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## SEC FINANCIAL REQUIREMENTS FOR BROKER-DEALERS: ECONOMIC IMPLICATIONS OF PROPOSED REVISIONS\*

JAMES S. MOFSKY†

The 1960's witnessed a tremendous growth for the securities industry, estimated to be twenty per cent compounded yearly.<sup>1</sup> During that period the volume of securities transactions swelled far more than had been predicted, and the number of shares outstanding, number of shareholders and amount of brokerage profits increased dramatically.<sup>2</sup> In retrospect, it does not seem surprising that the expansion of the securities industry during that period would generate its own set of special problems.<sup>3</sup> Yet those industry-wide problems either were not timely recognized or, if recognized, were not dealt with effectively as they occurred.<sup>4</sup> It was not until the market decline of 1966-1970, when a large number of securities firms were liquidated, merged or ceased doing business,<sup>5</sup> that those problems came into clearer focus for most non-industry observers. After those involved had failed to take immediate action to solve their problems,<sup>6</sup> the securities industry was unable to

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\* The field of securities regulation is a fast-moving area of the law. Prof. Mofsky's article was current as of December 1, 1971.

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1. See STAFF OF SPECIAL SUBCOMM. ON INVESTIGATIONS OF THE HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, 92D CONG., 1ST SESS., REVIEW OF SEC RECORDS OF THE DEMISE OF SELECTED BROKER DEALERS 1 (Comm. Print 1971) [hereinafter cited as SEC RECORDS REVIEW]. Portions of the study referred to in the text are reprinted in BNA SEC. REG. L. REP., July 28, 1971, at E-1 to E-4.

2. See SEC RECORDS REVIEW, *supra* note 1.

3. *Id.* See also note 52 *infra* and text accompanying.

4. For example, although the New York Stock Exchange established a ten million dollar trust fund with a fifteen million dollar line of credit for the protection of the customers of financially troubled members, the trust instruments provided that use of funds was voluntary, the Exchange vacillated with respect to use of the funds for those member firms forced into bankruptcy or liquidation and the fund eventually was almost exhausted. Additionally, there was no similar fund for the protection of investors who dealt with over-the-counter broker-dealers, and the existing bonding requirements of the various states or exchanges either were too small to afford adequate protection or were drafted so that persons other than customers were beneficiaries. For a discussion of those and other matters, see Sowards & Mofsky, *The Securities Investor Protection Act of 1970*, 26 BUS. LAW. 1271 (1971) [hereinafter cited as Sowards & Mofsky].

5. During the 1969-70 crisis, a total of 129 New York Stock Exchange member firms went out of business, merged or were otherwise acquired by other firms. See BNA SEC. REG. L. REP., Aug. 4, 1971, at A-11.

6. Eventually, the industry did initiate some solutions prior to the enactment of the Securities Investor Protection Act of 1970. See H.R. 18081, H.R. 18109, H.R. 18458, 91st Cong., 2d Sess. (1970). See also Barron's, Dec. 28, 1970, at 7, col. 1; Barron's, Dec. 21, 1970, at 3. But they came too late to overcome the strong sentiment favoring govern-

remedy the situation without government intervention. As the rash of brokerage failures, forced liquidations and mergers proliferated, the political pressures for regulatory solutions imposed by government increased. Congress responded by enacting the Securities Investor Protection Act of 1970<sup>7</sup> and embarking on subcommittee investigations and studies.<sup>8</sup>

In the aftermath of brokerage failures, the New York Stock Exchange and the Securities and Exchange Commission were severely criticized for their failure to anticipate the problems and to deal with them effectively as they occurred.<sup>9</sup> Although there were many reasons for the brokerage failures during that period, those reasons were often over-simplified as "capital deficiency."<sup>10</sup> Thus, the respective provisions of the Exchange and Commission net capital rules<sup>11</sup> that regulate the capital requirements of broker-dealers came under close scrutiny and attack. In July 1971 the Exchange responded with broad revisions of its rule<sup>12</sup> which, although deemed by the Commission to impose more comprehensive requirements than those of the Commission rule, in

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ment intervention that had built up. See *Hearings on S. 2348 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 91st Cong., 2d Sess. 33 (1970).

7. 15 U.S.C. § 78 o, 78aaa-78111 (1970).

8. See, e.g., SEC RECORDS REVIEW, *supra* note 1. Section 11(h) of the Securities Investor Protection Act of 1970 requires the SEC to make a study of unsafe and unsound practices of broker-dealers and report to Congress, within twelve months, the steps being taken to eliminate those practices. That study and report have not yet been released.

9. See *Hearings on S. 2348 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 91st Cong., 2d Sess. (1970).

10. Although the SEC RECORDS REVIEW, *supra* note 1, recognized the problems that resulted in brokerage failures during 1969-70, it too finally recorded each instance of brokerage failure as a capital deficiency. See BNA SEC. REG. L. REP., July 28, 1971, at E-1.

11. NYSE rules 325, 326, 313 and 320. For the revised texts of the Exchange financial rules for broker-dealers, see BNA SEC. REG. L. REP., July 21, 1971, at I-1 to I-9. The Commission's rule (15c3-1) may be found in 17 C.F.R. § 240.15c 3-1 (1971).

12. Among the more significant revisions of the New York Stock Exchange rule are: a lowering of the net capital ratio from twenty-to-one to fifteen-to-one; a doubling of the minimum capital requirement to 100,000 dollars; a limitation on the expansion of member firms having a net capital ratio in excess of ten-to-one for fifteen consecutive business days; notification of the Exchange and possible business cutbacks when a firm's ratio reaches twelve-to-one; restrictions on the withdrawal of firm capital; deduction of full short security differences more than 44 days old from net capital; and increased "haircuts" on securities held for capital purposes. For the complete revised text of the Exchange rules, see BNA SEC. REG. L. REP., note 1, July 21, 1971, at I-1 to I-9. Although the practice of carrying subordinated loans as assets but not as liabilities had been severely criticized during and after the 1969-70 crisis, that practice was not prohibited in the revised Exchange rules, although there were some limitations placed on withdrawal (no withdrawal for at least one year and then only on six months' notice). The proposed changes to the SEC's net capital ratio rule do nothing to alter previous practices in this connection.

certain respects actually impose less stringent requirements.<sup>13</sup> The Commission has proposed amendments to its net capital rule which, if adopted, could have far-reaching economic implications that are not obvious. In addition, the Commission has proposed other rules that pertain to the financial responsibilities of broker-dealers and that similarly may have significant, unannounced implications. It is the purpose of this article to point out those expensive consequences in the hope that the Commission will carefully weigh those costs against the presumed benefits and not blithely adopt additional regulation solely under the banner of "investor protection."

At the outset, it is important to recognize the underlying purpose of the net capital rule. There are actually two parts to the rule, each of which serves separate and related functions. First, the rule requires that a broker or dealer's "aggregate indebtedness" be not more than twenty times his "net capital," as those terms are defined.<sup>14</sup> This aspect of the rule amounts to a continuous, operational limit on the aggregate indebtedness of a broker-dealer that must be met as long as he remains in the business. If a broker-dealer decides to increase his aggregate indebtedness by 1,000 dollars, compliance with the rule requires him to increase his net capital fifty dollars.<sup>15</sup> Second, since 1965 the Commission's rule has required that brokers and dealers have and maintain a minimum capital of 5,000 dollars.<sup>16</sup> That requirement serves as a qualification device, since a broker or dealer cannot be registered with the Commission until he meets the 5,000 dollar requirement. The requirement serves also as

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13. In computing net capital under the SEC rule, there is a requirement that clearing corporation deposits, commissions receivable, securities shipped free and "haircuts" on net short positions be deducted. However, there is no requirement that amounts for those matters be deducted in computing net capital under the New York Stock Exchange rule. For a more detailed analysis of this matter and a computation of net capital under both SEC and NYSE rules (illustrating the less stringent requirements of the NYSE in some instances), see BNA SEC. REG. L. REP., Sept. 1, 1971, at A-7 to A-8. SEC rule 15c3-1(b)(2) exempts NYSE member firms from the Commission net capital rule on the ground that the Exchange rule and practices are more comprehensive than those of the Commission.

14. For detailed analysis of those terms, see E. WEISS, REGISTRATION AND REGULATION OF BROKERS AND DEALERS 57-71 (1965); 2 L. LOSS, SECURITIES REGULATION 1350-55 (2d ed. 1961, Supp. 1969).

15. See SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pt. I, at 86 (1963) [hereinafter cited as SEC SPECIAL STUDY REPORT].

16. 17 C.F.R. § 240.15c3-1(a)(2) (1970). Under certain circumstances the minimum capital need be only 2,500 dollars. These 2,500 dollar capital requirements are applicable only to broker-dealers whose transactions are limited to mutual fund shares and share accounts of insured savings and loan associations, provided such broker-dealers do not hold funds or securities for customers other than for prompt execution of transactions. 17 C.F.R. § 240.15c3-1(a)(2)(i-iii) (1970).

a continuous, operational requirement since the minimum capital must be maintained throughout the course of business. These two aspects of the rule are related in that the amount of aggregate indebtedness that may be incurred by a broker-dealer is computed as a multiple of the broker-dealer's net capital.

Originally, the Commission's rule was based solely on a ratio between net capital and aggregate indebtedness. There was no minimum capital requirement.<sup>17</sup> In 1963, the Special Study of Securities Markets, recommending the institution of a minimum capital requirement, emphasized its finding of a "disproportionate" number of violations of Commission rules (not necessarily rules relating to financial requirements of broker-dealers) among broker-dealers with small net capital positions.<sup>18</sup> Although the study showed no causal relationship between those violations and the low net capital of the broker-dealers involved, it nonetheless offered that evidence as a partial reason for its recommendation.<sup>19</sup> Additionally, the study offered evidence that broker-dealers with a net capital less than 5,000 dollars were more likely to violate the Commission's ratio rule than were securities firms having a greater capital.<sup>20</sup> Those reasons, along with a desire to instill more "confidence" among members of the financial community and a wish to create greater "commitment" and ability on the part of broker-dealers to meet their obligations, resulted in a recommendation that a minimum capital requirement be established as an essential qualification for securities firms.<sup>21</sup> The 5,000 dollar minimum capital requirement recommended by the study was ultimately adopted by the Commission in 1965.<sup>22</sup>

The question of minimum capital was not significantly raised again until the brokerage failures of 1969-1970. Although it was readily admitted that an increase in the minimum capital requirement to any specific level would not guarantee the success of a securities firm, a House of Representatives subcommittee staff in July, 1971 recommended such an increase.<sup>23</sup> In addition to advancing the old argument of "more serious commitment,"<sup>24</sup> the staff study also argued that an increase would provide more protection for funds contributed to the Securities

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17. See SEC SPECIAL STUDY REPORT, *supra* note 15.

18. *Id.* at 91.

19. *Id.*

20. *Id.*

21. *Id.* at 161-62.

22. See note 11 *supra*.

23. See note 1 *supra*.

24. See SEC SPECIAL STUDY REPORT, *supra* note 15, at 161.

Investor Protection Corporation.<sup>25</sup> Recommendations were also made by that same group to substantially reduce the permissible ratio of aggregate indebtedness to net capital.<sup>26</sup>

Shortly after publication of the subcommittee staff recommendations, the Securities and Exchange Commission proposed an amendment to its net capital rule that would impose an initial net capital ratio of eight-to-one (instead of the usual twenty-to-one ratio) on all brokers for the first twelve months of their existence and would increase the minimum capital requirement to 25,000 dollars.<sup>27</sup> Thus, the proposed lower ratio would be applicable only to relatively new brokerage firms. The proposed increase in minimum capital, while applicable to all firms regardless of their date of organization, would be imposed with respect to existing firms on the basis of 15,000 dollar minimum capital not later than six months after the effective date of the proposal increased to 25,000 dollars within twelve months after the effective date of the amendment.<sup>28</sup> New firms would be required to meet the 25,000 dollar standard immediately upon the amendment's effective date.<sup>29</sup>

The Commission offered only a short, superficial explanation for the proposed amendments to the net capital rule. In addition to references to the 1963 Special Study<sup>30</sup> and to the recommendations and findings of the staff of the House subcommittee,<sup>31</sup> the only rationale offered in the release proposing the amendments is a general statement that financial losses by customers, consisting of securities and cash in the possession of securities firms that have become insolvent, highlight the inadequacy of the present capital requirements for brokers and dealers.<sup>32</sup> Nowhere

25. For discussion of the function of the Securities Investor Protection Corporation, see notes 58-68 *infra* & text accompanying.

26. See note 1 *supra*.

27. Those persons described in note 16 *supra* were allowed to continue at the 2,500 dollar requirement level. SEC Exchange Act Release No. 9288 (Aug. 13, 1971).

28. *Id.*

29. *Id.*

30. See note 15 *supra*.

31. See note 1 *supra*.

32. The hardships as well as financial losses faced in recent years by customers respecting their securities and cash in the possession of broker or dealers who became insolvent have highlighted the inadequacy of the present capital requirements of brokers and dealers. It is accordingly imperative that increased net capital requirements be applied to brokers and dealers so that as going businesses they can meet all of their current obligations to transmit funds and securities to customers. In this connection, the Commission has recently cooperated with the New York Stock Exchange in its revision of the Exchange's net capital rule. One of the changes achieved thereby was to increase minimum net capital requirements to \$100,000 for member firms which carry customer accounts.

SEC Exchange Act Release No. 9288 (Aug. 13, 1971).

does the Commission release refer to the specific evidence upon which it bases its conclusion that the net capital rule is the culprit. The Commission mentions neither the number of securities firms affected by the proposals nor the possible harmful consequences of the amendments. The latter omission leads one to wonder whether such consequences were weighed against the benefits of the specific form of investor protection suggested.

Probably the most obvious implications of the proposed amendments to the Commission net capital rule are the anti-competitive ones. Although those ramifications are nowhere analyzed by the Commission, the long range interests of "investor protection," in whose name the amendments are being proposed, clearly require their consideration. A diminution of competition will surely breed such harmful side effects as higher brokerage commissions,<sup>33</sup> lower broker-dealer operating efficiency, decreased availability of securities firms to effect small transactions, a decline in quality and quantity of customer service and a reduction in innovations in the broker-dealer industry.

There probably are large New York Stock Exchange member firms that will fill small purchase orders. Yet it is common knowledge that many of those firms try to discourage and avoid such transactions.<sup>34</sup> As institutional domination of the market increases, there is reason to believe that such orders will probably be discouraged even more.<sup>35</sup> Therefore,

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33. One may argue that the SEC, through the authority granted in § 19(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78s(b) (1970), may prohibit higher commission rates. But the recent negotiations that led to the commission surcharge and then higher commissions on small transactions would lead one to think otherwise. This would seem to be an area where, based on the record, the regulators are dominated by the regulated.

34. For example, Merrill Lynch, Pierce, Fenner & Smith, Inc., a firm which built its reputation and size on the philosophy of serving the small investor, will not generally accept orders to sell securities (not purchased at Merrill Lynch) when those securities are priced under three dollars per share. Similarly, purchase orders for low-priced stocks are discouraged. See MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., COMPLIANCE RULES & REGULATIONS (1971). In a discussion with the operations manager of a Merrill Lynch branch office, the author was told that customers wishing to buy or sell low-priced stock (below three dollars per share) are generally advised by Merrill Lynch representatives to secure the brokerage services of a small securities firm.

35. There are two reasons usually offered by the large firms for not handling purchase and sale orders for low-priced stocks: profit to the brokerage firm for executing the transaction may be insufficient and problems could arise from executing purchase orders for highly speculative low-priced stocks. It is not within the scope of this article to analyze those reasons. But for our purposes it is important to note that if large securities firms will not execute orders for speculative securities, perhaps the most important function of the small firm would be the handling of these securities; and if small firms are driven out of business, the consequences with respect to a market for speculative securities could be severe. As that market becomes more restricted, new and un-

if small securities firms are forced out of business, who will be left to handle those transactions?

There are related ramifications that could prove even more costly to the public. For example, how will a decline in the number of small securities firms affect the ability of relatively small manufacturing or service businesses to raise capital through the public markets? The small business attempting to raise public capital necessarily relies on the investment banking services of small securities firms, since large New York Stock Exchange members do not generally underwrite securities offerings by speculative companies of firms lacking a strong earnings history.<sup>36</sup> In the long run, the most significant loss to society occasioned by a reduction in the number of small securities firms may not be the loss of the small securities firms themselves. Indeed, the more significant loss may well be all the small businesses that could only be capitalized with funds raised through the efforts of the small securities firm.<sup>37</sup>

There are, therefore, two aspects of this problem that require analysis: first, the extent to which the proposed amendments would eliminate competition; and, second, the ramifications of the anti-competitiveness brought about by the amendments. With respect to the initial question, the Commission has on file records that indicate the number of broker-dealers having net capital less than 25,000 dollars.<sup>38</sup> A survey of these records is needed to determine the number of such broker-dealers that could or would not meet the higher capital requirements. This computation, however, would be enlightening only with respect to the number of existing brokerage firms that would be forced to close their doors. With regard to firms that are not presently engaged in the business and that will never enter the industry because of the proposed higher net capital requirements, a precise measurement would obviously be more difficult.

There is no current published list of securities dealers that indicates

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tested companies will have greater difficulty in raising capital through public offerings of securities.

36. The large securities firms have minimum sales and earnings requirements that are quite substantial (750,000 to one million dollars in earnings). The standards of a regional house are also considerable, ranging from 400,000 to 500,000 dollars in net earnings. See *WHY, WHEN AND HOW TO GO PUBLIC* 14 (G. Hutchison ed. 1970).

37. For a somewhat complementary discussion of possible loss of small businesses as a result of blue sky merit regulation, see J. MOFSKY, *BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS* 1-58 (1971).

38. Since that information is within the exclusive control of the Commission and of persons authorized to view it by the Commission, any measurement of the effects of the proposed rule would have to be done by the Commission or by persons whom the Commission would make privy to such information.



the number of firms with capital below 25,000 dollars.<sup>39</sup> However, based upon the large number of unfavorable comments to the Commission's proposed amendments, there are apparently many such firms. Of more than 100 comments received on the proposal, less than five were favorable.<sup>40</sup> The reaction of one small broker typified the responses: "Why don't we stop kidding around and put everyone out of the securities business but Merrill Lynch."<sup>41</sup> Although that reaction perhaps exaggerated the problem, many of the brokers commented that the amendment, if passed, would compel them to go out of business. One broker asserted that Merrill Lynch was organized with capital of 6,000 dollars, Allen Co. with 1,500 dollars, and E. W. Hutton with only 500 dollars of borrowed funds.<sup>42</sup> Another dealer pointed out that in many instances the amount of capital mandated under the proposed amendment could be substantially in excess of 25,000 dollars, since a firm desiring to keep its capital in the form of securities would actually need \$35,714.20 worth of securities to cover the thirty per cent haircut requirement under the Commission's method of computing net capital.<sup>43</sup>

There are other possible anti-competitive ramifications of the proposed amendments that warrant comment. First, the full 25,000 dollar minimum capital requirement would not be applicable to existing securities dealers until twelve months after the amendment goes into effect.<sup>44</sup> Yet new firms just entering the industry would be required to have the full 25,000 dollar minimum capital before they could commence operations.<sup>45</sup> Thus, existing firms, for the first twelve months after the effectiveness of the rule, would have a competitive advantage over new firms attempting to raise sufficient capital to enter the business. This problem could be obviated, however, if the proposed amendment were revised to take effect with respect to all securities firms at the same time, providing it would become effective at some future date so as to allow ample notice and opportunity for existing firms to raise capital to meet the new standards without unduly disrupting their business operations.

Another problem arises in connection with the proposal that the

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39. There are some limited statistics in the SEC SPECIAL STUDY REPORT, *supra* note 15, at 169, but those statistics are now over nine years old. Presumably the study being completed by the SEC under the mandate of the Securities Investor Protection Act will provide more current information.

40. See BNA SEC. REG. L. REP., Sept. 22, 1971, at A-4 to A-5.

41. *Id.*

42. *Id.*

43. *Id.*

44. See SEC Exchange Act Release No. 9288 (Aug. 13, 1971).

45. *Id.*

net capital ratio be lowered to eight-to-one for broker-dealers during the first twelve months of their existence and raised to twenty-to-one thereafter.<sup>46</sup> Obviously that amendment, if adopted, would provide established securities firms with a competitive advantage over newly established firms during the first twelve months of the new firms' existence. Most of the broker-dealers who commented on the proposed amendments did not strenuously object to the eight-to-one ratio for new firms.<sup>47</sup> But this fact is readily explained since most of the comments on the proposals came from existing small firms which would not be affected by eight-to-one ratio but which would be affected by an increase in minimum capital.<sup>48</sup> The promoters of new firms that intend to register as broker-dealers in the future are not organized and, therefore, cannot voice objections to the proposals. There are probably many persons who would be interested in becoming securities brokers in the future but who do not presently know of the proposals. Therefore, there are ample reasons why strong comment was not forthcoming against the eight-to-one ratio proposal. Nonetheless, the discriminatory aspects of the proposal are obvious and should at least be considered.

In addition to the anti-competitive ramifications discussed above, there are other fundamental faults that may be found with the proposed amendments. Although the proposals are intended to help combat the kind of brokerage failures that occurred during the 1969-1970 period and the attendant losses to customers of the insolvent securities dealers,<sup>49</sup> there is no logical correlation between a high net capital requirement and the ability of securities firms to meet their obligations without difficulty, especially since the proposals are unrelated to the character and volume of business done by individual firms.<sup>50</sup> Efficiently managed firms may be operated profitably, although they are funded with relatively little capital. On the other hand, bad management can cause the rapid demise of a firm having a large amount of capital, and there was substantial evidence of the fact during the 1969-1970 period.<sup>51</sup> As a recent study suggested, there were many reasons for the brokerage failures of 1969-70: mismanagement, inefficiency, overexpansion of operations, fraud, irresponsible actions by principals, reduced volume of

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46. *Id.*

47. *See* note 40 *supra*.

48. *Id.*

49. *See* note 44 *supra*.

50. Several small brokers commented that the amendments to the net capital rule should be drafted in terms of the character and volume of business of securities firms. *See* note 40 *supra*.

51. *See* note 1 *supra*.

trading and substantial decline in stock prices.<sup>52</sup> An increase in net capital will obviously increase a securities dealer's commitment to his firm; however, there is no basis to believe that such an increase will improve either a firm's efficiency or a broker's ability to forecast market trends. In that connection, many firms with substantial capital (far in excess of the proposed 25,000 dollars) went under during 1969-1970.<sup>53</sup>

The proposed amendments are announced for the purpose of protecting the customers of small securities firms, which are basically broker-dealers with capital of less than 25,000 dollars. However, the irony of the Commission's proposal is that the number of firms with capital well in excess of 25,000 dollars that failed in 1969-1970 may be far greater than the number of smaller firms.<sup>54</sup> If that is true, then the total amount lost by customers of large firms was greater than the amount lost by customers of small firms during the period. The proposed regulation, however, is aimed solely at the smallest firms. Although the amendments would perhaps serve as some protection for the customers of a few small firms if a correlation between higher net capital and brokerage solvency is conceded, they would force other small firms either to raise additional capital that may be greater than their requirements or to close their doors. However, the large firms that are undercapitalized or inefficiently managed would be unaffected by the amendments, except that some competition from smaller firms would be eliminated. One would think that a more desirable goal would be to maximize competition in the hopes of causing all firms to behave more efficiently. Clearly the proposals are not designed to accomplish that objective. The proposed amendments to the net capital rule thus conform to a general theme of government regulation; namely, that regulation adopted in the name of a desirable public purpose will inevitably cause effects that were originally unannounced and that may be costly to the public.<sup>55</sup>

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52. *Id.*

53. See note 5 *supra*.

54. In a telephone conversation of November 30, 1971, with Mr. Ray Cocchi, President of the Independent Broker Dealers Trade Association, the author was advised that Mr. Cocchi's estimates indicated that the total number of dollars lost by customers of large firms was far greater than that lost by customers of small firms during 1969-70. There are no published statistics that can be cited with respect to this matter. However, that information is within the possession of the SEC and, it is submitted, such an analysis should be made and published by the SEC before the proposed amendments are adopted.

55. Such consequences have stemmed from the regulation of such matters as meat inspection, food and drug manufacture, railroads and the promotion of new businesses. See A. ALCHIAN & W. ALLEN, *UNIVERSITY ECONOMICS* 190-95 (1967); M. FRIEDMAN, *CAPITALISM AND FREEDOM* 129 (1962); G. KOLKO, *RAILROADS AND REGULATION*, 1877-

As previously indicated, the purpose of the proposed amendments to the Commission net capital rule is to provide greater safety for the cash and securities of customers that are in the possession of broker-dealers.<sup>56</sup> During 1969-1970, many customers permitted substantial amounts of their cash and securities to remain in the possession of their broker-dealers who, in turn, used those assets to help finance their brokerage activities. There was no general rule requiring segregation of customers' cash and securities and similarly there was no general requirement that a reserve be maintained by broker-dealers for the benefit of their customers.<sup>57</sup> When the securities firms failed, much of those assets were lost to their rightful owners. It was in recognition of those losses that the Securities Investor Protection Act of 1970<sup>58</sup> was enacted.

The 1970 Act created a nonprofit, federally chartered membership corporation, the Securities Investor Protection Corporation, the SIPC, to provide insurance protection for the customers of both exchange members and over-the-counter broker-dealers.<sup>59</sup> Generally speaking, members of the SIPC automatically include all broker-dealers registered under the Securities Exchange Act of 1934<sup>60</sup> and all members of national securities exchanges. In the event of liquidation of a member firm, the SIPC will pay up to 50,000 dollars per customer account, except that cash protection is limited to 20,000 dollars per customer account.<sup>61</sup> SIPC members are assessed amounts based on their volume of business to fund the insurance protection. In the event those contributions by members prove inadequate, standby authority is granted the SIPC to borrow up to one billion dollars from the United States Treasury.<sup>62</sup>

Even though the Securities Investor Protection Act was greeted generally with much fanfare, it is appropriate to note that there is evidence that the SIPC came into being after the industry had initiated its own solutions.<sup>63</sup> Although the Act is now law and the SIPC does insure customer accounts to the extent of the amounts indicated, it

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1916, at 26 *passim* (1965); G. KOLKO, *THE TRIUMPH OF CONSERVATISM* 57 *passim* (1963); E. HAWLEY, *THE NEW DEAL AND THE PROBLEM OF MONOPOLY* *passim* (1966); J. MOFSKY, *BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS* 1-3 *passim* (1971).

56. See note 44 *supra*.

57. For a discussion of the safeguards that existed for the protection of broker-dealer customers at the time of the 1969-70 brokerage failures, see Sowards & Mofsky, *supra* note 4, at 1271.

58. See note 7 *supra*.

59. See note 57 *supra*.

60. 15 U.S.C. § 78a-jj (1970).

61. See note 57 *supra*.

62. *Id.*

63. See Barron's, Dec. 28, 1970, at 7, col. 1.

would be a mistake, as a congressional study indicated, to consider the SIPC a panacea for the customers of securities firms.<sup>64</sup> It has been noted that the legislative history of the SIPC did not develop an accurate estimation of anticipated losses arising from the liquidation of securities firms in the future.<sup>65</sup> Financial information regarding broker-dealers obtained through the use of questionnaires, "early warning systems"<sup>66</sup> and other techniques provided information that, although accurate when prepared, may not correctly reflect the current conditions of some dealers. Since there is little basis upon which to compute the future number of brokerage liquidations that will be administered by the SIPC,<sup>67</sup> there is no way of knowing whether present assessments from SIPC members will be adequate in the event of future crises. Therefore, higher future assessments to the extent permitted by the statute, are not impossible.<sup>68</sup> Moreover, it would not be surprising to find those costs being passed on to customers of securities firms in the form of higher commissions.

One of the principal objectives of the 1970 Act was to provide authority for the Commission to adopt rules that would result in strengthening the financial responsibility of broker-dealers. Prior to the 1970 Act, regulation of financial responsibility was accomplished on a fragmentary basis.<sup>69</sup> In particular, the Commission's authority to adopt rules with respect to such matters as free credit balances and segregation of customers' securities was uncertain.<sup>70</sup> A primary aim of the 1970

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64. For example, a customer who is unable to obtain his stock certificate within a reasonable period of time forfeits the privilege of being in a position to trade the security in order to realize a profit or prevent further losses. He also forfeits the privilege of using his security as collateral for another business venture.

BNA SEC. REG. L. REP., July 28, 1971, at E-2. In addition to other matters, the Securities Investor Protection Act of 1970 does not protect against those situations.

65. See note 1 *supra*.

66. When a broker-dealer's net capital falls below the minimum requisite amount or when its books and records are not current, it must give immediate telegraphic notice to the SEC and to the self-regulatory organization to which it belongs. Additionally, when a broker-dealer's aggregate indebtedness is greater than 1200 per cent of its net capital, certain prescribed reports must be filed with regulatory agencies. See SEC Exchange Act Release No. 9268 (July 30, 1971).

67. In the event of a failure of an SIPC member, the 1970 Act provides for the liquidation of that member by the SIPC. See note 57 *supra*.

68. For a description of amount and manner of assessments for members of the SIPC, see Sowards & Mofsky, *supra* note 4.

69. For a description of the manner in which that regulation was accomplished, see *id.* at 1272-77.

70. See *Hearings on H.R. 13308 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce and Finance*, 91st Cong., 2d Sess. 211, 353, 366 (1970).

Act to clarify the Commission's position in that respect. Therefore, § 15(c)(3) of the Securities Exchange Act of 1934 was amended to specifically delegate broad rule-making authority to the Commission with respect to custody and use of customers' securities and the carrying and use of customers' deposits or credit balances.<sup>71</sup> Under that authority, the Commission recently proposed the adoption of new rules that are intended to deal with those matters.<sup>72</sup> If adopted, these rules would seem to obviate any need to up-grade the net capital requirements. These rules, however, are sure to have some adverse economic consequences, some of which have already been recognized by the Commission.<sup>73</sup>

The proposed rules would: (a) severely restrict broker-dealer use of customer cash; (b) impose cash liabilities on firms that misplace or fail to receive from other dealers securities that are bought and paid for by customers; and, (c) provide for the lending and hypothecation rules that are currently required by the self-regulatory organizations. With respect to (a) and (b), the rules are being proposed pursuant to the authority granted the Commission under the financial responsibility provisions<sup>74</sup> of the Exchange Act, while the lending and hypothecation provisions are being proposed pursuant to the Exchange Act sections granting the Commission power to promulgate rules regulating borrowing by brokers and dealers.<sup>75</sup>

Proposed rule 15(c)(3)-3 would require broker-dealers to maintain a "Special Account for the Exchange Benefit of Customers" in the nature of a trust fund through which broker-dealers would be required to effect transactions of cash left in their possession.<sup>76</sup> Withdrawals

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71. No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) [otherwise than on a national securities exchange] in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers *including, but not limited to, the acceptance of custody and use of customers' securities, and the carrying and use of customers' deposits or credit balances. Such rules and regulations shall require the maintenance of reserves with respect to customers' deposits or credit balances, as determined by such rules and regulations.* (Existing law that was omitted is enclosed in brackets; new material is in italics.)

15 U.S.C. § 78o(c)(3) (1970).

72. See SEC Exchange Act Release No. 9388 (Nov. 8, 1971).

73. *Id.*

74. 15 U.S.C. § 78o (1970).

75. Securities Exchange Act of 1934, §§ 8(c), 15; 15 U.S.C. §§ 78h(c),o (1970).

76. See note 72 *supra*.

from the Special Account could be made for limited purposes only; including settlements of transactions, payments of obligations to customers, reimbursement to broker-dealers for certain obligations owned them by customers and secured margin loans. Securities firms, however, would be generally prohibited from using customers' cash for non-customer related purposes. In other words, broker-dealers would be barred from financing their firms' transactions with the funds of their customers.<sup>77</sup> The rule also provides for a "Cash Reserve Bank Account" to hold the excess of cash accountabilities of broker-dealers to customers over specified accountabilities of customers to broker-dealers.<sup>78</sup>

With respect to brokerage custody of customers' securities, proposed rule 15(c)(3)-4 would require broker-dealers to obtain possession of and segregate fully paid and excess margin securities held for the accounts of customers.<sup>79</sup> In the event of a broker-dealer's inability to reduce the securities to physical possession, he would be required to make and maintain in a "Securities Reserve Bank Account" a deposit of an amount equal to the value to such securities. Withdrawals from that account could be made only to the extent that securities are in fact reduced to physical possession or control. If a broker purchases securities for a customer from another securities firm and the other firm fails to deliver within the prescribed time period, the purchasing broker would be required to make a deposit in the Securities Reserve Bank Account within five business days after the settlement date.<sup>80</sup> In the meantime, funds paid by the customer for the purchased securities would be held in the Special Account required by the provisions of proposed rule 15(c)(3)-3.

In addition to the requirement of the reserve account for fully paid and excess margin securities, proposed rule 15(c)(3)-4 has a mandatory buy-in provision after the expiration of a specified period of time. That provision is intended to interact with recently adopted rule 17(a)-13 that requires a quarterly box count verification of all securities not in a broker-dealer's physical possession.<sup>81</sup> If at the time of quarterly box count there is a finding that securities should be, but are not, in the possession of the brokerage firm, the broker must purchase those securities and reduce them to possession within thirty days.<sup>82</sup>

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77. *Id.*

78. *Id.*

79. *Id.*

80. *Id.*

81. For a detailed description of the quarterly box-count requirements, see SEC Exchange Act Release No. 9376 (Nov. 8, 1971).

82. See note 72 *supra*.

The final area of brokerage customer protection where changes have been proposed is in connection with the hypothecation rule. The effect of the proposed amendments, which are comparable to New York Stock Exchange and National Association of Securities Dealers Inc. standards,<sup>83</sup> would be to prohibit broker-dealers from borrowing for themselves or lending to third persons their customers' securities. This prohibition is operative unless the brokers first obtain for fair consideration the customer's written authorization designating the particular securities to be loaned or borrowed and specifying the terms and conditions under which they may be loaned or borrowed.<sup>84</sup> Furthermore, the proposed amendments would preclude broker-dealers from lending or hypothecating more securities carried for a customer's account than is "fair" and "reasonable" in light of the customer's indebtedness with respect to those securities.<sup>85</sup>

The express purpose behind the proposed rules restricting broker-dealer use of customer cash, requiring segregation of customers' securities and limiting the hypothecation activities of broker-dealers is "to afford as complete protection as possible to customers . . . without depriving the industry of necessary and legitimate means to carry on customer oriented business."<sup>86</sup> Although the proposed rules would, if adopted, obviously provide more protection than is presently afforded, there are implications of those rules that should be closely scrutinized. It has been estimated that from 260 to 400 million dollars of customers' cash has been used in recent years by New York Stock Exchange member firms in ways that would be prohibited under the new proposals.<sup>87</sup> If the practice of using customers' cash for broker-dealers' own business activities were to be banned, enormous amounts of capital would have to be raised from other sources. Securities firms might be forced to pay interest or dividends on capital raised from non-customer sources, whereas interest is not as a general rule currently paid on customers' cash. One

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83. See NYSE rule 402; NASD Manual, art. III, § 19.

84. See note 72 *supra*.

85. For the purpose of this rule, any such lending or hypothecation shall be deemed to be unreasonable if the market value of the securities in any general or special account carried for a customer, in the case of hypothecation, exceeds 140% of the debit balance in such account, and, in the case of lending, exceeds 100% of the debit balance in such account; and, if such securities are hypothecated in part and loaned in part, the aggregate market value of all such securities shall not in combination exceed 140% of the part hypothecated and 100% of the part loaned.

*Id.*

86. *Id.*

87. See BUSINESS WEEK, Nov. 13, 1971, at 41.



may even contemplate the possibility of some firms being forced out of business because of their inability to raise requisite capital in time to comply with the rules. In that connection, Commission officials have admitted that some firms will have considerable difficulty in meeting the requirements of the rules.<sup>88</sup>

Prior to the release of the proposed rules dealing with broker-dealer use of customers' cash and securities, the SEC's Division of Trading and Markets proposed reserve and segregation requirements that would result in virtually no risk of loss with respect to customers' funds and securities.<sup>89</sup> Perhaps this is what some Congressmen had in mind when the Securities Investor Act of 1970 was enacted.<sup>90</sup> But as the Commission's Office of Policy Research indicated in a recent study, the establishment of a 100 per cent reserve requirement with respect to customers' funds and securities could have severe repercussions on the broker-dealer industry.<sup>91</sup> The study concludes that broker-dealers could create a fifteen per cent reserve for customers' cash without too much difficulty, but as the reserve level nears 100 per cent, the adverse effects on the income and financial structures of broker-dealers would be very significant. Zero risk of loss has always proved too costly.

The Office of Policy Research study stated that if the new reserve and segregation rules were to be adopted:

The net capital rule no longer [would have to] bear the extremely heavy burden which it now carries, and market forces, by limiting the supply of capital available to brokerage firms and the kind of capital available to brokerage firms, would help maintain the financial responsibility of firms.<sup>92</sup>

Thus, the principal function of the net capital rule would be to protect securities firms from each other and to protect broker-dealer creditors from losses due to brokerage failures. Since the proposed amendments to the net capital rule are primarily intended to protect brokerage customers with respect to cash and securities in the possession of securities dealers,<sup>93</sup> those amendments would no longer appear necessary if the reserve and segregation proposals were adopted. Yet both sets of proposals remain open and the Commission has not proposed them as alternatives. If the Commission insists on adopting the segregation and

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88. *Id.*

89. See BNA SEC. REG. L. REP., Sept. 1, 1971, at A-1 to A-2.

90. *Id.*; Sowards & Mofsky, *supra* note 4, at 1286.

91. See note 89 *supra*.

92. BNA SEC. REG. L. REP., Sept. 1, 1971, at A-2.

93. See note 44 *supra*.

reserve requirements, at least it should refrain from contributing to additional concentration in the brokerage industry by adopting the proposed amendments to the net capital rule, especially when the segregation and reserve requirements would obviate the primary reasons for the net capital rule amendments.

The proposed reserve and segregation rules would provide standards that are so vastly different from current industry practices that, as the Commission has noted, they would probably require significant restructuring of broker-dealer operations.<sup>94</sup> Those brokerage firms that are unable to comply with the new standards would be driven out of business and, therefore, the proposed rules, like the proposed amendments to the net capital rule, are sure to have anti-competitive effects. Whether the protections afforded by the various proposed rules discussed in this article are a more desirable social alternative than the benefits resulting from more competition in the broker-dealer industry is a question beyond the scope of this paper. Moreover, we cannot know on an a priori basis whether the protection to brokerage customers implicit in such regulation will exceed the loss occasioned by the possible effects of decreased competition. We can, however, recognize that there are certain to be social welfare costs and it cannot be assumed that those costs will be less than the benefits to be derived from the proposed regulation. In fact, economic theory leads us to conclude precisely the opposite.

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94. See note 72 *supra*.