasury in amounts up to $1 billion. In the event of such a borrowing, assessments on SIPC members would be applied to the repayment of the loan; except if the plan of repayment based on assessments would not repay the loan within a reasonable time, the Commission may impose a transaction fee of not exceeding 1/50 of 1 percent of the purchase price of equity securities in transactions in the exchange or over-the-counter markets.

The liquidation procedures of the Act represent a blending of many provisions of the Bankruptcy Act and the special provisions of the 1970 Act.

SIPC does not, itself, liquidate a failing firm. Upon receipt of a notice that a SIPC member firm is in financial difficulty or approaching financial difficulty, and upon the occurrence of certain other events specified in the Act, SIPC may apply to a federal court for the appointment of a trustee. If the court grants the application, the trustee will take possession of the premises and property of the debtor firm and carry out the applicable statutory objectives. In brief, these are to:

a. return specifically identifiable property to customers entitled thereto;
b. distribute to customers the fund of cash and securities held for the account of customers, employing SIPC funds advanced for this purpose to the trustee, if necessary;
c. operate the business of the debtor to complete open contractual commitments made in the ordinary course of business by the debtor firm where customers have an interest; and
d. liquidate the business of the debtor firm.

In connection with the foregoing, rights of subrogation may be enforced.

The Act specifically precludes the reorganization of a debtor firm. Accordingly, SIPC funds cannot be used to rehabilitate a firm, reorganize it, or operate it in the hope it may recover. The trustee has no choice but to liquidate and, once that process has started, it probably is irreversible.

During the year 1971 and through March 31, 1972 SIPC did not apply for the appointment of a trustee for a member of any exchange.

On March 31 there were thirty-nine firms in liquidation under the 1970 Act. All of these were NASD members.

Details concerning these firms appear on Appendix III of this report. The basic causes of failures of these firms are summarized on pages 27-28.

It is estimated by the trustees that $7.8 million of SIPC funds may be required to satisfy the claims of customers of these firms. It is not possible at this time to project estimated total costs to SIPC, including administrative costs, for these liquidations. As of the end of March SIPC had advanced $600,000 to trustees to complete open commitments and to pay customers' claims and administrative expenses.

Finally, SIPC is not a regulatory agency and does not represent the addition of a new regulatory layer in the structure of the securities industry. SIPC has only a small staff. It relies on the exchanges, the National Association of Securities Dealers, Inc. and the Commission for its information. It is subject to oversight by the Commission and, of course, the Congress. SIPC has an advisory role in relation to the agencies just mentioned in matters relating to financial responsibilities of SIPC member firms and their reporting and inspection procedures and, in the exercise of that role, has commented upon a number of rule proposals published by the Commission and the NASD during the past twelve months.

In October 1971 SIPC published a brochure entitled "An Explanation of the Securities Investor Protection Act of 1970" for distribution by SIPC member firms to their personnel and their customers. The questions and answers contained in that brochure are reproduced on the following pages.

PROTECTION TO CUSTOMERS

NOTE:

This brochure attempts only a brief summary of some of the provisions of a new and complex statute. It presents the views of the staff with respect to some of the questions asked most frequently concerning SIPC and the Act. It should be recognized that definitive answers to many questions which may arise concerning the application of the Act to various persons or situations will depend upon future interpretations, administrative decisions, and court actions.

No person may by any representation, interpretation or otherwise affect the extent of the coverage provided customers' accounts by the Act or the rules adopted thereunder by SIPC or the SEC.

The text of this brochure has been made available by SIPC as of October, 1971. Changes therein may be made only by SIPC.

1. What is the principal purpose of SIPC?

SIPC's major function is to provide funds for use, if necessary, to protect the customers of a SIPC member firm in the event the firm is liquidated under the provisions of the 1970 Act.

2. Who are members of SIPC?

Except for certain excluded categories of firms, all broker-dealers registered with the Securities and Exchange Commission and all members of national securities exchanges are automatically members of SIPC. Four kinds of firms are specifically excluded from automatic membership—namely, firms engaged exclusively in the distribution of mutual fund shares or variable annuities or the business of insurance or furnishing investment advice to registered investment companies or insurance company separate accounts. Excluded firms, however, may be able to apply for membership if rules for this purpose are adopted by SIPC.

A SIPC member firm is permitted to display a distinctive sign indicating its membership.

3. What is the basic protection afforded a customer by SIPC?

In the event SIPC determines that the liquidation of a member firm is necessary under the 1970 Act, SIPC will apply to an appropriate Federal district court for the appointment of a Trustee to supervise the liquidation.

The Trustee will undertake to return to customers out of available assets securities that can be "specifically identified" as theirs. In general, these will be fully paid securities in cash accounts and excess margin securities in margin accounts which have been set aside as the property of customers as required by any applicable rules of the stock exchanges, the National Association of Securities Dealers, Inc., or the SEC.

In addition, if necessary, SIPC will advance funds to the Trustee to enable him to pay the remaining claims of each customer up to $50,000, except that in the case of claims for cash, as distinct from securities, not more than $20,000 may be paid with funds advanced by SIPC.

The Act does not, however protect customers against losses arising from fluctuations in securities prices.

4. What kinds of property are protected under the Act?

Basically customers' cash and securities are covered. Other property, such as commodities accounts, is not protected by the Act.

5. What happens if a customer's claims exceed the maximum allowable limits of SIPC coverage?

The customer becomes a general creditor of the firm in liquidation as to the remainder of his claim. Any recovery would depend upon the remaining assets of the firm and the amount of the claims of customers and other creditors.

6. May a customer have more than one protected account with the same SIPC member firm?

Yes, under certain circumstances. A customer who holds accounts with the same SIPC member in separate capacities, for example one account as an individual and another as a Trustee for another person under certain trust arrangements, would be deemed a different customer in each capacity. A customer having several different accounts must be acting in a bona fide separate capacity with respect to each.

All such accounts, however, must meet the requirements of rules of SIPC in effect from time to

time in addition to conforming to the policies and procedures of the securities firm.

A person who in a single capacity has several different accounts with the same firm, e.g., cash and margin, would be considered a single customer for purposes of applying the $50,000/$20,000 limit.

A customer having or proposing to have more than a single account with the same firm is advised to discuss his plans with representatives of the firm and his own attorney.

7. May a customer have protected accounts with more than one SIPC member firm?

Yes. A customer may have accounts with several different members. The account with each member would be protected in the manner and within the limits described in answers 6 and 8.

8. What are some examples of the application of the limits of SIPC protection to claims of customers?

a. The customer has a claim for $40,000 in securities. The claim would be paid in full.
b. The customer has a claim for $40,000 in securities and $20,000 in cash. All but $10,000 would be covered.
c. The customer has a claim for $15,000 in securities and $25,000 in cash. The claim would be covered to the amount of $35,000.
d. The customer has a claim for $60,000 in securities and $40,000 in cash. The claim would be covered to the amount of $50,000.
e. The customer has claims for $40,000 in securities in his own account and for $35,000 in securities in a joint account with his wife, as to which each has full authority. The wife also has an account in her own name in which there is a claim for $40,000 in securities. All three claims would be fully covered.

9. How is a customer's claim for securities valued?

Claims are valued as of the date on which the judicial proceedings involving the SIPC member firm were commenced (filing date). The Act provides that, to the greatest extent practicable, claims for securities should be discharged by the delivery of such securities in kind.

As a result of fluctuations in values of securities between the filing date and the date of distribution by the Trustee, a customer may receive securities with a current market value which differs materially from their value on the filing date. Likewise, cash paid for securities claims determined as of the filing date may differ from the market value of equivalent securities as of the date of payment.

10. How will customers of a firm placed in liquidation learn of this development?

Promptly after his appointment, the Trustee will cause notice of the commencement of the liquidation proceedings to be published. At the same time, he will cause a copy of such notice to be mailed to all customers of the firm as their addresses appear from its books and records. Customers of the firm should respond promptly with any claims they may have against the firm.

11. To whom does a customer of a SIPC member firm in liquidation submit his claim?

Directly to the Trustee. SIPC is not authorized to settle disputes or to make payments of any kind directly to customers and can advance funds only to the Trustee. The Trustee will liquidate the business and make distributions to the customers subject to the approval of the court.

12. Who runs SIPC?

SIPC is managed by a seven-member Board of Directors. Five of the members are appointed by the President of the United States (subject to Senate confirmation), of whom two are representatives of the general public and three are selected from the securities industry. The public members serve as Chairman and Vice-Chairman. In addition, one member is designated by the Secretary of the Treasury and another by the Federal Reserve Board from among their respective officers and employees.

The Securities and Exchange Commission has certain oversight and regulatory functions with respect to SIPC, particularly in connection with matters relating to assessments and any borrowing from the U.S. Treasury.

13. Who is responsible for financing SIPC?

The securities industry, through assessments by SIPC on its member firms, is the principal source of SIPC funds. SIPC members are assessed a percentage of their gross revenues from the securities business. It is expected that over a period of time the fund will be built to a total of not less than $150,000,000 or such other amount as the Commission may determine in the public interest.

14. What is the assessment schedule for SIPC members?

Continuing assessments of not less than one-half of one percent of a firm's gross revenues from the securities business are to be levied until a speci-

fied sum is reached. Thereafter, SIPC is expected to adjust assessments for different members or classes of members based on experience, risks and other factors. Under certain circumstances, assessments may exceed one-half of one percent but not more than one percent of a firm's gross revenues from the securities business during any twelve-month period.

15. Does SIPC have access to emergency financing in the event industry assessments prove insufficient?

Yes. Under such circumstances, SIPC may borrow up to $1 billion from the U.S. Treasury through the SEC if the Commission determines that such a loan is necessary for the protection of customers and the maintenance of confidence in the United States securities markets. SIPC must present a plan which provides as reasonable an assurance of prompt repayment as may be feasible under the circumstances. If the Commission determines that assessments on the industry would not satisfactorily provide for the repayment of the loan, it may impose a transaction fee on purchasers of equity securities at a rate not exceeding 1/50 of 1% of the purchase price ($.20 per $1,000.00). This fee would not apply to transactions of less than $5,000.

16. Who is a "customer" for purposes of a "liquidation proceeding" under the 1970 Act?

"Customers" of a firm in liquidation are persons who, on the filing date, have claims on account of securities received, acquired or held by the firm from or for the account of such persons (1) for safekeeping, (2) with a view to sale, (3) to cover consummated sales, (4) pursuant to purchases, (5) as collateral security, or (6) by way of loans of securities to the firm. Persons who have deposited cash with a firm for the purpose of purchasing securities are also considered as "customers."

A person is not regarded as a "customer" under the Act to the extent that he has a claim for property which by contract, agreement, or understanding, or by operation of law, is part of the capital of the firm or is subordinated to the claims of creditors of the firm.

Commodities accounts are excluded from coverage under the Act.

17. Which customers, if any, of a firm in liquidation would not be eligible for protection from SIPC funds?

SIPC may not advance funds to the Trustee to pay any claims of any customer who is: (1) a general partner, officer, or director of the firm; (2) the beneficial owner of five percent or more of any class of equity security of the firm (other than certain nonconvertible preferred stocks) or (3) a limited partner with a participation of five percent or more in the net assets or net profits of the firm. See also the answer to question 18.

18. Does SIPC afford any protection to customers of other firms which have had transactions with a firm being liquidated?

Yes, it does, in two respects. First, if a firm has open securities transactions on the filing date, SIPC is authorized to advance funds to the Trustee to complete certain of these transactions. The purpose is to minimize the disruption caused by the failure of a broker-dealer by precluding the possible "domino effect" of such a failure on other securities firms. Second, SIPC will advance funds, up to the $50,000/$20,000 limits for each separate customer of a broker-dealer or bank, to the extent that the claims of such broker-dealer or bank arise from transactions for its customers.

19. Who examines the financial condition of firms that are members of SIPC?

SIPC does not have an inspection or examining authority or function. Thus, the stock exchanges and the National Association of Securities Dealers, Inc. are the "examining authorities" with respect to their members. The Securities and Exchange Commission is the "examining authority" with respect to members of SIPC which are not members of an exchange or the NASD.

20. What is the explanation for the $20,000 limitation on the coverage of claims for cash?

Three agencies of the Federal Government currently observe similar limitations with respect to accounts which they respectively insure. They are the Federal Deposit Insurance Corporation, established by Congress in 1933 to insure bank deposits and thereby assist in maintaining public confidence in the nation's banking system; the Federal Savings and Loan Insurance Corporation, established by Congress for much the same purpose in 1934; and more recently, the National Credit Union Administration's share insurance program, authorized in October, 1970.

INTRODUCTION

The Corporation (SIPC) was created by the Securities Investor Protection Act of 1970, a federal statute which became effective December 30, 1970. Its principal purpose is to provide certain financial protections to the customers of failing brokers or dealers. The nature of these protections will be developed and explained in this report. The Corporation's role and method of operation can best be understood against certain background facts and events which shaped the ultimate form of the legislation and the interrelation between the Corporation and the various affected agencies of the Federal Government and the self-regulatory organizations[2] in the securities industry. In its original form, the proposed statute would have created an organization performing a role in relation to the securities industry somewhat similar to those which were established to insure depositors in banks, savings and loan associations and credit unions.[3]

In the early months of 1970, at a time when many firms in the securities industry were experiencing severe operational and financial problems and at a time when several different versions of a proposed statute for the protection of customers were pending in the House and Senate, a broad-based securities industry committee was formed for the purpose of developing an industry-wide customer protection plan. A letter dated April 14, 1970, creating an industry task force, was submitted to the Chairman of the Securities and Exchange Commission and to Congressional leaders. A copy of this letter appears as Appendix I of this report.

The proposed five point program unanimously endorsed by the industry committee included the following:

First, to expand the protection available to *all* customers [4] for their funds and securities held by broker-dealers.

Second, to develop such a program consistent with the established public policy of self-regulation in the securities industry.

Third, to develop the program to reflect the particular needs and circumstances of each industry organization.

Fourth, to provide an equitable formula of financing such a program—equitable in terms of both the size and nature of the risk involved.

Fifth, to present to the Securities and Exchange Commission and to Congress a unified and constructive approach by the entire securities industry.

The industry contemplated, among other things, that there should be no change in or addition to the statutory provisions (Sections 15(c)(3) and 19(b) of the 1934 Act) giving the Securities and Exchange Commission broad regulatory authority to provide safeguards with respect to the financial responsibility for exchange members and other broker-dealers, i.e.—net capital and other requirements; that the industry would develop within the fabric of self-regulation a plan to protect public customers of broker-dealers up to certain defined limits; and that it would be possible to maintain public confidence in the Nation's securities markets by assuring payments to public customers "without at the same time creating a vast new governmental agency in this highly specialized area." [5]

Thereafter representatives of the Federal Reserve Board, Office of Management and Budget, the Department of the Treasury, the securities industry and the Securities and Exchange Commission conferred with respect to draft bills proposed by the industry group and by the Commission's staff, respectively, and finally a joint proposal. The general pattern proposed by the industry task force was retained although the end product which finally emerged from the House and Senate conferences differed in many respects from the earlier versions. Significantly, the powers of the Securities and Exchange Commission with respect to financial responsibility of broker-dealer firms were broadened by

[2] American Stock Exchange, Inc., Boston Stock Exchange, Cincinnati Stock Exchange, Detroit Stock Exchange, Midwest Stock Exchange, National Stock Exchange, New York Stock Exchange, Inc., Pacific Coast Stock Exchange, Philadelphia-Baltimore-Washington Stock Exchange, Salt Lake Stock Exchange, Spokane Stock Exchange, and the National Association of Securities Dealers, Inc.

[3] Federal Deposit Insurance Corporation (FDIC), Federal Savings and Loan Insurance Corporation (FSLIC) and National Credit Union Administration (NCUA).

[4] At that time, certain trust funds had been created by the New York Stock Exchange, Inc. and several other exchanges for the protection of customers of member firms experiencing financial difficulty but there was no fund or machinery in existence for the protection of customers on an industry-wide basis.

[5] House Report No. 91–67, Testimony of Ralph D. DeNunzio, Vice Chairman, New York Stock Exchange, Inc., p. 169.

Section 7(d) of the new Act, while the Industry was afforded an opportunity to continue to rely upon the existing self-regulatory structure. The statute did not create a new regulatory organization nor an additional layering of regulatory authority.

SIPC is a nonprofit membership corporation whose primary function is to provide financial protection for the customers of failing broker-dealer firms. In order to perform this role effectively, SIPC has established and is accumulating a fund represented by assessments paid by its members based on their revenues from the securities business, supplemented when needed by confirmed lines of credit which it is hoped will at all times be sufficient for SIPC to discharge its responsibilities. Although SIPC is not an agency or establishment of the United States Government, the ties between the two are close and continuing. Two directors are appointed by government agencies and five by the President with the advice and consent of the Senate. The activities of SIPC are subject to SEC and Congressional oversight. In the event the SIPC fund should be insufficient for its purposes, SIPC is authorized to borrow not in excess of $1 billion through the SEC from the United States Treasury and arrange for a repayment plan subject to SEC approval. Finally, the 1970 Act provides that the provisions of the Securities Exchange Act of 1934 (unless otherwise provided) apply as if the 1970 Act was an amendment to the 1934 Act.

Advances are made by SIPC from the fund to trustees appointed by a federal court to liquidate failing broker-dealer firms. The trustee establishes the claims of customers for securities or cash and pays customers' claims with funds advanced by SIPC, if necessary, within the limits prescribed by the Act.

The liquidation is carried out under the special procedures of the 1970 Act which, while they draw upon certain aspects of the Bankruptcy Act, are quite different in their operation from the latter Act. These procedures give effect to the circumstances of the securities business and the intent of the Congress to make evident to investors the governmental concern with and commitment to the public interest and public confidence in our securities markets.

Since, in many respects, the provisions of Sections 5 and 6 governing the initiation and conduct of liquidation procedures are the heart of the Act, a brief historical note may be in order. Prior to December 30, 1970, Section 60(e) of the Bankruptcy Act governed the liquidation of a bankrupt stockbroker. The Commission's Special Study of the Securities Markets, published in 1963, described certain defects in Section 60(e) which the Study Group believed should be remedied at an appropriate time. These included proposals that, under some circumstances, securities held in bulk segregation systems be considered to be specifically identifiable, that the term "stockbroker" include dealers as well as brokers, and that the term "customers" include the persons depositing cash for the purchase of securities.

A memorandum submitted by the Securities and Exchange Commission for the record in the Senate Hearings explains some of the special liquidation procedures of the 1970 Act:

1. Liquidation of a broker-dealer firm pursuant to the bill would not be an ordinary bankruptcy proceeding initiated by creditors, but rather would be a special proceeding initiated by the Securities Investor Protection Corporation, provided for in the bill, primarily for the protection of all customers of the broker-dealer in question.
2. To the extent necessary, the Corporation will advance funds to the trustee for the benefit of customers, in amounts up to the limit of $50,000 for each customer which is provided for in the bill. Such arrangements have no parallel in bankruptcy proceedings.
3. The procedure is designed to pay customer claims as rapidly as possible, making use of funds advanced by the Corporation and other special procedures provided in the bill for this purpose, thus avoiding the lengthy delays which may occur in ordinary bankruptcy proceedings.
4. The trustee will normally complete open contractual commitments of the debtor where customer's interests are involved. This would not necessarily be done in ordinary bankruptcy proceedings.
5. Subparagraph (m) (7) [6] together with subparagraph (m) (11) [6] of the bill contemplate that the trustee, to the extent practicable, will satisfy the claims of customers who are entitled to securities by delivering such securities to them. In ordinary bankruptcy proceedings the trustee would normally sell all securities and distribute cash to customers.
6. Subparagraph (m) (13) [6] excludes from the class of customers who may benefit from ad-

[6] These refer to sections of a draft bill which became part of Section 6 of the statute as enacted.

vances by the Corporation, customers who are partners, officers, directors or substantial stockholders of a broker-dealer in liquidation.

This memorandum appears as Appendix II of this report.

The extent to which SIPC must rely upon existing regulatory and self-regulatory organizations and procedures is demonstrated by a brief review of the manner in which the system has operated in a typical case.

Under existing regulations of the Commission, the exchanges and the NASD, financial and other reports are submitted by broker-dealer firms to the self-regulatory organization to which they belong, i.e., the National Association of Securities Dealers, Inc. or one or more of the national securities exchanges, or the Securities and Exchange Commission. The firms, likewise, are subject to inspections by the examiners of one or more of these organizations. When it appears to the Commission or any self-regulatory organization that a broker or dealer is in or is approaching financial difficulty, SIPC is to be notified immediately.

If SIPC determines that any member has failed or is in danger of failing to meet its obligations to customers and that there exists one or more of the conditions specified below, SIPC, upon notice to the member, may apply to an appropriate federal district court for a decree adjudicating that the customers of the member are in need of the protection provided by the Act. The court shall grant the application and issue a decree if it finds that the member—

a. is insolvent within the meaning of Section 1(19) [7] of the Bankruptcy Act, or is unable to meet its obligations as they mature, or

b. has committed an act of bankruptcy within the meaning of Section 3 of the Bankruptcy Act,[8] or

c. is the subject of a proceeding pending in any court or before any agency of the United States or any state in which a receiver, trustee, or liquidator for such member has been appointed, or

d. is not in compliance with applicable requirements under the 1934 Act or rules or regulations of the Commission or any self-regulatory organization with respect to financial responsibility or hypothecation of customers' securities, or

e. is unable to make such computations as may be necessary to establish compliance with such financial responsibility or hypothecation rules or regulations.

Members of SIPC file their financial statements and reports with the Commission or one or more of the self-regulatory agencies, and the firms are inspected or examined by the personnel of these agencies. SIPC does not, and it was intended that it should not, become involved in activities which duplicate or become pyramided upon the existing reporting and inspection machinery. Accordingly, SIPC considers information supplied by the staff of the Commission or one of the self-regulatory agencies, or both, as well as pertinent information from any other source bearing on the question of whether a firm is in or is approaching financial difficulty. SIPC's principal concern in most instances is with the question of the probable ability of a firm, even if in financial difficulty, to meet its obligations to public customers. At all times between receipts of a notice that a firm is in or approaching financial difficulty, until the firm recovers or is otherwise dealt with, the principal judgment to be made by SIPC has to do with the threat of danger to customers and their need for the protections of the Act. In every case one or more of the five conditions above specified must exist as a prerequisite to filing an application for the appointment of a trustee.

In most of the cases in which SIPC has filed applications, its action has followed or been concurrent with the Commission's application for an injunction and the appointment of a receiver. Typically, these

[7] "(19) A person shall be deemed insolvent within the provisions of this Act whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, removed, or permitted to be concealed or removed, with intent to defraud, hinder, or delay his creditors, shall not at a fair valuation be sufficient in amount to pay his debts;"

[8] "§ 3. Acts of Bankruptcy. a. Acts of bankruptcy by a person shall consist of his having (1) concealed, removed, or permitted to be concealed or removed any part of his property, with intent to hinder, delay, or defraud his creditors or any of them, or made or suffered a transfer of any of his property, fraudulent under the provisions of section 67 or 70 of this Act; or (2) made or suffered a preferential transfer as defined in subdivision a of section 60 of this Act; or (3) suffered or permitted, while insolvent, any creditor to obtain a lien upon any of his property through legal proceedings or distraint and not having vacated or discharged such lien within thirty days from the date thereof or at least five days before the date set for any sale or other disposition of such property; or (4) made a general assignment for the benefit of his creditors; or (5) while insolvent or unable to pay his debts as they mature, procured, permitted, or suffered voluntarily or involuntarily the appointment of a receiver or trustee to take charge of his property; or (6) admitted in writing his inability to pay his debts and his willingness to be adjudged a bankrupt."

actions by the Commission have been based on alleged violations of the net capital rules or the absence of or such inadequacy of books and records as to make impossible a determination that the firm is in compliance with the financial responsibility rules. Increasingly in recent months, SIPC has appeared in court with the Commission and has requested the appointment of a trustee concurrently with the Commission's request for an injunction when the action of the Commission would establish one or more of the five statutory conditions mentioned above. There have been two instances[9] in which SIPC applied for the appointment of a trustee on the basis of the information supplied by the Commission and the self-regulatory organization where no court action was sought by the Commission. In other cases SIPC has delayed filing its application for a period after the issuance of an injunction or restraining order and the appointment of a receiver on application by the Commission. Thus SIPC has not requested the appointment of a trustee until there appeared to be no reasonable doubt that customers would need the protection of the Act even though the Commission was prepared to go forward at an earlier date with its own action pursuant to its own enforcement policies. This situation could arise in at least four ways.

1. A violation of the net capital rule might not portend as serious a situation from the point of view of customer protection as originally feared. This rule basically is a test of liquidity as of a particular time. It does not necessarily follow that a temporary or possibly inadvertent failure to comply with a required condition of liquidity at the particular time at which a computation is made makes losses to customers inevitable.
2. On some occasions additional capital is invested in the firm or it is determined that adjustments can be made correcting the capital deficiency.
3. In some cases it develops that the firm has no public customers.
4. In some situations a firm will propose as an alternative to a SIPC liquidation that it will self-liquidate or will liquidate under the supervision of one of the self-regulatory organizations without loss to customers.

[9] Buttonwood Securities, Inc., San Diego, California, and Charisma Securities Corporation, New York, New York.

If in fact there is no real danger to customers SIPC should not seek an adjudication and the appointment of a trustee. This is so because SIPC can only liquidate; it may not reorganize or furnish funds for the rehabilitation of a firm. Once a liquidation proceeding has begun it is unlikely that the process can be stopped or reversed without the rights of others having been prejudiced. Accordingly, it is important that SIPC not enter a case unless it is clear that protection of customers requires it.

The system of relying upon a flow of information from the field offices of the National Association of Securities Dealers, Inc., the Commission and the examiners of the exchanges, through the central offices of these organizations to SIPC, at times has produced delays. These arise partly because of the number of people involved, the geographic dispersion of the industry, problems of communication caused by the need to coordinate the work of two or more agencies, and the frequent inability to secure up-to-date and reliable information because of the inadequacies of records or the ignorance or uncooperative attitudes of principals. Delays of this character are being reduced as procedures are developed and the many persons involved become familiar with a new and complex Act.

A principal problem in many cases arises from the fact that the broker-dealer has failed to establish and maintain on a current basis adequate and reliable records. In some instances it has been necessary to attempt to reconstruct records or rely upon the investigatory efforts of a receiver in order to determine the situation as to customers. The various officers and personnel of the Commission and the self-regulatory organizations consistently have demonstrated a desire to furnish all the help and assistance their resources permit and the efforts of all concerned are to be commended.

Certain other characteristics of the regulatory structure should be mentioned since they bear upon the judgments which must be made in developing an appropriate form of organization and effective and uniform procedures.

SIPC has no control over who or what firms enter the securities business and thus become "members" of SIPC or continue as such.

As indicated above, SIPC has no regulatory authority of the character conferred upon the National Association of Securities Dealers, Inc., the Securities and Exchange Commission and the securities exchanges by the federal securities Acts. As will be explained, however, SIPC has an advisory role to per-

form in this area and expects to articulate positions on many aspects of the regulatory process as experience is gained with the liquidation problems and the causes of failures. SIPC should be able to make its contributions to fair and competitive markets and the improvement of the regulatory and self-regulatory process even if that is accomplished by persuasion and indirection.

The statute confers no subpoena power on SIPC and does not provide specific authority to conduct investigations.[10] It is evident from the short experience to date, however, that the review of claims, the search for assets, the ascertainment of preferences, the revelation of misconduct, and the determination of whether to sue the principals of firms or others, will require the development and exercise of at least informal investigative procedures to supplement the more formal activities and procedures of the Commission and the self-regulatory authorities and the procedures of the trustees. In other words, although SIPC must carry out its statutory obligations to pay customers claims promptly, SIPC also has an obligation to take all reasonable steps to prevent the disbursal of its funds in payment of false, fraudulent or erroneous claims, or those barred by the Act (all of which have been encountered to date).

It is too early to venture judgments on many aspects of the statutory procedures for protecting the customers of failing firms introduced in the SIPC Act. For example, SIPC does not yet have a basis for reliable estimates of the incidence of failures, the probable demands on the SIPC fund to satisfy customer claims, the costs of estate administration and liquidation or the timing and methods by which assessment rates may be varied to accommodate risk and expense factors. These and many other matters will come more clearly into focus as SIPC gains experience and as precedents are established to guide future action.

SIPC was created at the end of 1970. It began its corporate life without staff or funds of its own. During the period from January through May 1971 SIPC was located in offices made available by the Securities and Exchange Commission at its headquarters office in Washington. The development of appropriate bylaws and the design, drafting and testing of the assessment forms which were mailed to SIPC members in mid-March could not have been accomplished within the periods required by the statute without the help of many people not directly connected with SIPC.

The staffs of the Treasury Department, the Federal Reserve Board and the Commission worked for many weeks on SIPC's bylaws and assessment forms. The industry task force and their counsel gave SIPC every assistance. The officials and staffs of the exchanges, particularly the American Stock Exchange, Inc., the New York Stock Exchange, Inc., and the National Association of Securities Dealers, Inc. also were generous in their efforts to assist SIPC's start-up. The Commission gave SIPC professional, clerical and institutional assistance during the first few months, and has continued thereafter to make available to SIPC's staff the benefit of its staff, experience and facilities when needed. The Commission's Office of Policy Research has been particularly helpful in providing statistical, financial and economic material and research assistance.

SIPC wishes to acknowledge and express its appreciation for the efforts and help of all of these, not only through the "start-up" months, but also for the continuing cooperation, assistance and support without which SIPC could not function. Finally, SIPC wishes to acknowledge the work and cooperative efforts of the trustees and their counsel in a new and difficult field.

[10] The trustee, of course, has available the processes of the court under the Bankruptcy Act.

THE CORPORATION

SIPC is a nonprofit membership corporation subject to, and with the powers confered upon a nonprofit corporation by, the District of Columbia Nonprofit Corporation Act, except where inconsistent with some provision of the 1970 Act.[11] The Corporation is to exist until dissolved by Act of Congress and, except for taxation on real property and on certain tangible personal property, is exempt from any taxation by federal or local taxing authorities.

Members

The membership of SIPC is composed of all persons registered as brokers or dealers under Section 15(b) of the Securities Exchange Act of 1934 and all persons who are members of a national securities exchange other than persons in certain excluded categories. These categories [11a] include persons whose broker-dealer business consists exclusively of:

a. The distribution of shares of registered open-end investment companies or unit investment trusts,

b. The sale of variable annuities,

c. the business of insurance, or

d. the business of rendering investment advisory services to one or more registered investment companies or insurance company separate accounts.

As of December 31, 1971, there were approximately 4,000 members of SIPC with their affiliation, for purposes of collection of SIPC assessments, indicated in the following table.[12]

Agent for Collection of SIPC Assessments	Number of SIPC Members
National Association of Securities Dealers, Inc.	2,496
New York Stock Exchange, Inc.	760
SECO (Securities and Exchange Commission Only) [13]	298
American Stock Exchange, Inc.	180
National Stock Exchange	100
Philadelphia-Baltimore-Washington Stock Exchange	83
Midwest Stock Exchange	41
Boston Stock Exchange	14
Spokane Stock Exchange	11
Salt Lake Stock Exchange	6
Detroit Stock Exchange	3
Pacific Coast Stock Exchange	2
	3,994

During the Congressional hearings and debates leading up to the passage of the 1970 Act, considerable attention was given to the desirability of including in the statute standards or requirements which securities broker-dealers would have to meet in order to become members of SIPC, and indeed, the Senate bill was amended to include standards. This amendment was discussed in the conference committee but was not included in the final bill. The bill, as passed by the Congress and signed by the President, contains no eligibility requirements or standards for membership in SIPC.

The following statement by Hamer H. Budge, then Chairman of the Commission, during the hearings before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce is indicative of the Congressional rationale for not imposing any standards or conditions for membership in SIPC:

[11] Section 3(a).

[11a] Section 3(a)(2).

[12] Members shown in one category in the table may, in fact, also be members of one or more of the other organizations.

[13] These firms are not members of the National Association of Securities Dealers, Inc. or any exchange.

"It is my understanding that at the time of the establishment of the Federal Deposit Insurance Corporation that some banks and savings and loans were not permitted to become members because of their financial condition at that time. It is our feeling in this bill that it is necessary to insure the entire community, and we would not feel that it was in the public interest to remove the firms which might be in the same category as those banks and savings and loan that were not permitted to become members at the time."

"The purpose of the legislation is to protect the customers of the brokerage houses, and if we take out the funds where the greatest exposure is we are removing the protection of all the customers of those firms. It isn't as easy to determine the financial condition of a brokerage house as it is a bank and savings and loan. The financial condition can change radically very quickly, much more so than a bank or savings and loan." [14]

The legislative history of the 1970 Act is replete with statements of legislators and witnesses as to the desirability of upgrading the financial responsibility of broker-dealers. The Committee of Conference thought that such upgrading could best be accomplished by granting the Commission increased authority. Section 7(d) of the 1970 Act, which amends Section 15(c)(3) of the 1934 Act, was thought to provide the Commission with authority to achieve this objective.

Section 3(f)(1) of the Act provides that any person who is a broker, dealer, or member, of a national securities exchange and who is excluded from membership in SIPC under Section 3(a)(2) may become a member of SIPC under such conditions and upon such terms as SIPC shall require. SIPC has received only a minimal number of requests for voluntary membership. All such persons have been advised that the terms and conditions for voluntary membership have not yet been prescribed and that they will be notified when appropriate requirements are adopted. Section 3(f)(2) of the Act provides that any person who becomes a member of SIPC under Section 3(f)(1) shall be subject to such assessments as SIPC determines to be equitable.

Broker-dealer firms which are excluded from membership under the Act are required to file, annually, a notification of that fact with SIPC, indicating the basis for exclusion. If the facts with respect to the character of business change, a written notice to this effect is required by SIPC.

Directors

Section 3(c) of the Act provides for a board of seven directors to determine the policies and govern the operations of SIPC. One director is appointed by the Secretary of the Treasury and one by the Federal Reserve Board. Five directors are appointed by the President of the United States, by and with the advice and consent of the Senate, as follows:

a. three from persons associated with and representative of different aspects of the securities industry, not all of whom shall be from the same geographical area,
b. two from the general public who are not associated with any broker or dealer or a national securities exchange or other securities industry group and have not had any such association during the two years preceding appointment.

The Act further provides that the President shall designate the Chairman and Vice Chairman from those persons listed in (b) above. Directors are to be appointed for a term of three years except that, of the directors first appointed:

a. Two shall hold office for a term expiring December 31, 1971;
b. Two shall hold office for a term expiring December 31, 1972;
c. Three shall hold office for a term expiring December 31, 1973;

as designated by the President.

Persons who have served as directors and those now in office are identified on page (iv). For compensation of directors see page 33.

Corporate Powers

Section 3(b) of the 1970 Act gives SIPC the following Powers in addition to the powers granted to SIPC elsewhere in the Act:

1. to sue and be sued, complain and defend, in its corporate name and through its own counsel, in any court, State, or Federal;
2. to adopt, alter, and use a corporate seal, which shall be judicially noticed;
3. subject to the provisions of the Act, to adopt, amend, and repeal, by its Board of Directors, bylaws and rules relating to the conduct of its business and the exercise of all other rights and powers granted to it by the Act;
4. to conduct its business (including the carrying on of operations and the maintenance of offices) and to exercise all other rights and

[14] House Report No. 91–67, pp. 367–68.

powers granted to it by the Act in any State or other jurisdiction without regard to any qualification, licensing, or other statute in such State or other jurisdiction;

5. to lease, purchase, accept gifts or donations of or otherwise acquire, to own, hold, improve, use, or otherwise deal in or with, and to sell, convey, mortgage, pledge, lease, exchange or otherwise dispose of, any property, real, personal or mixed, or any interest therein, wherever situated;
6. subject to the provisions of subsection (c) of the Act, to elect or appoint such officers, attorneys, employees, and agents as may be required, to determine their qualifications, to define their duties, to fix their salaries, require bonds for them and fix the penalty thereof;
7. to enter into contracts, to execute instruments, to incur liabilities, and to do any and all other acts and things as may be necessary or incidental to the conduct of its business and the exercise of all other rights and powers granted to SIPC by the Act; and
8. by bylaw, to establish its fiscal year.

These general corporate powers are in addition to the specific grants of authority or statutory directives relative to the funding and liquidation functions and those relative to the self-regulatory organizations and SIPC's membership.

SIPC is directed to establish a fund, collect assessments, and borrow monies, if necessary (Sections 4 and 8); to apply for the appointment of trustees and to assist in the liquidation of debtor firms (Sections 5 and 6); to consult and cooperate with the self-regulatory organizations with respect to inspections and reports concerning SIPC member firms (Section 9); and to prescribe the means by which members of SIPC may advertise the protection afforded customers and their accounts under the Act (Section 11).

The statute authorizes oversight of many of SIPC's activities by the Securities and Exchange Commission and, in some situations, the role of the Commission is controlling. To the extent that SIPC elects or is required to proceed by rule or bylaw, these must be filed with the Commission. Each bylaw or rule takes effect upon the 30th day after filing a copy with the Commission, or such earlier date as the Commission may determine, unless the Commission disapproves the same as being contrary to the public interest or contrary to the 1970 Act. Thereafter any change in, or supplement, or repeal of an existing bylaw likewise must be filed with the Commission. Further, the Commission may, by its rules and regulations, require the adoption, amendment, alteration of, supplement to, or rescission of any bylaw or rule by SIPC, whenever adopted.

In the event of the refusal of SIPC to commit its funds or otherwise to act for the protection of customers of any member of SIPC, the Commission may apply to the district court of the United States in which the principal office of SIPC is located for an order requiring SIPC to discharge its obligations under the Act and for such other relief as the court may deem appropriate to carry out the purposes of the Act.

The Commission may make examinations and inspections of SIPC and require SIPC to furnish it with reports and records. The Act requires, in addition, that promptly after the close of each fiscal year SIPC shall submit a written report relative to the conduct of its business and the exercise of its functions during the fiscal year. These reports are required to include financial statements examined by independent public accountants selected by SIPC with the approval of the Commission. The financial statements must be accompanied by the report thereon of the accountant. The Commission, in turn, is required to transmit such report to the President and the Congress, with such comment thereon as the Commission deems appropriate.

SIPC's bylaws and rules are available for public inspection.

Although it was recognized that under Section 3 of the Act the procedures for adopting bylaws and rules would be identical, SIPC determined as a matter of policy that bylaws would be employed to set forth standards for the conduct of its internal operations, and that rules would be used to set forth matters of more general interest, including the exercise of rights and powers granted by the Act.

Section 11(a) of the Act provides that "nothing herein shall act to deny documents or information to the Congress of the United States or the committees of either House having jurisdiction over financial institutions, securities regulation, or related matters under the rules of each body. Nor shall the Commission be denied any document or information which the Commission, in its judgment, needs."

Interim reports of SIPC's activities were distributed during May 1971, and at the end of June 1971.

THE SIPC FUND

As provided in the Act,[15] the SIPC fund at any time consists of the aggregate of cash on hand or on deposit, amounts invested in United States Government or agency securities, and confirmed lines of credit. At the end of 1971 the fund amounted to approximately $91 million, not including assessments for the fourth quarter of 1971 which were received after the close of the year in the amount of $5,700,000. Of the $91 million, $65 million consisted of a confirmed line of credit with a group of banks, the remainder being cash and short-term United States Government securities.

There are seven sources of monies for the SIPC fund. First, the principal support will come from the industry in the form of assessments based on the revenues of SIPC members. Second, the statute provides that there may be contributed and transferred to SIPC any funds held by any trust established by a self-regulatory organization prior to January 1, 1970. SIPC's first funds were received on February 23, 1971 when a check for $3 million, from the Exchange's trust fund, was presented to SIPC by the President and Chairman of the Board of Governors of the American Stock Exchange, Inc. Third, SIPC may borrow from banks or other financial institutions pursuant to lines of credit or other written agreements which provide that monies borrowed are to be repayable not less than one year from the time of borrowing. Fourth, SIPC receives income on its investments, a potentially material item. Fifth, SIPC is entitled to be repaid advances made to trustees for the completion of open contractual commitments and to recoup administrative expenses from the single and separate fund in priority to claims of customers against such fund. Sixth, SIPC may be able to recover funds from the single and separate fund, the general estate, the principals of failing firms or from others on claims of customers to which SIPC becomes subrogated as provided in the Act. Finally, in the event of the inadequacy of the SIPC fund, which presumably would result only from a crisis of great severity and magnitude, SIPC may borrow from the Commission which, in turn, may borrow from the Secretary of the Treasury amounts up to $1 billion.

[15] Section 4(a).

Assessments

The Act provides authority for SIPC by bylaw or rule, to impose a General Assessment upon each of its members at a rate of not less than ½ of 1 per centum of the gross revenues from the securities business [16] of such member. This general authority is subject to several qualifications.

A general assessment may be made at a rate in excess of ½ of 1 per centum during any twelve month period if SIPC determines, in accordance with a bylaw or rule, that such rate will not have a material adverse effect on the financial condition of its members or their customers. No such assessment may be made, however, upon a member which would require payments in excess of 1 per centum of the member's gross revenues from the securities business for the period.

The Act contemplates that this ½ of 1 per centum rate shall be imposed (a) until the balance of the fund aggregates not less than $150 million or such other amount as the Commission may determine in the public interest, (b) during any period when there is any outstanding borrowing, and (c) whenever the balance of the fund (exclusive of confirmed lines of credit) is below $100 million or such other amount as the Commission may determine.

The rate may not be less than ¼ of 1 per centum during any period during which (a) the fund (exclusive of confirmed lines of credit) aggregates less than $150 million or such other amount as the Commission may determine, or (b) SIPC is required under Section 4(d)(2)(B) to phase out of the fund all confirmed lines of credit.

On February 23, 1971 the Board approved SIPC's assessment forms [17] and collection procedures. Extensive assistance was received from the staffs of

[16] Gross revenues from the securities business are defined in Section 4(i) of the Act and the instructions to the assessment forms.

[17] These assessment forms were based on the Commission's Form X–17A–10 which prescribes the income and expenses and related financial and other information which must be filed by every member of a national securities exchange and every broker or dealer registered under the 1934 Act not later than 120 days after the close of each calendar year.

Commission and industry organizations as well as SIPC's independent accountants in developing these end products since SIPC had no staff during this period. In March 1971 the forms [18] were mailed to SIPC members.

The Board decided that the 1971 assessments might be paid quarterly on the basis of estimates of gross revenues for each quarter, on the basis of actual gross revenues for each quarter, or on the basis of quarterly assessments not smaller than the initial [19] assessment. It was further decided that during the first quarter of 1972 SIPC member firms should file a reconciliation of revenues estimated and revenues actually received and pay any additional assessments due on 1971 income not later than the date for paying the assessment for the first quarter of 1972. Any overpayments may be credited against future assessments payable. The Board decided also to continue to permit payments to be made on the basis of estimates of gross revenues with a similar year-end reconciliation. The determination that the general assessments for 1971 could be paid on a quarterly basis made it possible for SIPC to meet the required fund balance within 120 days of enactment of the Act.[20]

The agreement for the existing line of credit was entered into on April 14, 1971 and provided for a maximum availability of $65 million. The agreement provided that the balance of the available unused credit would be reduced by $10 million on April 1, 1972 and by an equal amount on April 1 of the next succeeding four years, with a final balance of $15 million expiring on October 13, 1976, assuming that there is no borrowing under the agreement. Accordingly, the SIPC fund has been reduced by $10 million since the end of the fiscal year.

The Act provides that after December 31, 1973 confirmed lines of credit shall not constitute more than $50 million of the fund and that when the balance of the fund aggregates $150 million (or such other amount as the Commission may determine) SIPC shall phase out of the fund all confirmed lines of credit.

In connection with the Credit Agreement, SIPC agreed to maintain with the participating banks compensating demand deposits equal to ten percent of the banks' respective commitments. The Credit Agreement requires that SIPC pay, quarterly, a commitment fee of ½ of 1 percent per annum based on the unused commitment.[21] On any borrowing under the Credit Agreement SIPC is required, among other things, to pay, quarterly, interest at a rate which is equal to 1 percent per annum greater than the prime rate charged by the agent [22] for the participating banks on ninety day loans to substantial and responsible borrowers. An additional 1 percent is payable on all principal amounts not paid when due. Coincident with any borrowing under the Credit Agreement, SIPC is required to pledge assessments received or receivable during the period that any portion of the borrowing is unpaid except that such pledge is limited, during the period that any borrowing by SIPC from the Commission under Section 4(g) of the Act is outstanding to payments of ¼ of 1 percent of members' SIPC gross revenues for any twelve month period. There have been no borrowings by SIPC under the credit agreement or otherwise.

The amount and composition of the fund as of 120 days after enactment of the statute were as follows:

Cash and U. S. Government securities provided by:	
Initial Assessment [23]	$ 4,450,000
First quarter installments and optional estimated prepayments of 1971 General Assessments (1)	5,164,000
Transfer from an existing trust fund	3,000,000
	12,614,000
Confirmed lines of credit	65,000,000
	$77,614,000

(1) Net of approximately $76,000 expended for operations.

[18] The forms employed for the reports of assessments and other information by SIPC members firms are listed in Appendix V.

[19] The Act provided for the payment by each member of SIPC, or or before the 120th day following the date of the Act, of an assessment equal to ⅛ of 1 per centum of the gross revenues from the securities business during the calendar year 1969. No assessments were payable on revenues for 1970. This initial assessment produced approximately $5.7 million.

[20] See page 16.

[21] SIPC accepted the provision for maintaining compensating balances and a commitment fee of ½ of 1 per centum per annum rather than pay the 1 percent per annum fee which otherwise would have been required by the banks. This decision reflected a recognition that SIPC's investments in the early years should be maintained in relatively short term maturities. At rates of return of less than 5 percent on these investments it would be to SIPC's advantage to pay the lower fee. It should be noted that the compensating balances are available for SIPC's use at all times if needed. With the expiration of $10 million of the line of credit on April 1, 1972, the compensating deposits were reduced by $1 million, which amount thereupon was invested in United States Government securities.

[22] The Chase Manhattan National Bank National Association acts as agent for the participating banks under the Credit Agreement.

[23] It is stated in footnote 3 of the notes to the financial statement that receipts from initial assessments aggregated $5.7 million. The data above reflect the status of the fund as of 120 days after enactment of the Act. The difference of approximately $1.2 million represents payments of initial assessments received after the date they were due.

On December 31, 1971 the SIPC Fund totaled approximately $91 million [2] and was composed of the following categories:

Cash (includes compensating balances)	$ 6,653,000
U.S. Government obligations at cost plus accrued interest	19,852,000
Confirmed lines of credit	65,000,000
	$91,505,000

(2) Without giving effect to assessments for the 4th quarter of 1971 received after the end of the year in the amount of $5.7 million.

With the assistance of the Commission's staff and after review of a proposal to designate the various self-regulatory organizations as examining authorities solely for the purpose of acting as SIPC's collection agents, such designation was made, by bylaw approved by the Board February 23, 1971.[24]

Designations for this purpose were as follows:

1. The New York Stock Exchange shall serve as examining authority for the purpose of acting as collecting agent for each of its members.
2. The American Stock Exchange shall serve as examining authority for the purpose of acting as a collecting agent for each of its members who is not also a member of the New York Stock Exchange.
3. The National Association of Securities Dealers, Inc. shall act as examining authority for the purpose of acting as collecting agent for each of its members who is not also a member of either the New York Stock Exchange or American Stock Exchange.
4. The registered national securities exchange (other than the New York Stock Exchange or the American Stock Exchange) of which a member of SIPC is a member shall serve as examining authority for the purpose of acting as a collecting agent for each of its members which is not also a member of the National Association of Securities Dealers, Inc.

SIPC members who are not members of any self-regulatory organization pay their assessments directly to a bank depository for the account of SIPC. The Board approved a resolution at that same time which indicated that until it had an opportunity to consider the staff capabilities, regulatory procedures employed and geographic factors, the Board would rely on existing practices under which self-regulatory organizations undertake to enforce applicable financial responsibility rules. SIPC's independent accounts were engaged to assist the collection agents in the establishment of accounting procedures for the handling, deposit and reporting to SIPC of assessment forms and payments.

Each SIPC member firm now pays a general assessment at a rate of ½ of 1 per centum per annum of its gross revenues from the securities business. Assessments will continue at not less than this rate until the balance of the fund aggregates not less than $150 million or such other amount as the Securities and Exchange Commission may determine.

A uniform rate of assessment, of course, results in some members of the industry bearing what they consider to be a disproportionate and discriminatory burden of the costs of SIPC. Many SIPC member firms, including for example some of the trading houses and the exchange specialists, do no business directly with public customers, yet assessments are imposed upon them by the Act at the same rate paid by the firms doing a substantial retail business.

Inquiries from members at the time of the collection of the assessment for the first quarter of 1971 indicated some lack of understanding that the rate of ½ of 1 percent is prescribed by the Act and that the decision by Congress to impose assessments at a minimum rate during the early years of SIPC was a deliberate one. This policy decision stemmed in part from a desire to build up the fund rapidly from industry sources and thus minimize the risk that government borrowing might be necessary. There was an intention, also, to spread the cost of the program, which is designed to contribute to public confidence in the securities markets, over a broad spectrum of the industry since the entire industry benefits from the attainment of these objectives.

After the fund has reached the desired level, SIPC is expected, as indicated in Section 4(c)(2) of the Act, to vary assessments as between classes of members. Thus as to any one or more classes of members, assessments may be based in whole or in part on, or measured by, the amount of gross revenues from the securities business, or all or any of the following factors: the amount or composition of gross revenues from the securities business, the number or dollar volume of transactions effected, the number of customer accounts maintained or the amounts of cash and securities in such accounts, their net capital, the nature of their activities (whether in the securities business or otherwise) and the consequent risks, or other relevant factors.

It is not possible at this time to estimate the probable time at which SIPC can undertake to vary assess-

[24] Section 9(a).

ments as between classes of members on the basis of allocations of risks, costs, or other factors.

Much will depend upon the time required to build the fund to the prescribed $150 million. This, in turn, will be affected by the future financial health of the industry, the volume of assessments received, the volume of liquidations of SIPC member firms, and the demands upon the SIPC fund for advances to trustees for the benefit of customers and administration and other costs, the need for and the amount of any borrowing, and finally the rapidity of the phase-out of confirmed lines of credit.

It probably will be a number of years, therefore, before SIPC may make effective a variable assessment system with rates less than ½ of 1 per centum. It is important, however, that the formulation of a program for this purpose be initiated and the Board has directed the staff to develop the basic data which will be necessary for the evaluation of the elements which properly may enter into an assessment schedule as contemplated by the Act. In this connection, SIPC anticipates that its staff will work with the representatives of the various examining authorities under Section 8, including, of course, the Commission, in the collection of data and the development of appropriate bylaws in this area.

Borrowing Authority Other Than From Commercial Sources

In the event that the fund is or may reasonably appear to be insufficient for the purposes of the Act, the Commission is authorized to make loans to SIPC. With the application for, and as a condition to such loan, SIPC must file with the Commission a statement respecting the anticipated use of the loan proceeds. If the Commission determines that such loan is necessary for the protection of customers of brokers or dealers and the maintenance of confidence in the United States securities markets, and that SIPC has submitted a plan which provides, under the circumstances, a reasonably feasible assurance of prompt repayment, then the Commission shall so certify to the Secretary of the Treasury and issue notes or other obligations to the Secretary of the Treasury in an aggregate amount not to exceed $1 billion. If the Commission determines that the amount of, or time for, payment of the assessments pursuant to such plan would not satisfactorily provide for the repayment of such loan, it may, by rules or regulations, impose upon the purchasers of equity securities in transactions on national securities exchanges and in over-the-counter markets, a transaction fee in such amount as at any time or from time to time it may determine to be appropriate, but not exceeding 1/50 of 1 percent of the purchase price of the securities. No such fee shall be imposed on a transaction (as defined by rules or regulations of the Commission) of less than $5,000. The term "purchasers" does not include a broker or dealer registered under Section 15(b) of the 1934 Act or a member of a national securities exchange unless such purchase is for an investment account of such broker, dealer or member. The Commission may, by rules and regulations, exempt any transaction in the over-the-counter markets in order that assessment of fees on puchasers in those markets be on a basis comparable to the assessment of fees on purchasers in transactions on national securities exchanges. Such fees are to be collected by the broker or dealer effecting the transaction for or with the purchaser and are to be paid to SIPC in the same manner as assessments are otherwise paid under the Act.

The Secretary of the Treasury prescribes the terms and conditions of any notes issued by the Commission for purposes of a loan to SIPC. During any period when any treasury borrowing is outstanding, no pledge of any assessment upon a member to secure any other borrowing shall exceed ¼ of 1 percent of the member's gross revenues from the securities business for any twelve-month period.

Treatment of Prior Trusts

The transfer of the trust fund of the American Stock Exchange in the amount of $3 million in February 1971 has been mentioned. A second such transfer occurred in December 1971, when $11,925.06 was received from that fund. It is unlikely that any large amounts will be received in the future by transfers of the remainders of any trust funds which had been established by any of the other exchanges.

Consequences of Nonpayment or Underpayment of Assessments

If a member of SIPC fails to pay when due all or any part of an assessment, the unpaid portion may be subject to interest charges as may be determined by bylaw or rule of SIPC. To date, the Board has been of the view that during a start-up period and until SIPC's rules and bylaws are known and understood by the industry, no attempt should be made to impose penalty charges for nonpayments or short payments. This could, of course, change quickly upon evidence of abuse.

The statute provides that if a member of SIPC fails to pay assessments when due, and the failure shall not have been cured by making payment within five days after receipt by the member of written notice of such failure given by or on behalf of SIPC, it shall be unlawful for the member, unless specifically authorized by the Commission, to engage in business as a broker or dealer.

SIPC has not given nor authorized any "written notice" of failure to pay. Rather, a continuing effort has been in progress to identify delinquents and to reduce the number by informal procedures through the collecting agents and self-regulatory organizations. It is believed that the dollar amount involved is not large and, of course, the firms involved represent a very small percentage of the securities industry.

As of March 31, 1972, 182 broker-dealers had failed to pay any SIPC assessment. It is anticipated that 59 of these will pay their assessments at an early date.

General Assessment Reconciliation Forms are due to be filed by May 1, 1972. Promptly thereafter SIPC intends to review the matter and determine what action to take, as provided under Section 10(a) or otherwise, against all members that have failed to file the information required or to pay any and all assessments due.

SIPC members pay their assessments and submit their assessment reports and forms to their collection agencies which review the assessment forms, maintain proper records, and deposit the collections to a SIPC account in one of the three depository banks employed for the purpose. SECO members pay their assessments directly to a bank depository for the account of SIPC. Duplicate deposit slips and assessment forms are sent directly to a local accounting firm for processing and recording.

SIPC thus does not receive directly any assessment payments from its members and the entire collection procedure including the keeping of the basic records is handled by the collection agencies which in turn file reports of collections and deposits with SIPC.

During July and August of 1971, SIPC's public accounting firm reviewed on a test basis the assessment procedures and records of some of the collection agencies.

In addition, in order to secure a check on the adequacy and accuracy of the determination of "revenues from the securities business" and the correctness of the assessment calculations by the SIPC member firms and their payments for SIPC's accounts, SIPC requested the Commission to promulgate a rule which would require the independent auditor for the firm to review these calculations and payments in connection with his annual review of the firm's accounts. SIPC has been advised that an amendment to the Commission rules for this purpose is in the course of preparation.

It was discovered during the review of the information supplied by the NASD in connection with a notice under Section 5 of the Act, that a SIPC member which had claimed to be excluded from membership in SIPC because of the asserted nature of its business was in fact a SIPC "member." It was evident that the claim of exclusion by the firm was false when filed and, of course, the firm had paid no assessment. As a result of this incident, SIPC has requested the NASD to make a check of the so-called "excluded" firms in order to determine the extent of this type of problem. In view of the large number [25] of these firms, this review will undoubtedly require a considerable period of time.

[25] It is estimated that firms excluded from membership by the terms of Section 3(a)(2) may exceed 1200.

NOTICE TO SIPC THAT A FIRM IS IN OR APPROACHING FINANCIAL DIFFICULTY

Section 5(a)(1) requires the Commission and the self-regulatory organizations to notify SIPC immediately upon discovery of facts which indicate that a broker-dealer subject to regulation is "in or is approaching financial difficulty."

There is no statutory definition of what constitutes "financial difficulty." Neither has it seemed practicable, on the basis of the relatively limited experience to date, for SIPC to attempt to define these terms or to establish particular criteria.

In general, SIPC has relied upon the judgment and experience of the examining staffs of the self-regulatory organizations and the Commission as to when and upon what basis a Section 5(a) notice [26] shall be given. Frequently, the first intimation of trouble will be communicated to SIPC by a telephone call advising of the results of an inspection or of a report by a SIPC member to an exchange, the NASD or the Commission that a net capital, record keeping or other problem has arisen. This will set in motion a series of inquiries and the exchange of information among the staffs of the Commission, the NASD, and sometimes one or more of the exchanges and SIPC for the purpose of ascertaining the existence and magnitude of the "difficulty." Frequently a written notice to SIPC referenced to Section 5(a) will follow at a later date when the facts have been more definitely determined.

As soon as it is brought to SIPC's attention that a firm is in trouble, a file is established, information is collected from any available source, an effort is made to determine whether and to what extent there may be customer exposure, and arrangements are made for identifying possible qualified candidates in the community in which the firm operates for the position of trustee, trustee's counsel if necessary, and an accounting firm familiar with brokerage accounting.

The New York Stock Exchange has followed a practice of submitting a written report to SIPC in the form of a letter from the Department of Member Firms. These reports, which are usually submitted weekly, describe the member firms which are on the Exchange's special surveillance list due to some failure or anticipated failure of the member firm to comply with the Exchange's rules or criteria. The reports also indicate the actions being taken or proposed to be taken by the member or the Exchange, or both, to identify the nature and magnitude of any problem and the steps being taken to remedy it.

For the year 1971 and through March 31, 1972, SIPC was notified that 36 New York Stock Exchange member firms that carried customer accounts were under special surveillance for various periods because the firms failed to meet the Exchange's criteria as they existed from time to time. SIPC was also notified that 23 other firms which introduced accounts on a fully disclosed basis to other New York Stock Exchange member organizations were under special surveillance at various times. These latter firms, although members of SIPC, posed no problem for SIPC since they had no public customers.

Of the 36 firms that carried customer accounts, one has been liquidated, three have been merged with other firms,[27] 29 have been removed from the list (difficulties corrected), and the three remaining on the list are being monitored by the staff of the Exchange.

SIPC has not applied for the appointment of a trustee for any member of any exchange.

The president of the New York Stock Exchange, Inc. advised the House Committee in July of 1970 concerning procedures followed in attempting to prevent the deterioration of the financial condition of their member firms.[28]

> "As you know, member organizations doing business with the public are required under our Rule 325 to maintain a ratio of aggregate indebtedness to capital of not greater than 20 to 1. In general the Exchange feels that it need not be concerned with the financial condition of any firm whose ratio is 12 to 1 or better. In order to provide a long lead-time in case a firm's trend of business indicates it

[26] These notifications and the information on which they are based are not made public by SIPC when received since to do so might make difficult, if not impossible, efforts to prevent failure of a firm. If SIPC files an application and a trustee is appointed the public file would include the notification as well as the court record.

[27] The liquidation and mergers were carried out under Exchange supervision without loss to public customers.

[28] See letter of Robert W. Haack dated July 23, 1970 in House Hearings No. 91–67 at pp. 396–7.

may be getting into difficulty, we start watching ratios when they get above 12 to 1. . . ."

"In addition to identifying firms that have a ratio better than 12 to 1, we instituted in early 1970, during a period of sustained operating losses and stockmarket declines, an alert system that identifies any firm that incurs a monthly loss exceeding 15 percent of excess net capital. This criteria means that firms are identified if their excess available capital would be consumed in approximately six months or less assuming the same rate of continuing monthly loss."

If a firm exceeds these standards it is requested to embark on a program to reduce costs or infuse new capital and, absent these, to curtail operations—all under monitoring by the exchange.

The first letter from the Exchange, dated January 15, 1971,[29] notifying the Commission of the firms on its special surveillance list stated that "A member firm becomes under special surveillance when its monthly loss exceeds 15 percent of excess net capital or its capital ratio exceeds 1200 percent."

In December 1971 the Exchange advised that new criteria would be applied to firms which do not carry customer accounts. The general effect of this change was to provide that firms having a net capital equal to or in excess of 200 percent of minimum net capital required under the Exchange's capital rule would not be included as a special surveillance firm unless the total operating loss represents 25 percent of the firms' excess net capital as of the date of the most recent computation.

In general, the present policy of the Exchange as applied to firms carrying customer accounts requires that a firm may not expand its business if aggregate indebtedness is more than 1000 percent of net capital or if scheduled capital withdrawals during the next six months would result in a ratio in excess of 1000 percent. Further, a firm must take steps to reduce its business if the ratio exceeds 1200 percent, or if scheduled capital withdrawals during the next six months would result in a ratio in excess of 1200 percent.

Under the present rules a ratio in excess of 1500 percent involves a violation of the Exchange's net capital rule.[30]

SIPC has received advice by telephone from the American Stock Exchange in regard to one of its member firms, from the Philadelphia-Baltimore-Washington Stock Exchange with respect to two of its member firms, and several from the Midwest Stock Exchange to the effect that the member firms in question had violated one or more rules of the respective organizations. In each instance SIPC was advised that there was no risk to customers.

The National Association of Securities Dealers, Inc., has a larger constituency, one which is more diversified and geographically dispersed, and one to which, under the existing federal regulatory structure, there exists relatively free access with limited capital requirements. This has resulted in an organization and surveillance system which, historically, has not been as tightly knit nor subject to the same degree of control as the New York Stock Exchange and some of the other national exchanges.

Further, because of the different legal structure and powers as well as its historical background, the NASD has not had the facilities for applying particular surveillance formulae throughout the 13 district organizations in monitoring the operations of its membership of several thousand firms. However, late in 1970 or early 1971, the NASD initiated a quarterly reporting system which has been gradually improved. In September 1971 the Commission's Rule 17a-11 [31] became effective. These have, in effect, resulted in a type of early warning system. The annual report for the Association for 1971 describes an increased activity in the examination of NASD member firms and handling of customer complaints.

Typically, an NASD case is likely to be one in which the NASD examiners have discovered by inspection, notice or otherwise that a firm either is in violation of the net capital rules, has failed to keep and maintain proper books and records, or is insolvent, or a combination of these. Since the NASD has no authority under the 1934 Act to institute injunctive action or to suspend a firm summarily, the NASD usually will refer such a case to the Commission. The Commission may then seek an injunction and in some cases the appointment of a receiver.

During the past year reporting forms have been developed for use by the staffs of the NASD and the Commission to accompany, or follow, the form of

[29] This date preceded the appointment of the SIPC directors.

[30] Rule 325.

[31] This rule provides a number of self-policing procedures: a broker-dealer must give telegraphic notice of a failure to meet appropriate net capital rule; a report must be filed when a net capital ratio exceeds 1200 percent or net capital falls below a specified minimum; a telegraphic notice must be sent if books and records are not kept current and, finally, if a firm fails to give a required notice or file a required report the self-regulatory body, upon learning of these matters, must give notice. (Commission Release No. 9268.)

letter now customarily employed to give SIPC "notice" in NASD or SECO cases. These forms have been developed informally as the respective staffs and organizations gained experience. They, doubtless, will be further modified.

For the year 1971 and through March 31, 1972, SIPC was notified by the NASD that 65 NASD member firms were in or were approaching financial difficulty. Of these 65, ten are no longer registered brokers or dealers, two are out of business although currently registered, eight are in receivership, six were removed from the list of firms because their difficulties were corrected, and 13 are being monitored or their status reviewed. In the remaining 26 cases SIPC applied for the appointment of a trustee and these firms are now being liquidated under the provisions of the 1970 Act. SIPC also applied for the appointment of trustees for 13 additional NASD member firms which were referred to SIPC by the SEC.[32] These firms also are being liquidated under the Act.

Under existing procedures the Commission's staff automatically notifies SIPC that a firm is in or approaching financial difficulty in either of two circumstances: (1) whenever there is a determination to recommend that the Commission file an application for an injunction against a firm for net capital or bookkeeping violations (preliminary notice is often given prior to Commission approval of this recommendation with the full information on which to premise an application by SIPC being furnished later), and (2) whenever a firm notifies the Commission, under its Rule 17(a)-11, of bookkeeping or capital violations.

In a fairly common situation the Commission's headquarters office receives notification from one of its regional offices that a firm appears to be in violation of the net capital rule. Some of these notifications indicate serious financial difficulty on the part of the firm. In other cases, however, the net capital or other violation is an isolated or temporary condition where an otherwise adequately capitalized firm suddenly finds itself in violation as a result, for example, of some abrupt market movement or a delay in closing out an underwriting or other commitment. The Commission usually has not transmitted notices in these latter cases. The usual procedure is to wait until it appears that the firm has failed to put itself quickly into compliance or will be unable to do so. A considerable number of the firms for which some form of notice has been received by SIPC from the Commission or NASD rectify their net capital situation without becoming the subject of a Section 5 notice.

A Commission Section 5 notice usually takes the form of a letter with an attached form which, if properly filled out, contains the financial data necessary for a determination by SIPC whether or not to enter the case. In cases where the information called for has not been furnished, [33] SIPC may communicate directly with the field office of the Commission or the NASD or, indeed, send one of its own staff to visit the firm.

[32] Some of these may have been referred to the SEC by the NASD.

[33] This occurs not infrequently due to the inadequacies in or absence of the required books and records. In such situations it is necessary to seek information from whatever source may be available.

SIPC APPLICATION FOR COURT DECREE THAT CUSTOMERS NEED THE PROTECTION PROVIDED BY THE ACT

One purpose [34] of the notice under Section 5 is, of course, to provide SIPC with the facts upon which to base its decision whether to seek the appointment of a trustee and thus initiate the liquidation of a firm in accordance with the specialized procedures of the Act.

There are five conditions [35] specified in Section 5(b), at least one of which must be found to exist in every case by SIPC as a condition to its filing of an application.[36] One of these conditions also must be found to exist by the court in making the requested adjudication.

In addition, before SIPC files an application for the appointment of a trustee it must have determined that the SIPC member firm in question has failed or is in danger of failing to meet its obligations to customers.

If, within three days after the filing of a SIPC application, or such other period as the Court may order, the member shall consent to or fail to contest the application, or fail to controvert any material allegation of the application, the Court shall issue a decree adjudicating that the customers of the member are in need of protection under the Act. The Court then appoints, as trustee for the liquidation of the business of the member and as attorney for the trustee, such persons as SIPC specifies. It is provided, however, that no person shall be appointed to either position if he is not "disinterested" within the meaning of Section 158 of the Bankruptcy Act.

Section 5 (b)(4) of the Act defines the term "debtor" (a term employed throughout Section 6) to mean the SIPC member firm, and the term "filing date" (a date critical to the interpretation and administration of Section 6) to mean the date on which a SIPC application is filed with the Court, except that if

a. a petition was filed before such date by or against the debtor under the Bankruptcy Act, or

b. the debtor is the subject of a proceeding pending in any court or before any agency of the United States or any State in which a receiver, trustee, or liquidator for the debtor was appointed which proceeding was commenced before the date on which the SIPC application was filed,

then the term "filing date" means the date on which such petition was filed or such proceeding commenced.

The critical question in virtually all cases, and the one as to which it is usually most difficult to get solid facts as of the time a decision is required, is whether the firm has failed or is in danger of failing to meet its obligations to customers.

The Commission, in the discharge of its regulatory duties, usually will proceed promptly to seek an injunction and frequently will petition at the same time for the appointment of a receiver, when it learns that a broker-dealer is violating the net capital or record keeping rules or is engaged in other illegal conduct.

During the early months of SIPC it was not always possible to determine at the time the Commission went to court in such cases whether there was customer exposure. Accordingly, it frequently occurred

[34] Another and probably very significant effect, if not purpose, of the notice provisions is to cause the self-regulatory organizations to concentrate on types of early warning signals and to seek to detect difficulties as soon as possible.

[35] See page 6 of the "Introduction" where the five conditions are stated.

[36] Section 5(a)(2) provides in pertinent part that ". . . SIPC, upon notice to such member, may apply to any court . . . ."

that a restraining order would be issued and a receiver appointed some time before SIPC was prepared to make the determination required by the 1970 Act. In some cases, of course, it developed that the firm had no public customers or that they had been paid amounts owing to them or that the violations which had prompted Commission action had been remedied. In these situations, SIPC would not apply for a trustee and would take no action except to complete its records in the matter.

In other cases the nature and scope of obligations to public customers would be determined after the beginning of the SEC court action and it would become evident that SIPC protection of customers would be necessary. In these cases SIPC filed an application for the appointment of a trustee after the court had appointed a receiver on the petition of the Commission. In all of these SIPC (although not required to do so) designated the court appointed receiver as the trustee or as counsel to the trustee. One case merits special note in this connection. Buttonwood Securities, Inc., a California corporation, filed a petition for an arrangement under Chapter XI of the Bankruptcy Act on September 8, 1971 and a receiver was appointed. Since this was a voluntary proceeding for an "arrangement" it seemed appropriate for SIPC to designate a trustee of its choice. On October 12, 1971 SIPC filed an application seeking a determination that the customers of Buttonwood were in need of the protection of the 1970 Act and the appointment of a trustee. The District Court for the Southern District of California issued an order on October 18, 1971 making the requisite determination, and appointed a trustee. As part of this order the court stayed the Chapter XI proceedings.

As the staffs of the NASD, the Commission and SIPC gained experience, an effort was made to reduce or eliminate the lag between the time the Commission acts and SIPC is prepared to act. Increasingly in recent months, it has been possible for SIPC and the Commission to appear in court at the same time, with their respective applications.

Section 5(b)(2) of the Act states that "the court to which application is made shall have exclusive jurisdiction of the debtor involved and its property wherever located with the powers, to the extent consistent with the purposes of this Act, of a court of bankruptcy and of a court in a proceeding under Chapter X of the Bankruptcy Act."

In the same section the statute states that the "court shall stay" pending proceedings to reorganize, conserve, or liquidate the debtor or its property, any other suit against any receiver, conservator or trustee of the debtor or its property. In addition, each SIPC application that is granted stays any action, other than one brought by the Securities and Exchange Commission, unless an order of the court has first been obtained.

In designating the trustee and the attorney for the trustee to conduct liquidations under the 1970 Act, SIPC has attempted to locate attorneys and accountants who have had experience in the brokerage industry and some familiarity with bankruptcy and securities laws. Generally, the trustee is an attorney. In one smaller case one of SIPC's employees was appointed trustee, partly in the interest of economy, and partly to gain firsthand experience with the problems encountered in a stockbroker liquidation. In several cases accountants have been designated trustees.

If SIPC determines that certain conditions exist, it may in its discretion apply to the appropriate federal court for a decree adjudicating the customers of a member to be in need of the protection afforded by the 1970 Act. If, however, SIPC refuses to act for the protection of the customers of any of its members, the Commission has authority under Section 7(b) of the 1970 Act to apply to the federal court for the district in which SIPC's principal office is located for an order requiring SIPC to discharge its statutory obligations. No application under this section has been filed.

SIPC has employed a form of consent to the SIPC application and when it is signed by the member firm it is possible for the court to make its adjudication and appoint a trustee immediately upon the filing of the application. In most cases in which the firms have not consented the court usually has directed that a hearing be held within a short period. No court has made its adjudication and appointed a trustee prior to the expiration of the three business day period prescribed in the Act in any case in which the firm has not consented.

In view of the possibility of the injection of new capital or some other corrective action during that period, earlier court action might indeed be premature. Nevertheless, SIPC considers it important in many cases to bring to an end the firm's access to its assets and books and records and it is in this connection that SIPC urges the appointment of a temporary receiver under Section 5(b)(2) to take control of assets pending adjudication.

LIQUIDATION PROCEEDINGS

General Nature of a SIPC Liquidation

Section 6 of the 1970 Act sets forth the purposes of a proceeding in which a trustee has been appointed, the procedures to be followed, the powers and duties of the trustee, and the rights and priorities of the customers of the debtor firm.

The proceeding is essentially a liquidation proceeding, and the 1970 Act denominates it as such. In order to assure that only a liquidation will take place, Congress provided that, even though the proceeding is to be governed to a very large extent by those provisions of the Bankruptcy Act (11 U.S.C. § 1 *et seq.*) relating to corporate reorganizations (Chapter X), in no event is a plan of reorganization to be formulated.

The powers and duties of the trustee are quite broad. Section 6(b)(1) gives the trustee the same powers and title with respect to the debtor and its property, and the same rights to avoid preferences, as a trustee in bankruptcy and a trustee under Chapter X of the Bankruptcy Act would have. In addition, the trustee is given the right to operate the debtor's business so as to complete certain open contractual commitments and, with SIPC approval, to hire and fix the compensation of persons deemed necessary by the trustee for purposes of the liquidation proceedings, all without court approval.

The duties of the trustee, except where inconsistent with the 1970 Act or as otherwise ordered by the court, are the same as the duties of a trustee in bankruptcy.[37]

A liquidation proceeding is to be conducted:

> "in accordance with, and as though it were being conducted under, the provisions of chapter X and such of the provisions (other than section 60e) of chapters I to VII, inclusive, of the Bankruptcy Act as section 102 of chapter X would make applicable if an order of the court had been entered directly that bankruptcy be proceeded with pursuant to the provisions of such chapters I to VII, inclusive. . . ."

As indicated, where inconsistent with the provisions of the 1970 Act, the Bankruptcy Act does not apply. As a result, the above quoted provision effects a blending of the 1970 Act, the provisions of the Bankruptcy Act dealing with ordinary bankruptcy (Chapters I to VII, inclusive) and the provisions of the Bankruptcy Act dealing with corporate reorganizations (Chapter X). Such a blending was intended to provide the court and the trustee with the flexibility necessary to the proper conduct of a complex proceeding.[38]

The 1970 Act specifically excludes Section 60e of the Bankruptcy Act which heretofore had governed the bankruptcy liquidation of stockbrokers.[39]

Prior to enactment of Section 60e in 1938, the rights of customers of stockbrokers depended upon the law of the state in which the transactions in question took place, and most cases involved the rights of margin customers. Two doctrines, the "Massachusetts" rule and the "New York" rule, emerged. Under the Massachusetts rule, a broker who carried stock in a margin account for customers was treated as the owner of that stock. The relationship between the parties was said to be that of debtor and creditor, with the customer treated as a general creditor. Under the New York rule, which was followed in most jurisdictions, the relationship was viewed as one of pledgor-pledgee, and a customer who could find similar securities in the possession of the stockbroker or the stockbroker's pledgee could reclaim them. Thus under the New York rule some customers might fare well and others fare poorly, depending simply upon which customers were lucky enough to discover that the stockbroker had in his possession some of the kinds of securities in which they had an interest.

[37] However, the trustee in a 1970 Act proceeding has no obligation to reduce securities to money.

[38] However, the blending also creates certain problems, in that there are conflicts between certain provisions of Chapters I through VII of the Bankruptcy Act and Chapter X of that Act. In addition, the major purpose of a Chapter X proceeding (the rehabilitation of the debtor) is inconsistent with one of the major purposes of a SIPC proceeding (the liquidation of the debtor), while certain provisions of Chapters I through VII which conflict with provisions of Chapter X are perfectly consistent with the purposes of a SIPC proceeding. SIPC is attempting to resolve these conflicts as they appear in any particular case.

[39] Section 60e continues to govern a bankruptcy liquidation of a stockbroker not a member of SIPC.

Section 60e of the Bankruptcy Act was enacted primarily to correct the inequities caused by the operation of the New York rule. The section's major feature was the establishment of three classes of claimants to a stockbroker's assets. These three classes have been adopted, with minor changes, by the 1970 Act.

Section 6(c)(2)(C) of the 1970 Act establishes as one class those customers who are able to "specifically identify" their property in accordance with the terms of that section and who are entitled to the immediate possession of such property without the payment of any sum to the debtor. Specifically identifiable property includes property which "remained in its identical form in the debtor's possession until the filing date . . . [or which] was allocated to or physically set aside for such customers on the filing date." § 6(c)(2)(C). Cash, while it can be specifically identifiable property of a customer (e.g., when found in an envelope with the customer's name on it or, for instance, an uncashed check or monies held for a particular payment in a separate account), usually does not fit within this definition.

The Section 60e definition of specifically identifiable property was very similar, though it required that property be physically set aside for or allocated to customers while the stockbroker was solvent or for four months before bankruptcy. Stock was usually not considered specifically identified unless tagged with the customer's name or account number or segregated individually. The 1970 Act refines and expands the Section 60e concept of specifically identifiable property to include securities held in "bulk segregation" or as part of a central certificate service.

A second class are those customers entitled to share pro rata in a "single and separate" fund.[40]

Finally, to the extent that a customer's claim is not satisfied from the foregoing sources and advances from SIPC, he shares with other creditors in any remaining assets in the debtor's estate.

The 1970 Act attempts to eliminate certain problems which arose in the application of Section 60e. For example, while Section 60e deals with insolvent "stockbrokers", the term "stockbroker" is not defined in the Bankruptcy Act. It has been stated that the term refers only to those holding customers securities as agents, rather than those dealing with customers as principals. *Gordon v. Spalding,* 268 F. 2d 327, 330-331 (CA. 5, 1959). The 1970 Act clearly covers both brokers and dealers.[41]

Another problem arising under Section 60e involved the definition of the term "customer." A person leaving cash with a broker for the purpose of purchasing securities might not be considered a "customer" if the purchase did not occur prior to bankruptcy. The 1970 Act remedies this by providing that the term "customer" ". . . shall include any person who has deposited cash with the debtor for the purpose of purchasing securities . . ." §6(c)(2)(A)(ii).

One of the major innovations of the 1970 Act is the provision for the completion of open contractual commitments. Section 6d) states that:

> "The trustee shall complete those contractual commitments of the debtor relating to transactions in securities which were made in the ordinary course of debtor's business and which were outstanding on the filing date—
>
> (1) in which a customer had an interest, except those commitments the completion of which the Commission shall have determined by rule or regulation not to be in the public interest, or
>
> (2) in which a customer did not have an interest, to the extent that the Commission shall by rule or regulation have determined the completion of such commitments to be in the public interest." [42]

SIPC has been working on drafts of certain proposals for rules under this Section which it is hoped can be submitted to the Commission in the near future. As more experience is gained with contractual commitments, SIPC will develop guidelines for trustees in this aspect of the liquidation process.

Other than specifically identifiable property of customers which is not the subject of an open contractual commitment, all property held by or for the debtor and all property in the single and separate fund may be used to complete open contractual commitments. In addition, SIPC may be required to ad-

[40] The single and separation fund consists of: "All property at any time received, acquired, or held by or for the account of a debtor from or for the account of customers, except cash customers, who are able to identify specifically their property in the manner prescribed in subparagraph (C), and the proceeds of all customers' property transferred by the debtor, including property unlawfully converted. . . ." §6(c)(2)(B).

[41] See page 11 for a discussion of the types of brokers and dealers covered by the 1970 Act.

[42] "For purposes of [Section 6(d)] (but not for any other purpose of this Act) (i) the term 'customer' means any person other than a broker or dealer, and (ii) a customer shall be deemed to have had an interest in a transaction if a broker participating in the transaction was acting as agent for a customer, or if a dealer participating in the transaction held a customer's order which was to be executed as a part of the transaction." § 6(d). In other words, a customer is deemed to have an interest in a transaction if the broker or dealer was acting for a customer either in an agency or principal capacity.

vance moneys necessary to complete certain open contractual commitments of the debtor in which customers have an interest.

Section 6(e) of the Act prescribes that promptly after his appointment the trustee will publish a notice of the commencement of the proceedings in appropriate newspapers. As promptly as possible the trustee is to mail a copy of the notice to each of the customers of the debtor.

Except as the trustee may otherwise permit, claims for certain specifically identifiable property and certain claims payable from the single and separate fund are not to be paid, other than from the general estate of the debtor, unless filed within such period of time (not exceeding 60 days) as may be fixed by the court. No claim may be allowed which has not been filed within six months, except as provided in Section 57 of the Bankruptcy Act.

Section 6(f) deals with SIPC advances to trustees, subsection (1) relating to advances for customers' claims. To provide for prompt payment and to satisfy the net equities of customers of the debtor, SIPC is to advance to the trustee monies to satisfy claims in full of each customer, but not to exceed $50,000 for such customer. The amount advanced by reason of such claim to cash shall not exceed $20,000.[43]

A customer who holds accounts with the debtor in bona fide separate capacities is considered a different customer in each capacity. In October 1971, SIPC issued Rules Identifying Accounts of Separate Customers of SIPC Members.

No advance may be made by SIPC to the trustee to satisfy any claims of any customer who is a general partner, officer, or director of the debtor, the beneficial owner of 5 percent or more of any class of stock, or limited partner with a participation of 5 percent or more in net assets or net profits of debtor. No advance shall be made by SIPC to the trustee to satisfy the claims of any broker or dealer or bank unless such claims arise out of transactions for customers of such broker or dealer or bank, in which event, each such customer shall be deemed a separate customer of the debtor.

Other Advances

SIPC may advance to the trustee such monies as may be required to hire and pay all personnel that are necessary for the liquidation proceeding and to pay proper administrative expenses. SIPC is to advance to the trustee monies required to complete open contractual commitments.

Section 6(g) of the Act requires the trustee to discharge promptly all obligations of the debtor to each of its customers relating to, or net equities based upon, securities or cash by the delivery of securities or the payment of cash to customers insofar as such obligations are ascertainable from the debtor's books and records, or are established to the satisfaction of the trustee.[44] The court is empowered to (1) authorize the trustee to make payment out of SIPC advances for claims for securities or cash; and (2) in respect of claims for securities, authorize the trustee to the greatest extent practicable to deliver, in payment of claims of customers for their equities based on securities held on the filing date in their accounts, securities of the same class and series of an issue ratably up to the respective amounts so held in those accounts. The amounts and number of such advances are indicated in Appendix III.

Any payment or delivery of property by the trustee may be conditioned upon requiring claimants to file in support of their claims appropriate receipts, supporting affidavits, or properly executed assignments. Trustees have generally required copies of confirmations, cancelled checks, and statements of account in support of claims filed. Trustees have, from time to time, disallowed various claims. The nature of any additional data in support of claims has been a matter for the individual trustee to work out with the claimant, depending on the specific circumstances relating to the disallowance.

[43] In other words, advances to cover customer losses may not exceed $50,000 but if the claim is one for cash the advance to cover customer losses may not exceed $20,000. The "filing date" (see page 22) is the critical date for computing "net equities."

[44] The statute contemplates that in the interest of maintaining public confidence and minimizing the period during which investors' property is not available to them for investment or other purposes, customer claims should be paid promptly. SIPC agrees with this objective and believes that procedures now employed and being developed should result, in many cases, in the payment of non-disputed claims within a few months. However, SIPC also has taken the position that advances should not be made until the trustee and SIPC are satisfied that claims are bona fide and accurate. Experience to date has warned of the need to be watchful for fraudulent claims or at least erroneous ones. The state of the books and records frequently is such that it is possible for claims to be misstated under circumstances making difficult detection and prevention of overpayments or improper payments. In some cases the staff has been alerted to the probability that plans have been made to establish accounts for the purpose of reaching SIPC funds. SIPC has followed a practice, therefore (which in no way is to be construed as a reflection on any trustee), of having its own accountants review debtor accounts on a sample basis or otherwise as to the validity of claims and the adequacy of the documentation as a basis for the SIPC advance.

SIPC is entitled to be repaid in priority to all other claims payable from the single and separate fund the amounts of all advances made by SIPC to the trustee to permit the completion of open contractual commitments and, except to the extent that other assets of the debtor may be available or as otherwise ordered by the court to be paid, all costs and expenses specified in clauses (1) and (2) of Section 64(a) of the Bankruptcy Act in priority to claims of customers against the single and separate fund.

The statute also provides that, to the extent that monies are advanced by SIPC to the trustee to pay claims of customers, SIPC shall be subrogated to the claims of such customers.

Basic Causes of Failures of Firms being Liquidated

As of March 31, 1972 SIPC was involved in the liquidation of 39 securities firms by court-appointed trustees. These firms were in all stages of the liquidation process. In some cases the claims of customers had been settled or substantially settled and the trustees were involved in the later stages of dealing with the general estates and the claims of other creditors. In some the trustees had just been appointed and had not yet had time in which to publish notices. In the remaining cases assets were being marshalled, claims processed and customers paid net equities or delivered specifically identifiable property. In some, disputed claims were being researched. In others, it appeared that litigation might be necessary.

It is too early, therefore, to make the studies necessary for a comprehensive determination of the causes or apparent causes of the failure of these firms or to make an evaluation of the relative significance of each of multiple causes. Furthermore, in the interest of not causing the trustees problems in addition to those they already face, it is not believed advisable to publish the details of pending cases. Accordingly, SIPC has reviewed data so far available from various records and other sources, including data furnished by the trustees, and has prepared preliminary conclusions regarding causes for failure without disclosing the names of the firms or the trustees and without linking the data with any firm or persons.

Inadequate, inaccurate or nonexistent books and records must be mentioned as one of the most significant conditions encountered in almost all of these cases. It is not possible on the basis of present knowledge to characterize this state of affairs as a primary cause of failures or an inevitable consequence of failures. It is clear, however, that in the securities business, perhaps more than in most, failure of record keeping can result in loss of control of the business. The work of the trustees in all of these cases has been impeded in varying degrees by bad records, no records, false records or non-current records. In some situations it has been impossible for trained accountants to reconstruct the books and records needed by the trustee.

Lack of adequate capital has been mentioned frequently by the trustees as a major factor in firm failures. Of course, this explanation by itself is not too revealing as an indication of the reason for failures. This term can include a number of situations ranging from too small a capital base to such matters as temporary illiquidity, overcommitment in a particular security or venture, inability to absorb an adverse market movement, too rapid expansion or improper controls. The initial capital of the firms in liquidation as reflected in the broker-dealer register forms filed with the Commission is shown in Appendix III. Figures were available for 38 of the 39 firms. The firm reporting the smallest initial capital began business in 1964 with $4,000. The firm with the largest initial capital started business in February 1970 with $250,000 and failed within two years.

Thirty of the 38 firms, or approximately 80 percent, reported an initial capital of less than $50,000; 18 of the 38 firms, or approximately 42 percent, reported an initial capital of less than $25,000; and 8 reported capital of less than $10,000.

Mismanagement likewise has been stated frequently as a major factor. Again SIPC does not yet have sufficient facts to know whether this springs from lack of knowledge and experience in the business, emphasis on sales to the exclusion of other aspects of the business, ineptitude, failures of records or controls or other matters such as, for example, as has been demonstrated in at least one case, a scale of corporate and personal living which could not be supported by the available resources, including those belonging to customers.

There have been a number of cases where it seems clear that grossly improper conduct was a major factor in the failures.

Of the 38 firms in liquidation, 28 began business in 1968 or later. In other words, 74 percent of the firms in liquidation failed within four years and 32 percent failed within two years.

Generally, failures have resulted from various combinations of the foregoing. In most cases there were multiple causes rather than any single cause.

Although it is dangerous to generalize, particu-

larly on the basis of a few months of SIPC's experience with liquidations, these cases at least would suggest the need for an upgrading of the qualifications of principals, improved capital requirements and closer monitoring of compliance with record keeping and capital requirements.[45]

Selection of Trustees

As of March 31, 1972, there were 39 trustees engaged in liquidations under the 1970 Act. Of these trustees, 17 had been receivers appointed by the courts prior to the time SIPC filed an application. SIPC designated them as trustees for purposes of the 1970 Act when the court approved SIPC's applications.[46]

Nineteen trustees serving in 21 cases were not receivers at the time the SIPC applications were made. These 19 were selected by SIPC and designated under Section 5(b)(3). Six of these individuals were selected on the basis of their prior experience with banks or broker-dealers. Six others were recommended to SIPC by the SEC's regional offices; two had prior trusteeship experience, and three were recommended by others.

During the past nine months SIPC has been developing a roster of persons in all parts of the country reputed or known to have had experience in various operational aspects of the brokerage business. Similarly, the names of prospective accountants and counsel to assist trustees are being accumulated. Eventually it should be possible to secure on short notice the services of highly qualified candidates for the key roles in SIPC liquidations.

Work to be Done in this Area

It is anticipated that the records and history of each firm liquidated under the procedures of the Act will be reviewed and case studies prepared which should be useful in a number of ways to SIPC and its staff, and to the Commission and the self-regulatory agencies. These case studies should include information concerning the principal suppliers of firms' capital, the character of that capital, the nature of the business attempted or conducted, the causes of failures, the qualifications of the personnel, types of securities handled, and all significant aspects of the firms' history and operations as well as significant aspects of the liquidation process, procedures and results including costs.

This work can be expected to provide a basis for assisting SIPC to reach conclusions and make recommendations concerning such matters as inspections, reporting, record keeping, qualifications of principals (Sections 7, 8, 9 and 10), accounting requirements and, with other data to be developed, with respect to various criteria for determining varying rates of assessments which must be devised in due course. These case studies can also be valuable sources of material for one of SIPC's most important and continuing functions, i.e., the preparation and updating of guides and instructions for the benefit of trustees, their employees and our own personnel, in the various steps and stages of the trustees' functions in liquidations. Finally, the experience gained in working with the problems of failing broker-dealers and their customers will be of value in suggesting changes in the rules or procedures of the Commission or the self-regulatory organizations in relation to the reporting requirements and need for inspections or monitoring of SIPC member firms.

The long-range objective of the regulatory and self-regulating structure, in addition to upgrading the financial responsibility of SIPC member firms generally, of course, is to identify and correct if possible the causes of failures or, if that cannot be wholly realized, to devise a system under which customer losses and SIPC's costs may be minimized.

The liquidation process under the Bankruptcy and the 1970 Acts inevitably is time-consuming, costly and essentially wasteful. Hopefully, the SEC and the self-regulatory organizations will be able to develop within the existing structure effective means, with as much uniformity, as possible, to reduce the number of failing firms and improve the operational, financial and other features which have contributed to the collapse of many firms.

Litigation

In addition to the litigation in connection with applications for the appointment of trustees pursuant to Section 5 of the Act, SIPC has been named as defendant in two proceedings. The first commenced in April 1971 in the United States District Court for the District of Colorado. (*Lohf* v. *Casey, et al.*, Docket No. C-3039.) The second commenced in November

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[45] See page 31, Review of Proposals for New or Amended Rules and Regulations of the Commission and Others.

[46] In one case (Buttonwood), because of special facts, SIPC designated an individual other than the court-appointed receiver to be trustee. In one of these cases SIPC designated the court-appointed receiver to serve as counsel to the SIPC-designated trustee.

1971 in the United States District Court for the Northern District of Texas (*Bohart-McCaslin, et al.* v. *Midwestern Securities Corporation, et al.*, Docket No. 2-1119.) Both cases basically seek to compel SIPC to apply to a district court for the appointment of a trustee for defunct broker-dealer firms. SIPC filed a motion to dismiss [47] in the *Lohf* case, and in August of 1971 the district court granted that motion. The plaintiffs filed an appeal which is pending before the United States Court of Appeals for the Tenth Circuit. SIPC has filed a motion for summary judgment and a motion to dismiss in the *Bohart-McCaslin* case, and those motions are still pending. These cases involved questions as to the retroactive application of the 1970 Act.

One broker-dealer firm for which a trustee had been appointed pursuant to the 1970 Act appealed the district court's decision granting the SIPC application. (*Alan F. Hughes, Inc.* v. *Securities and Exchange Commission and Securities Investor Protection Corporation*, Docket No. 72-1196.) The briefs on this appeal have been filed and oral argument was heard by the Second Circuit Court of Appeals on March 10, 1972. No decision had been handed down as of March 31, 1972.

[47] 330 F. Supp 356, D. Colo. 1971.

ADVERTISING OF SIPC MEMBERSHIP AND CUSTOMER PROTECTION

Section 11(e) of the 1970 Act provides as follows:

> "SIPC shall by law or rule prescribe the manner in which a member of SIPC may display any sign or signs (or include in any advertisement a statement) relating to the protection to customers and their accounts, or any other protections, afforded under this Act. No member may display any such sign, or include in any advertisement any such statement, except in accordance with such bylaws and rules."

In May 1971, the staff transmitted to the national securities exchanges, the NASD, the Association of Stock Exchange Firms, the SEC and the SIPC directors, a first draft of a document outlining, in question and answer form, many of the provisions of the 1970 Act, together with the advertising regulations of the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation and the National Credit Union Administration, and copies of the advertising material which each of these organizations permits or requires its members to display or distribute. Each recipient was requested to submit comments or suggestions relating to the content of the SIPC advertising literature and bylaws, or to the procedural steps which should be followed in the development thereof.

Shortly thereafter an industry committee was formed under the direction of Leon T. Kendall, President of the Association of Stock Exchange Firms, and Lawrence B. Morris, Jr., President of Dean Witter & Co., Inc. On June 30, 1971 this committee submitted copies of a proposed bylaw, a proposed brochure, a plan for an advertising and promotional campaign, and three proposals for the SIPC symbol. The committee's proposed bylaw was similar in content to the FDIC regulations which require FDIC member banks to display an official sign denoting FDIC membership and to include FDIC's official advertising statement or symbol in certain of the bank's advertisements, and thus would require all SIPC members to utilize an official SIPC symbol and legend or statement in their advertising. The descriptive literature or brochure proposed by the committee was in question and answer form and similar in appearance to the FDIC brochure.

In August the SIPC Board of Directors determined that advertising of SIPC by SIPC members should be permissive rather than mandatory. The Board at the same time agreed to adopt as the corporate logotype

the symbol which was preferred by a majority of the members of the industry committee. The advertising bylaw became effective in October 1971.

It was decided that the brochure describing SIPC and the 1970 Act would not be considered to be an "advertisement" and, therefore, that distribution of the brochure by SIPC members to their customers would not be in contravention of the bylaw. The brochure is viewed as the equivalent of a collection of staff explanations or interpretations with respect to the subjects covered thereby which may be freely distributed by all members of SIPC.

During the development of the brochure, it became apparent that it would be necessary to promulgate rules defining customer "account or accounts" and accounts held by a customer in "separate capacities." These definitions are important in the construction of Section 6(c)(2)(A)(iv) of the 1970 Act relating to the definition of customer's "net equity" and in operation of Section 6(f) of the Act relating to SIPC advances to pay or otherwise satisfy the net equities of customers.

Account rules, designated as the "Series 100 Rules," after submission to the Commission became effective in October. Shortly thereafter printed copies of a booklet setting forth these rules were distributed to all SIPC members, together with copies of the brochure entitled "An Explanation of the Securities Investor Protection Act of 1970," a one page condensation of that brochure, a foldout setting forth the SIPC bylaw relating to advertising and the SIPC symbol.

Arrangements were made with the National Association of Securities Dealers, Inc. and the Securities Industry Association for SIPC members to purchase these materials as well as signs and posters of various types at prices representing approximate cost.

ROLE OF SIPC IN RELATION TO CERTAIN FUNCTIONS OF THE SELF-REGULATORY ORGANIZATIONS

One of the purposes of the Act was to achieve, over a period of time, an upgrading of the financial practices and financial responsibility of members of the securities industry. SIPC was intended to participate in this effort in an indirect way, through certain activities outlined in Section 9, in consultation and cooperation with the Securities and Exchange Commission and the self-regulatory organizations.[48]

Under Subsections (c), (d) and (e) of Section 9, SIPC is to designate one of the self-regulatory organizations, for any SIPC member which belongs to more than one such organization, to inspect or examine the member for compliance with applicable financial responsibility rules.[49] The selection by SIPC is to be on the basis of regulatory procedures employed, availability of staff, convenience of location, and such other factors as SIPC may consider appropriate for the protection of customers. In addition SIPC may, by bylaw or rule, designate the reports of inspections or examinations of SIPC members to be filed with SIPC by the self-regulatory organizations. Furthermore, SIPC is directed to consult and cooperate with the self-regulatory organizations with the objective:

1. of developing procedures reasonably designed to detect approaching financial difficulty upon the part of any member of SIPC;
2. that examinations of members will be conducted by the self-regulatory organizations under appropriate standards (as to method

[48] "Your committee has been concerned about the need for a general upgrading of financial responsibility requirements of broker-dealers, and it recognized this when it stated in its report: "It is clear that the protections provided by the proposed SIPC fund are really only an interim step. The long-range solution to these problems is going to be stated in its report: 'It is clear that the protections provided found in the ultimate raising of the financial responsibility of the brokerage community.' " (Conference Report, December 18, 1970, No. 91-1788, p. 26.)

[49] The term "financial responsibility rules" means the rules and regulations pertaining to financial responsibility and related practices which are applicable to a broker or dealer as prescribed by the Commission under Subsection (c)(3) of Section 15 of the 1934 Act, or prescribed by a national securities exchange.

and scope) and that reports of such examinations will, where appropriate, be in standard form;

3. that as frequently as may be practicable under the circumstances each member of SIPC will file financial information and be examined by the self-regulatory organization which is the examining authority for that member.

Early in 1971 SIPC determined that for the present it would rely upon the then existing allocation of inspection responsibilities. In general, the New York Stock Exchange examines its own members and the National Association of Securities Dealers, Inc. undertakes to examine all of its members other than those which are also members of that exchange. The other exchanges have the responsibility for inspecting their sole members who are not members of the National Association of Securities Dealers, Inc.

In order for SIPC to reach conclusions and attempt to formulate a program under Sections 9(c), (d) and (e), it was first necessary to review the existing reporting and examination procedures of the various exchanges and the National Association of Securities Dealers, Inc.

In July 1971 SIPC wrote to all national securities exchanges and the NASD, requesting data regarding the subject matter of Sections 9(c), (d) and (e). As of early February, most of the requested material had been received and is now under study and review by the SIPC staff.

REVIEW OF PROPOSALS FOR NEW OR AMENDED RULES AND REGULATIONS OF THE COMMISSION AND OTHERS

As 1971 progressed and SIPC began to recruit a staff, considerable time and effort was devoted to studying various rules and rule proposals published for comment by the Commission and the NASD and determining what, if any, comment or suggestions SIPC should make in response. In addition, materials which became available and which were relevant to the financial problems of the industry were reviewed from the point of view of SIPC's role.

In July the staff confirmed by letter certain suggestions made orally at a Commission conference at which possible actions in the areas of eligibilty requirements for entrants into the securities business and stricter capital and reporting requirements, particularly for NASD and SECO members, were considered.

In August the staff, at the request of the Commission, commented upon a Commission memorandum which had been prepared following a study of the so-called Lefkowitz Report.[50]

The SIPC Board considered the Commission's proposal, set forth in its release No. 9288, for revisions of the Commission's net capital rule. In a letter sent on September 21, 1971 the Board supported the proposal to increase the required net capital but indicated that further steps would be desirable in the capital and eligibility rules. The Board also stated its support of a rule which would permit over-the-counter brokers or dealers to introduce accounts on a fully disclosed basis [51] and a proposed rule [52] which would provide that non-member broker-dealers which have been expelled or suspended from a registered national securities association or exchange for conduct inconsistent with just and equitable principles of trade and individuals who have been barred or suspended from association with any such member would not be qualified to engage in securities activities.

In December a letter and memorandum dealing with the subject of qualifications of member firms of SIPC were sent to four of the exchanges and to the NASD and the Commission.

A staff letter was sent to the Commission in November with preliminary comments on the Commission's proposed rules dealing with reserves and segregation. In February the Board's reactions to

[50] A Report on The Auditors of Wall Street, Attorney General of the State of New York, July 1971.

[51] Rule 17(a)(3)

[52] Rule 15b8-2

these proposed rules [53] were conveyed to the Commission. In general, these were to the effect that while the Board strongly endorsed the objective of the rules to provide greater protection for customers' property and credits, a requirement for an appropriate reserve formula might afford a less complex and more easily enforceable solution to the problem.

The Board also authorized the dispatch of a letter to Herman W. Bevis, Executive Director of the Banking and Securities Industry Committee, supporting the Committee's program for encouraging state legislatures to amend state statutes in order to make possible more widespread use of securities depositories and thus reduce the volume of physical transfers of securities.

Following a staff review of proposals of the NASD, published in December 1971, for substantial revisions of its net capital requirements, the Board at its March meeting authorized a letter expressing SIPC's general support of the proposal and suggesting consideration of certain changes as to subordinated loans and a more stringent approach to "haircuts" on issues of small size and new issues when there is no record of earnings.

The Board, also at its March meeting, authorized the transmittal of comments by SIPC on a proposed revision of the Commission's Rule 17a-5.[54]

SIPC recently received advice that some progress was being made by the NASD and the Commission with representatives of certain insurance companies on the subject of requiring bonding of brokers or dealers doing a public securities business—a matter raised by SIPC in 1971.

[53] SEC Release No. 9388 relating to Proposed Rules 15c3-3 and 15c3-4.

[54] SEC Release No. 9404.

ADMINISTRATION

Directors

Information concerning the compensation of SIPC's Directors is reflected in the bylaws, which are public documents.

Two directors are employees of their respective government departments or agencies and as such are paid their salaries and expenses by their employers, including those which might be attributable to SIPC. Neither they nor their employees receive remuneration or reimbursement from SIPC.

The three industry directors have declined any compensation from SIPC but are reimbursed by SIPC for out-of-pocket expenses in connection with the attendance of SIPC Directors' meetings. They have made available to SIPC personnel, staff assistance and data from their firms without charge to SIPC in connection with SIPC's consideration of various industry problems.

The Chairman of the Board has been serving SIPC on a full-time basis as Chief Executive Officer since January 1971 at an annual salary equal to that paid a member of the Securities and Exchange Commission ($38,000) plus reimbursement of out-of-pocket expenses when away from Washington on SIPC business. Chairman Woodside was a commissioner of the Securities and Exchange Commission from 1960 until 1967. In addition he had served in various capacities with the Commission since its creation in 1934, including service for 8 years as Director of its Division of Corporate Finance.

Personnel

The Vice President-Finance, a former chief examiner of the New York Stock Exchange, Inc., assumed his position with SIPC on March 15, 1971; and the General Counsel, who previously had been connected with the Securities and Exchange Commission, the University of Connecticut and the House Interstate and Foreign Commerce Committee, joined the staff on March 22, 1971. At the end of March 1972 the staff consisted of 18 persons. Five were attorneys, and five were accountants, three of whom had had experience in the operation or liquidation of brokerage firms. Two of the professional people had investigative or financial backgrounds, one of whom had had many years experience at the Securities and Exchange Commission. The professional personnel have the support of an excellent secretarial staff.

It is estimated that additional people may be required in the not too distant future. The Board wishes to secure the services of an economist. Experience to date indicates the need for establishing a fraud unit, and additional lawyers and accountants will be needed, particularly if, as it appears, SIPC or the trustees will become increasingly involved in litigation. During the first year it was necessary to rely heavily on outside counsel and accountants, particularly in the initial stages. The general policy has been to provide for only a small specialized permanent staff and seek the assistance of professional help on a consulting or temporary basis for some of the larger or more difficult problems, or when distance presents difficulties. It would not be feasible to attempt to have a network of offices around the country and, accordingly, SIPC relies on local legal and accounting firms to represent SIPC at distant points when necessary.

SIPC is developing an employee benefit and retirement plan for the employees which compares favorably with the United States Government plan. SIPC's salary scale also compares in a general way with the salaries paid by government offices to professional people.

Lease

SIPC has a five-year lease running from September 1971 on approximately 4500 square feet of space in a new building. The office layout was designed to accommodate operations as visualized in mid-1971. The course of events necessarily will determine whether more or less space will be required.

SIPC Expenditures for 1971

Appendix IV shows the expenditures of the Corporation during the year 1971, appropriately classified according to functions. The average employment in 1971 should be considered as 9-10 persons. The average employment for 1972 will not exceed 21-22 persons since the first quarter of the year has passed with the employment level below 20 and the recruiting process extends over several months.

FINANCIAL STATEMENTS

LYBRAND, ROSS BROS. & MONTGOMERY

The Board of Directors
Securities Investor Protection
Corporation

We have examined the statement of financial condition of Securities Investor Protection Corporation as of December 31, 1971, and the related statements of operations and fund balance and changes in financial position for the period December 30, 1970 (inception date) to December 31, 1971. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As explained in Note 3, the balance of assessments due by May 1, 1972 for the year ended December 31, 1971 is not presently determinable and consequently it has not been recorded. Furthermore, as explained in Note 5, no provision for liquidation costs to be incurred in subsequent years on liquidations commenced under the Act during the year ended December 31, 1971, is determinable as of that date and consequently it has not been recorded.

In our opinion, except for the matters discussed above, the aforesaid financial statements (page 35 to 37) present fairly the financial position of Securities Investor Protection Corporation at December 31, 1971 and the results of its operations and changes in financial position for the period December 30, 1970 (inception date) to December 31, 1971, in conformity with generally accepted accounting principles.

Lybrand, Ross Bros. & Montgomery

Washington, D. C.
March 6, 1972

SECURITIES INVESTOR PROTECTION CORPORATION
STATEMENT OF FINANCIAL CONDITION
December 31, 1971

ASSETS

Cash:	
Operating and collection accounts	$ 152,834
Compensating balances (Note 2)	6,500,000
	6,652,834
Member assessments receivable (Note 3)	5,710,000
U. S. Government obligations, at cost, plus accrued interest receivable, approximates market value (face value $20,345,000)	19,852,060
Furniture, equipment and leasehold improvements, at cost, less $1,548 accumulated depreciation and amortization	40,472
Advances to trustees less $475,800 provision for possible losses (Note 5)	—
Other	1,018
	$32,256,384

LIABILITIES AND FUND BALANCE

Accounts payable and accrued expenses	$ 355,788
Commitments (Notes 5 and 6)	
Fund balance	31,900,596
	$32,256,384

STATEMENT OF OPERATIONS AND FUND BALANCE
for the period from December 30, 1970 (inception) through December 31, 1971

Revenues:	
Member assessments (Note 3)	$29,778,269
Contribution from a prior trust (Note 4)	3,011,925
Income from U. S. Government obligations	490,042
	33,280,236
Expenses:	
Administrative:	
Salaries and employee benefits	189,878
Assessment collection direct costs	35,780
Credit agreement commitment fee (Note 2)	236,527
Legal fees	70,987
Accounting fees	22,074
Other	64,634
	619,880
Preparation costs related to potential major liquidations	156,328
Start-up expense—attorney's and accountant's fees and printing expense related to credit agreement and assessment procedures	127,632
Provision for possible loss on advances to trustees (Note 5)	475,800
	1,379,640
Excess of revenues over expenses and fund balance	$31,900,596

The accompanying notes are an integral part of the financial statements.

STATEMENT OF CHANGES IN FINANCIAL POSITION
for the period from December 30, 1970 (inception) through December 31, 1971

Source of funds:	
Excess of revenues over expenses	$31,900,596
Provision for possible loss on advances to trustees	475,800
Provision for amortization and depreciation	1,548
	32,377,944
Accounts payable and accrued expenses	355,788
Total funds provided	32,733,732
Application of funds:	
Accrued member assessments	5,710,000
Accrued interest	331,204
Purchases of U. S. Government obligations (net)	19,520,856
Leasehold improvements and purchases of furniture and equipment	42,020
Advances to trustees	475,800
Other	1,018
Total funds applied	26,080,898
Cash balance	$ 6,652,834

The accompanying notes are an integral part of the financial statements.

NOTES TO FINANCIAL STATEMENTS

1. Organization

The Securities Investor Protection Corporation (SIPC) was created by an Act of Congress on December 30, 1970, for the purpose of providing protection to customers of brokers or dealers. SIPC is a non-profit membership corporation and shall have succession until dissolved by an Act of Congress. Its members include all persons registered as brokers or dealers under section 15(b) of the 1934 Securities Exchange Act and all persons who are members of a national securities exchange except for those persons excluded under the Act. SIPC had no financial transactions prior to January 1, 1971.

2. Lines of credit

Under a provision of the Act, SIPC entered into an agreement dated April 14, 1971, and expiring on October 13, 1976, with certain banks which extended confirmed lines of credit in an aggregate amount of $65,000,000. A 10/65th portion of the original commitment, to the extent not theretofore availed of, expires annually on the anniversary date, commencing with the year 1972. The Act requires a phase-out of confirmed lines of credit when the balance of the SIPC fund (as defined by the Act) aggregates $150,000,000.

Pursuant to the April 14, 1971 agreement, SIPC has agreed to maintain compensating cash balances equal to 10% of the confirmed lines of credit and to pay a fee of ½ of 1% per annum on the average daily unused portion thereof to each bank.

In the event that the SIPC fund is or may reasonably appear to be insufficient for the purposes of the Act, the Securities and Exchange Commission is authorized to make loans to SIPC and in that connection, the Commission is authorized to issue to the Secretary of the Treasury, notes or other obligations in an aggregate amount not to exceed $1,000,000,000.

3. Member assessments receivable and assessment revenues

The Act imposed an initial assessment of ⅛ of 1% per annum on each member's 1969 gross revenues from the securities business as defined in the Act, payable within 120 days of enactment date. Revenues from initial assessments aggregate $5,669,180.

An annual general assessment was imposed for 1971 payable quarterly at the rate of ½ of 1% per annum on gross revenues from the securities business. SIPC members were also allowed to make estimated quarterly payments based upon 1969 gross revenues. Any underpayment for the year 1971 is due by May 1, 1972. Member assessments receivable at December 31, 1971 are based upon collections received through February 29, 1972, and do not include any additional amounts due by May 1, 1972. Any 1971 overpayment may be credited against future assessments.

4. Contribution from a prior trust

$3,011,925 was contributed from a special trust fund of the American Stock Exchange Inc., members of which shall be entitled to a reduction in amounts payable on future assessments, as provided in the Act. The Board of Directors has not determined when and on what basis such reductions may be made.

5. Advances to trustees and commitments

Trustees have been appointed under the Act for twenty-four SIPC member firms as of December 31, 1971. As of February 29, 1972 a total of thirty-three trustees have been appointed. Because of inadequate and incomplete books and records of these firms, data presently available from the Trustees are inconclusive and no determination of the ultimate amounts which may be required for advances to satisfy customer claims nor for the liquidation expenses which will be incurred is possible at this time.

The amounts advanced in connection with these liquidations represent actual disbursements through February 29, 1972. SIPC has adopted the policy of providing a 100% reserve for all advances made to Trustees.

6. Lease

The Corporation leases office space under a lease providing for aggregate annual payments of $31,823 through September 1976.

APPENDICES

April 14, 1970.

Hon. Hamer H. Budge,

Chairman, Securities and Exchange Commission,
Washington, D. C.

Dear Chairman Budge: Various securities industry groups have been considering for some time new ways of extending and expanding programs for the protection of customers' funds and securities held by broker-dealers. Last week, the presidents of the New York Stock Exchange and the Investment Bankers Association informed you that a broad-based securities industry committee had been formed to develop a definitive program for this purpose.

Today, the Committee, composed of the major industry organizations listed below, met and unanimously endorsed a program with the following objectives:

First, to expand the protection available to *all* customers for their funds and securities held by broker-dealers.

Second, to develop such a program consistent with the established public policy of self-regulation in the securities industry.

Third, to develop the program to reflect the particular needs and circumstances of each industry organization.

Fourth, to provide an equitable formula of financing such a program—equitable in terms of both the size and nature of the risk involved.

Fifth, to present to the Securities and Exchange Commission and to Congress a unified and constructive approach by the entire securities industry.

Accordingly, within the fabric of self-regulation and based on appropriate analysis, the securities industry is undertaking an unequivocal commitment to develop a plan that will protect public customers of broker-dealers up to certain defined limits.

A "task force" composed of the following industry representatives was formed to develop a program consistent with the objectives agreed upon and to provide a report by July 1, 1970:

Mr. Ralph D. DeNunzio (New York), New York Stock Exchange—Chairman.

Mr. Watson B. Dabney (Louisville), National Association of Securities Dealers, Inc.

Mr. Robert M. Fomon (Los Angeles), Pacific Coast Stock Exchange.

Mr. Clifford W. Michael (New York), Association of Stock Exchange Firms.

Mr. Francis R. Schanck, Jr. (Chicago), Midwest Stock Exchange.

Mr. Robert C. Van Tuyl (New York), American Stock Exchange.

Mr. Wheelock Whitney (Minneapolis), Investment Bankers Association of America.

The Committee hopes that the precedent of careful study and consultation between the Securities and Exchange Commission and the securities industry will be followed to provide a sound program for the protection of all public investors.

Sincerely,
Ralph S. Saul, President, American Stock Exchange; Harold A. Rousselot, Chairman, Association of Stock Exchange Firms; James E. Dowd, President, Boston Stock Exchange; Andrew J. Melton, Jr., President, Investment Bankers Association of America; Michael E. Tobin, President, Midwest Stock Exchange; Gordon S. Macklin, Jr., President, National Association of Securities Dealers: Robert W. Haack, President, New York Stock Exchange; Robert M. Fomon, Chairman, Pacific Coast Stock Exchange; Elkins Wetherill, President, Philadelphia-Baltimore-Washington Stock Exchange.

Memorandum of the Securities and Exchange Commission Regarding Possible Amendment of the Bankruptcy Act

At the hearings before the Subcommittee on Securities of the Senate Committee on Banking and Currency on July 16, 1970 with respect proposed legislation to protect investors against loss due to a broker-dealer's financial difficulties, Senator Williams requested a memorandum with respect to possible amendments to the bankruptcy law contained in the proposed Securities Investor Protection Act of 1970 a draft of which was submitted for the record during those hearings. This memorandum is submitted in response to that request. Hereafter in this memorandum reference will be made to that draft bill which is dated July 16, 1970.[1]

The bill does not in fact amend the Bankruptcy Act in any way. Rather, the bill contemplates the liquidation of broker-dealer firms in financial difficulties, not pursuant to the Bankruptcy Act, but pursuant to special procedures set forth in subsection (m) of section 35 of the Securities Exchange Act as proposed to be added by the bill. There are a number of reasons for adopting this approach, including the following:

1. Liquidation of a broker-dealer firm pursuant to the bill would not be an ordinary bankruptcy proceeding initiated by creditors, but rather would be a special proceeding initiated by the Securities Investor Protection Corporation, provided for in the bill, primarily for the protection of all customers of the broker-dealer in question.

2. To the extent necessary, the Corporation will advance funds to the trustee for the benefit of customers, in amounts up to the limit of $50,000 for each customer which is provided for in the bill. Such arrangements have no parallel in bankrutcy proceedings.

3. The procedure is designed to pay customers claims as rapidly as possible, making use of funds advanced by the Corporation and other special procedures provided in the bill for this purpose, thus avoiding the lengthy delays which may occur in ordinary bankruptcy proceedings.

4. The trustee will normally complete open contractual commitments of the debtor where customer's interests are involved. This would not necessarily be done in ordinary bankruptcy proceedings.

While the bill, therefore, provides its own special liquidation procedures as a substitute for ordinary bankruptcy laws in order to obtain the benefits of existing legislation and experience in this area. Thus, subparagraphs (m)(6) and (7) provide that a trustee appointed pursuant to the bill is vested with the same powers and duties as a trustee in bankruptcy together with certain additional powers appropriate to the special nature of the proceedings. Subparagraph (m)(8) provides that except to the extent inconsistent with the provisions of the bill and except that no reorganization shall be attempted, proceedings shall be conducted in accordance with the provisions of Chapter X of the Bankruptcy Act and such other provisions of the Bankruptcy Act as Section 102 of Chapter X of the Act would make applicable.

Subparagraph (m)(7) together with subparagraph (m)(13) excludes from the class of customers who the extent practicable, will satisfy the claims of customers who are entitled to securities by delivering such securities to them. In ordinary bankruptcy proceedings the trustee would normally sell all securities and distribute cash to customers. Subparagraph m)(13) excludes from the class of customers who may benefit from advances by the Corporation, customers who are partners, officers, directors or substantial stockholders of a broker-dealer in liquidation.

Section 60(e) of the Bankruptcy Act (11 U.S.C. 96(e)) contains special definitions and procedures applicable to the bankruptcy of a "stock broker."

Clause (a) of paragraph 10 of subsection (m) of the bill incorporates section 60(e) of the Bankruptcy Act by reference and thus brings into play the provisions of section 60(e) dealing with the right of customers of a bankrupt stock broker to recover specifically identifiable property in the custody of the stock broker and the concept of a "single and separate fund" consisting of all property received, acquired, or held by a stock broker from or for the account of customers except specifically identifiable property of a customer which would be recovered, by him. Such single and separate fund is used to pay claims of customers.

The remaining clauses of paragraph 10 of subsec-

[1] A bill substantially identical to such draft was introduced in the House of Representatives on July 14, 1970, by Chairman Moss and other members of Congress, as H.R. 18458.

tion (m) modify to some degree the operation of the provisions of section 60(e) of the Bankruptcy Act as so incorporated by reference, in order to eliminate certain anomalies and to accommodate the procedures to changes in the practices of the securities industry which have developed since 1938 when section 60(e) was enacted. Thus, the first sentence of subparagraph (B) makes it clear that the term "stock broker" includes a securities firm acting as a dealer as well as a firm acting as a broker. Subparagraph (D) contemplates the completion of open contractual commitments. Subparagraph (E), together with other provisions of the bill, provides for the recovery of certain advances by the Corporation, and subparagraph (F) includes in the category of specifically identifiable property which may be recovered by customers securities held in bulk segregation or as a part of any central certificate service of a stock clearing corporation or similar depository if the identity of the customers entitled to these particular securities is established to the satisfaction of the trustee. This subparagraph also grants to the Commission certain rule-making power with respect to the identification of property as belonging to particular customers.

In summary, the bill does not in any way amend the Bankruptcy Act, as such, but rather, provides, a specialized liquidation procedure for securities firms in financial difficulties which is designed to accomplish the purposes of the bill in a prompt and fair way, including utilization of any funds advanced by the Corporation. In so doing, the bill draws heavily upon the provisions of the bankruptcy laws, many of which are incorporated by reference, but modifies these procedures to the extent determined necessary to accomplish the special purposes of the bill.

FIRMS IN LIQUIDATION BY DATE OF APPOINTMENT OF TRUSTEE AND BY QUARTER

First Quarter 1971

Company, location of main office and trustee	Date registered as Broker-Dealer	Initial Capital	Receiver Appointed	Trustee Appointed	Notice of appointment of Trustee Published	No. to whom Notices and claim forms were mailed
Orin R. Dudley d/b/a Orin R. Dudley Co. New York, New York (J. Lincoln Morris, Esq.)	12/12/63	$ 26,210	3/ 5/71	3/29/71	4/10/71	1,400

Total trustees appointed this quarter: 1

Second Quarter 1971

Joseph Garofalo d/b/a Josephson Company New York, New York (Sidney Leeds)	12/ 8/68	10,500	3/ 5/71	4/23/71[1]	10/13/71	550
Howard Carlton, Inc. New York, New York (Clark Gurney, Esq.)	5/31/69	5,000	2/16/71	4/ 8/71	4/26/71	350
Stan Ingram & Associates Los Angeles, California (Harold Orchid, Esq.)	12/22/68	19,871	2/22/71	6/ 8/71[2]	10/27/71	400
First Investment Savings Corp. Birmingham, Alabama (William Green, Esq.)	3/16/56	9,137	None	6/18/71	6/30/71	300
Packer, Wilbur & Co., Inc. New York, New York (Martin Gold, Esq.)	6/22/61	9,000	4/ 7/71	6/21/71	8/ 2/71	475
PLM Securities, Inc. Syracuse, New York (Howard Port)	8/ 9/67	25,000	4/ 8/71	6/28/71	7/24/71	900

Total trustees appointed this quarter: 6

[1] Application for appointment of trustee was filed August 9, 1971.

[2] Final report of Receiver was filed July 23, 1971 and approved by the Court August 9, 1971. Attorney to the Trustee was appointed by Court July 29, 1971.

R FOR THE PERIOD FROM DECEMBER 30, 1970 (INCEPTION) THROUGH MARCH 31, 1972

Number of Claims Received	Date Trustee's First Request for Advance Received	Detail of Trustees' Requests for Advances and Disposition thereof					
		Request Received	Advance Made	Administration Expenses	Open Contractual Commitments	Cash in Lieu of Securities	Free Credit Balances
128	8/20/71	8/20/71	10/ 1/71			$ 5,755.05	$ 7,020.09
		2/ 9/72	2/16/72			2,190.75	11,760.85
		2/18/72	2/24/72	$33,006.75			
		3/ 3/72	3/21/72	50.00			
				33,056.75		7,945.80	18,780.94
30							
22	9/16/71	9/16/71	10/14/71				3,514.78
		10/26/71	11/ 9/71	3,119.30		251.04	
		3/13/72			$15,513.50		
40							
225	7/26/71	7/26/71	7/30/71	1,800.00			
		8/31/71	9/ 8/71				25,000.00
		9/27/71	9/28/71		2,380.00		5,604.20
		10/14/71	10/15/71			478.12	
		10/11/71	10/19/71	2,908.16			
		12/ 7/71	12/ 7/71	14,694.37			
238	11/18/71	1/18/72	1/20/72			112,437.25	82,001.66
21	8/30/71	8/30/71	10/14/71			18,448.76	
		10/28/71	10/29/71			10,385.13	351.00
		11/19/71	11/24/71			687.50	
				22,521.83	17,893.50	142,687.80	116,471.64

FIRMS IN LIQUIDATION BY DATE OF APPOINTMENT OF TRUSTEE AND BY QUARTER

Third Quarter 1971

Company, location of main office and trustee	Date registered as Broker-Dealer	Initial Capital	Receiver Appointed	Trustee Appointed	Notice of appointment of Trustee Published	No. to whom Notices and claim forms were mailed
John Edward & Co., Inc. Lebanon, New Hampshire (George Manias, Esq.)	1/17/68	$ 48,500	3/ 5/71	7/ 1/71	9/28/71	2,071
Security Planners Ltd. Boston, Massachusetts (William Foehl, Esq.)	2/12/68	45,000	7/ 2/71	8/ 6/71	8/17/71	50
Karle Burglund d/b/a Colonial Investment Securities Worchester, Massachusetts (Gordon A. Martin, Esq.)	12/13/68	20,173	1/15/71	8/ 6/71	8/16/81	49
Barnes, Ryder, Waddles & Co., Inc. Wichita, Kansas (Thomas R. Brunner)	11/13/69	42,270	6/28/71	8/18/71	8/27/71	2,900
Security Brokers Associates, Inc. Security Brokers Investment, Inc. Ft. Lauderdale, Florida (Carmen A. Accordino, Esq.)	2/26/69 3/26/70	88,400 25,000	None	8/20/71	8/28/71	41
Lang-Lasser & Co., Inc. Beverly Hills, California (Kevin O. Lewand, Esq.)	1/30/70	63,116	6/16/71	9/14/71	10/25/71	200
Far Western Securities, Inc. Tucson, Arizona (Thomas A. Latta, Esq.)	4/15/70	56,750	6/16/71	10/13/71	12/28/71	165

Total trustees appointed this quarter: 7

FOR THE PERIOD FROM DECEMBER 30, 1970 (INCEPTION) THROUGH MARCH 31, 1972

Number of Claims Received	Date Trustee's First Request for Advance Received	Detail of Trustees' Requests for Advances and Disposition thereof					
		Request Received	Advance Made	Administration Expenses	Open Contractual Commitments	Cash in Lieu of Securities	Free Credit Balances
181	11/29/71	11/29/71	12/ 2/71	$ 5,598.02			
		2/28/72	3/ 6/72	4,207.31			
30							
22	12/17/71	12/17/71	12/22/71				$13,427.66
		1/ 3/72	1/14/72	2,571.00			
		3/13/72	3/14/72				6,560.50
976	12/ 9/71	12/ 9/71	12/13/71				7,266.68
		3/27/72					
41	3/15/72	3/15/72					
6	12/22/71	12/22/71	1/ 6/72	981.10			
		12/22/71	1/ 6/72			$22,378.13	
100							
				13,357.43		22,378.13	27,254.84

FIRMS IN LIQUIDATION BY DATE OF APPOINTMENT OF TRUSTEE AND BY QUARTER

Fourth Quarter 1971

Company, location of main office and trustee	Date registered as Broker-Dealer	Initial Capital	Receiver Appointed	Trustee Appointed	Notice of appointment of Trustee Published	No. to whom Notices and claim forms were mailed
Buttonwood Securities, Inc. LaJolla, California (Edwin M. Lamb)	2/27/69	$ 60,500	9/ 8/71	10/18/71	11/18/71	4,300
Commonwealth Securities Nashville, Tennessee (Fred D. Bryan)	12/ 1/62	10,312	8/30/71	10/22/71	11/ 5/71	4,100
Financial Equities, Ltd. Los Angeles, California (Gilbert Robinson, Esq.)	3/26/70	217,004	9/17/71	11/ 8/71	1/16/72	4,000
Aberdeen Securities Co., Inc. Wilmington, Delaware (Claude P. Hudson)	5/14/69	26,000	9/20/71	11/22/71	12/ 8/71	1,800
Baron & Co., Inc. Jersey City, New Jersey (Mark F. Hughes, Esq.)	9/26/69	10,000	None	12/ 1/71	12/27/71	272
International Funding-Securities, Incorporated Long Beach, California (Sheldon Jaffe, Esq.)	3/31/62	32,988	6/ 8/71	12/ 6/71[2]	2/ /72	12,000
Securities Northwest, Inc. Seattle, Washington (George M. McBroom, Esq.)	6/23/71	5,000	None	12/ 7/71	1/14/72	940
Rodney B. Price & Co., Inc. Atlanta, Georgia (Robert E. Hicks, Esq.)	4/29/70	31,755	None	12/ 7/71	2/16/72	1,500
E. P. Seggos & Co., Inc. New York, New York (Clark J. Gurney, Esq.)	2/ 6/70	250,000		12/14/71	1/10/72	
Kelly, Andrews & Bradley, Inc. New York, New York (Edwin L. Gasperini, Esq.)	8/10/68	5,000	None	12/21/71	1/14/72	1,327

Total trustees appointed this quarter: 10

[1] Specifically identifiable property has been distributed to customers pursuant to Court order dated February 18, 1972. Distributions to meet customers' net equity claims are planned for the near future.

[2] Application for appointment of trustee was filed August 9, 1971.

FOR THE PERIOD FROM DECEMBER 30, 1970 (INCEPTION) THROUGH MARCH 31, 1972

Number of Claims Received	Date Trustee's First Request for Advance Received	Detail of Trustees' Requests for Advances and Disposition thereof					
		Request Received	Advance Made	Administration Expenses	Open Contractual Commitments	Cash in Lieu of Securities	Balances Free Credit
1,500	2/18/72	2/18/72	2/18/72				$13,179.92
250	11/ 5/71	11/ 5/71	11/12/71	$ 4,802.00			
		11/26/71	12/ 1/71				7,005.70
		11/26/71	3/20/72			$10,229.75	
		1/13/72	3/20/72			32,912.57	5,974.03
546	[1]						
323	12/22/71	12/22/71	12/29/71		$17,472.00		
193							
800	2/25/72	2/25/72	3/ 1/72	13,248.12			
80	12/10/71	12/10/71	12/10/71		14,180.00		
		12/10/71	12/22/71		17,642.57		
84							
	12/27/71	12/27/71	1/ 3/72	2,500.00			
200	1/14/72	1/14/72	1/14/72	3,000.00			
		3/ 2/72	3/ 2/72	3,000.00			
		3/13/72	3/15/72	5,612.50			
				32,162.62	49,294.57	43,142.32	26,159.65

FIRMS IN LIQUIDATION BY DATE OF APPOINTMENT OF TRUSTEE AND BY QUARTER

First Quarter 1972

Company, location of main office and trustee	Date registered as Broker-Dealer	Initial Capital	Receiver Appointed	Trustee Appointed	Notice of appointment of Trustee Published	No. to whom Notices and claim forms were mailed
Mid-Continent Securities Co., Inc. Wichita, Kansas (Thomas R. Brunner)	12/31/50	$ 20,000	None	1/ 3/72	1/14/72	1,385
F. O. Baroff Company, Inc. New York, New York (Edward S. Davis, Esq.)	10/29/66	19,679	None	1/ 6/72	1/ 7/72	4,225
Alan F. Hughes, Inc. Schenectady, New York (William J. Quinlan, Esq.)	12/ 9/65	9,001	9/ 9/71	1/11/72	1/31/72	802
A. H. Simon Securities New York, New York (Winthrop J. Alleagert, Esq).	9/14/70	12,575	None	1/17/72	2/24/72	110
Quodar Equities, Ltd. Great Neck, New York (Edward J. Rosner, Esq.)	12/30/70	28,055	None	1/21/72	2/11/72	804
Murray, Lind & Co., Inc. Jersey City, New Jersey (Mark F. Hughes, Esq.)	5/23/69	227,215	None	1/24/72	2/16/72	1,186
S. J. Salmon & Co., Inc. New York, New York (John C. Fontaine, Esq.)	8/17/68	10,000	None	2/ 7/72	2/ 8/72	4,945
JNT Investors, Inc. New York, New York (Jerry B. Klein)	6/17/70	35,000	None	2/15/72	2/25/72	3,150
C. H. Wagner & Co., Inc. Boston, Massachusetts (Thomas J. Carens, Esq.)	6/23/69	20,500	2/23/72	2/28/72		

FOR THE PERIOD FROM DECEMBER 30, 1970 (INCEPTION) THROUGH MARCH 31, 1972

Number of Claims Received	Date Trustee's First Request for Advance Received	Detail of Trustees' Requests for Advances and Disposition thereof					
		Request Received	Advance Made	Administration Expenses	Open Contractual Commitments	Cash in Lieu of Securities	Free Credit Balances
456							
1,626	1/13/72	1/13/72	1/13/72	$ 5,000.00			
		1/21/72	1/21/72	4,000.00			
		1/26/72	1/26/72	17,000.00			
		2/ 2/72	2/ 2/72	3,600.00			
		2/ 9/72	2/17/72	8,400.00			
		2/24/72	3/ 6/72	14,500.00			
270							
	2/28/72	2/28/72	3/ 1/72	2,380.00			
	2/10/72	2/10/72	2/17/72	1,686.00			
749							
1,798	2/10/72	2/10/72	2/10/72	10,000.00			
889							
	3/27/72	3/27/72					

FIRMS IN LIQUIDATION BY DATE OF APPOINTMENT OF TRUSTEE AND BY QUARTER

First Quarter
1972 (Page 2)

Company, location of main office and trustee	Date registered as Broker-Dealer	Initial Capital	Receiver Appointed	Trustee Appointed	Notice of appointment of Trustee Published	No. to whom Notices and claim forms were mailed
J. R. Radin & Co., Inc. New York, New York (William W. Golub, Esq.)	3/30/70	78,000	None	3/ 9/72	3/20/72	1,190
Charisma Securities Corp. New York, New York (Edwin L. Gasperini, Esq.)	7/ 4/69	19,115	None	3/ 9/72	3/24/72	804
First Continental Securities, Inc. Dallas, Texas (William M. King, Esq.)	12/ 2/64	4,002	None	3/14/72		
Robert E. Wick Company Oak Park, Illinois (J. Kirk Windle, Esq.)	1/15/70	62,751	None	3/14/72	3/24/72	49
Barrett and Co., Inc. Minneapolis, Minnesota (Lawrence Perlman, Esq.)	5/17/71	30,867	None	3/29/72		
White and Co. St. Louis, Mo. (Hugh S. Hauck)	3/ 5/47	N/A	None	3/30/72		

Total trustees appointed this quarter: 15

[1] Debtor filed motion January 21, 1972 for reconsideration of the Court order appointing trustee. Motion was denied February 10, 1972 and an appeal of this denial is pending.

Amounts above are reflected in SIPC accounting periods as follows:
December 30, 1970 (inception) through December 31, 1971
January 1, 1972 through March 31, 1972 (Except as to advances requested but not made which may be subject to adjustment)

GENERAL NOTES:

1. The books and records of the debtors being liquidated are generally found by the Trustee to be (1) not up to date, (2) incomplete, (3) irreconcilable, (4) non-existent, or a combination of these. Construction of the necessary financial data is proving to be a task of major proportions and a cause of considerable administrative expense.
2. Based upon claims received by them to date, Trustee have reported the following number of claims that exceeded the $50,000/$20,000 limitations provided in the Act:

	No. of claims reported
Claims for free credit balances	3
Claims for securities	5

FOR THE PERIOD FROM DECEMBER 30, 1970 (INCEPTION) THROUGH MARCH 31, 1972

Number of Claims Received	Date Trustee's First Request for Advance Received	Detail of Trustees' Requests for Advances and Disposition thereof					
		Request Received	Advance Made	Administration Expenses	Open Contractual Commitments	Cash in Lieu of Securities	Free Credit Balances
	3/21/72	3/21/72	3/22/72	3,000.00			
				69,566.00			
			Totals				
			$475,799.54	74,980.70	51,674.57	173,011.73	176,132.54
			166,874.28	95,683.93	15,513.50	43,142.32	12,534.53
			$642,673.82	$170,664.63	$67,188.07	$216,154.05	$188,667.07

ANALYSIS OF SIPC 1971 EXPENDITURES

Administrative		
Salaries and Employee Benefits		
Salaries	$178,036.47	
FICA taxes	4,509.10	
Federal unemployment tax	250.00	
D. C. unemployment tax	1,298.00	
Group life insurance	2,943.00	
Group health insurance	2,841.75	$ 189,878.32
Assessment collection direct costs		
Printing and mailing SIPC forms	33,629.95	
SECO collection agent	2,150.00	35,779.95
Credit agreement commitment fee		236,527.00
Legal Fees		70,986.57
Accounting Fees		22,074.32
Other		
Directors fees and expenses	8,608.75	
Travel and subsistence	4,154.65	
Personnel recruitment	3,789.81	
Rent—office space	10,849.26	
Depreciation and amortization	1,548.00	
Insurance	2,549.00	
Postage	1,068.71	
Office supplies and expense	13,139.70	
Telephone and telegraph	4,583.56	
Custodian fees	4,537.66	
Miscellaneous	9,806.04	64,635.14
		619,881.30
Costs of Preparing for Possible Major Liquidation in Early 1971		
Legal fees	126,528.13	
Accounting fees	29,800.00	156,328.13
Start-Up Expense—Attorneys' and Accountants' Fees and Printing Expense Related to Credit Agreement and Assessment Procedures		
Accounting fees	69,359.04	
Legal fees	48,570.76	
Printing	9,702.40	127,632.20
Provision for Possible Loss on Advances to Trustees		475,799.54
Total		$1,379,641.17

FORMS FOR USE BY SIPC MEMBER FIRMS

1. SIPC members during the year 1971 filed with their examining authority, pursuant to Section 8 of the Act, one or more of the following forms adopted by SIPC for use by members in paying SIPC assessments under Section 4:

SIPC–1 **Initial Assessment and Information Form**—filed by members who, in 1970, filed Part I, II or III to Form 17A–10 covering calendar year 1969.

SIPC–2 **Initial Assessment and Information Form**—filed by members who, in 1970 filed only the introduction for Form 17A–10 covering calendar year 1969.

SIPC–3 **Certification of Exclusion from Membership**—filed by a broker-dealer who is excluded from membership in SIPC under Section 3(a)(2) of the Act and who does not wish to apply for voluntary membership under Section 3(f) of the Act.

SIPC–4 **Application for Voluntary Membership**—filed by a broker-dealer who is excluded from membership in SIPC under Section 3(a)(2) of the Act but who wishes to apply for voluntary membership under Section 3(f) of the Act.

SIPC–5 **Initial Assessment and Information Form**—filed by members of SIPC who became registered broker-dealers or exchange members subsequent to December 31, 1969 and prior to April 29, 1971 and did not receive any gross revenues from the securities business during the calendar year 1969.

SIPC–6 **Quarterly General Assessment Payment Form**—filed by all members of SIPC.

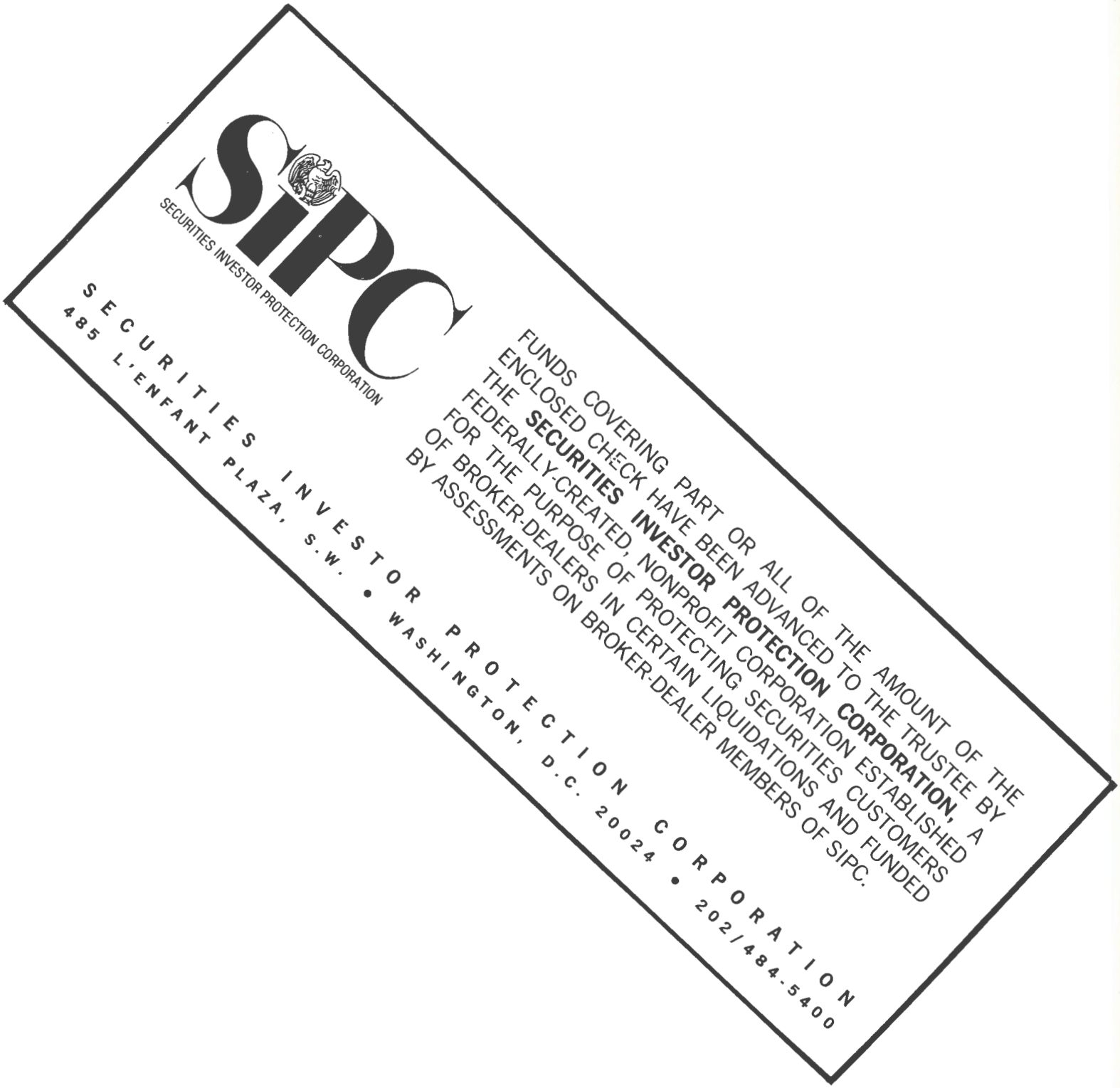
SIPC–7 **Annual General Assessment Reconciliation Form**—filed by members of SIPC who file the Introduction, Part I, II or III of Form 17A–10 covering calendar year 1971.

Each of the above forms, with the exception of Forms SIPC 3 and 4, are designed to report the members' gross revenues from the securities business as defined in Section 4(i) of the Act, and to compute the assessment based on those revenues.

SIPC–3 is a certification by a member that his business as a broker or dealer is confined exclusively to one or more of the exclusions set forth in Section 3(a)(2) of the statute.

SIPC–4 is an application for voluntary membership pursuant to Section 3(f) of the Act. The statute provides that any person who is a broker, dealer or member of a national securities exchange and is excluded from membership pursuant to Section 3(a)(2) may become a member of SIPC under such terms and conditions as SIPC may require. The Board of Directors has, for the immediate future, deferred adopting policies concerning requirements for membership under Section 3(f).

FORM OF NOTICE ENCLOSED WITH TRUSTEES' CHECKS IN PAYMENT OF CUSTOMERS' CLAIMS



DESIGNED AND LITHOGRAPHED by HENNAGE • WASH., D. C.

SECURITIES INVESTOR PROTECTION CORPORATION

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