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ADDRESS OF

FRANCIS T. GREENE

Assistant Director of the
Trading and Exchange Division
Securities and Exchange Commission

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I am most grateful to the National Association of Securities Dealers for giving me this opportunity of talking to you on two subjects of vital concern to the securities industry and the Commission -- over-the-counter manipulation and the Commission's new rules governing the hypothecation of customers' securities -- Rules X-8C-1 and X-15C2-1 under the Securities Exchange Act of 1934.

I know that in discussing over-the-counter manipulation I am bringing up a subject which is both delicate and difficult. Yet the inquiries which have come to the Commission with respect to the legality of various types of over-the-counter trading practices indicate that a brief statement of what is illegal manipulation may be helpful.

As you know, manipulation on stock exchanges was explicitly prohibited by Congress in Section 9 (a) (2) of the Securities Exchange Act. Furthermore, the general prohibitions against fraud as contained in both the Securities Act and the Securities Exchange Act operate to make the anti-manipulative principles of Section 9 (a) (2) of the Securities Exchange Act just as applicable to the over-the-counter market as they are on exchanges.

The general prohibition against manipulation contained in Section 9 (a) (2) of the Securities Exchange Act is really very simple. The statute, broadly speaking, prohibits three things: (1) Raising the price of a security for the purpose of inducing others to buy the security; (2) depressing the price of a security for the purpose of inducing others to sell the security; and (3) creating actual or apparent active trading for the purpose of inducing others either to buy or sell the security. The meaning of Section 9 (a) (2) as applied to trading on exchanges has been clarified by a number of published opinions of the Commission and the courts. On the other hand, the application of the underlying principles of that prohibition to manipulation in the over-the-counter market has not yet been delineated by formal opinions of the Commission or of the courts. So far as I can, I should like to supply this gap by emphasizing that the same basic law which applies to trading on exchanges also applies with equal force in the over-the-counter market.

Prior to 1938 the Commission's General Counsel on numerous occasions had rendered opinions to the effect that the statutory prohibitions against fraud and the use of manipulative, deceptive or other fraudulent devices or contrivances prohibit raising prices or quotations of a security in the over-the-counter market for the purpose of inducing others to buy that security. As early as August, 1937 the Commission had promulgated a rule - Rule X-15C1-2 - which expressly prohibited brokers and dealers from engaging in any act or practice which operates or would operate as a fraud or deceit upon any person. The Commission has always considered that this prohibition is broad enough to embrace manipulation.

Since the General Counsel had expressed this view on several occasions, the Commission in the Spring of 1938 promulgated a rule, then known as Rule GB4, which specifically provided, in line with this well settled view, that the express anti-manipulative provisions of Section 9 (a) of the Exchange Act against wash sales, matched orders and transactions designed to stimulate buying or selling by others should be applicable to the over-the-counter market, regardless of whether the security was or was not registered on a national securities exchange. However, at the request of certain representatives of the over-the-counter securities industry who claimed that some

portions of the *language* of Section 9 (a) of the Act were not appropriate to over-the-counter markets, the application of this rule, now known as Rule X-10B-4, to those markets was indefinitely suspended.

During our conferences with your representatives about this rule and its suspension, I do not recall that any claim was made by them that the basic principles of Section 9 (a) (2) of the Act were not, and should not be, just as applicable to the over-the-counter market as to exchanges. The viewpoint of the industry, as I understood it, was limited to the contention that certain of the wording of Section 9 (a) (2), which had been enacted with the mechanics of stock exchange trading primarily in mind, would create doubts, confusion and uncertainty if applied *verbatim* to the counter market. In other words, the dispute was confined to a question of drafting, not to questions of substance. It was mainly for this reason that Rule X-10B-4 was suspended in relation to securities not traded on any exchange. The rule, however, has been in full effect so far as exempt exchanges are concerned.

Some confusion appears to exist, at least judging from certain newspaper comment, as to the effect of the Commission's partial suspension of the rule. Therefore, I should reemphasize that the suspension of this particular rule does not render lawful any over-the-counter manipulation which would otherwise be unlawful under the general fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. At the time of the initial suspension of the rule, the Commission sought to make it clear that the statutory prohibitions against fraud or the use of "any manipulative, deceptive or other fraudulent device or contrivance" were alone effective prohibitions against over-the-counter transactions which violate the principles of Section 9 (a) (2) of the Act. For, the Commission in its release announcing the suspension stated --

> *"The rule as originally adopted in no way altered its (the Commission's) prior policy, but was a mere codification of interpretations of the Securities Exchange Act of 1934 as reported in opinions of the General Counsel which had been issued from time to time."*

On November 1, 1938, the Commission published a second release which again emphasized --

> *"Certain activities with respect to a security not registered on any national securities exchange which would violate Section 9 (a) of the Securities Exchange Act if it related to a security registered upon a national securities exchange will, generally speaking, violate Section 15 of that Act as well as Section 17 (a) of the Securities Act of 1933."*

I doubt if I need go into the details of the legal reasoning which underlies the Commission's conclusion that the principles of the statutory prohibitions against manipulation are applicable in the over-the-counter market. The basis of the Commission's view, however, lies in the fact that the raising of market prices or quotations for the purpose of thereby inducing others to buy the security operates, or would operate, as a fraud or deceit upon any person who might be induced to buy the security at the higher market prices so established by the manipulator. But I do want to

reiterate that, entirely independently of Rule X-10B-4, the statute does, in the Commission's opinion, prohibit raising prices or quotations in the over-the-counter market for the purpose of inducing others to buy the security to the same extent that it does where the security is registered on a national securities exchange. And the same is true where market prices are depressed for the purpose of inducing people to sell the security.

On the other hand, the raising or depressing of security prices so long as it is merely incidental to maintaining an over-the-counter market in securities is, in general, not illegal. Thus, a dealer who is trading only for the purpose of making a normal trading profit on the spread between his bid and asked prices, and who raises market prices or quotations would not seem to be doing so for the purpose of inducing others to buy the security because of the rise in price or quotations. On the contrary, such changes in his market prices would merely reflect the forces of supply and demand as exerted on him and, unless the dealer moved market prices up for the purpose of getting other people to buy the security by reason of its rising market price, he would not contrevene the principles underlying Section 9 (a) (2).

However, there may be many circumstances under which a dealer who raises prices in the course of making a market will open himself to the charge of unlawful manipulation. In most of these the dealer would have a motive for manipulating the price of the security. Such a motive would be present if, for instance, a dealer had a relatively substantial long position or held an option or was negotiating or had entered into an underwriting agreement. Under any of these circumstances he would obviously be in a position to profit from a rise of market prices otherwise than from taking the regular merchandising profit represented by the normal spread between his bid and asked prices. Thus, wherever, by reason of substantial positions which represent more than ordinary trading inventory, or by reason of options, etc., a dealer is in reality a distributor who stands to profit as such from a rise in the market price of the security, his transactions raising its price will at the very least be suspected and, indeed, under many circumstances, may be clearly indicative of a violation of the anti-manipulative provisions of the Securities Exchange Act.

Perhaps it would be helpful if I illustrated the application of the anti-manipulative provisions of the Securities Exchange Act to the over-the-counter market by referring briefly to the facts alleged in two proceedings recently instituted by the Commission charging over-the-counter manipulations. In the first case, the firm concerned began to raise the price of a stock in the over-the-counter market from around 4 bid, 5 asked in August of 1939 to about 10-1/2 at 12-1/2 in the following January by a long series of purchases. The dealer had obtained an option on some 32,000 shares of the stock at $10 a share early in November and at a time when the market was well below this price. The market price of the stock had to rise before any distribution at these prices could be undertaken, much less prove profitable. Investigation indicated that the dealers concerned had raised the price from 4 at 5 to the neighborhood of the proposed offering price of $12.50 a share, not in exercising their legitimate function of filling supply and demand, but for the purpose of inducing others to buy the stock at the prices to which they had raised it.

The Commission instituted proceedings to determine whether or not the firm in question should be suspended or expelled from membership on the National Association of Securities Dealers if, as the staff's preliminary investigation would tend to indicate, the firm did in fact raise market prices for the purpose of inducing others to buy the stock in violation of Section 15 (c) (1) of the Act and Rule X-15C1-2 thereunder.

In the second recent manipulation case, the notice of hearing alleges that the Commission has reason to believe that the firm, while underwriting an issue of preferred and common stock, had raised market prices to stimulate the distribution. During the continuance of the distribution and while the underwriter was not only "long" substantial amounts of both preferred and common stock but also had an option on an additional block of 5,000 shares of common stock, the firm raised its bid, its asked and actual transaction prices for both preferred and common stock. Since the firm in question made the prime market -- in fact, the only real market -- for these stocks, there was no question but that it was raising market prices. Furthermore, the firm caused another dealer to publish rising quotations in the daily quotation sheets under the latter's name in such a way that the second dealer's published quotations looked as though they were independent. The Commission's order for hearing alleges that it had reason to believe that the respondent had raised its own quotations and the prices in the market which it was making and that it had caused the other firm to do the same "for the purpose of influencing the market and artifically raising the price of said securities in order to effect a more profitable distribution than would otherwise have been possible."

As a matter of fact, I understand that the Commission will amend Rule X-10B-4 within the next few days so that it will, on its face, be applicable only to trading on exempt exchanges. The amendment will probably be accompanied by an explanatory release expressing the same interpretations of the basic law as those which I have just voiced.

In so short a discussion as this, I cannot, of course, render precise opinions as to particular instances. In the first place, that would involve questions of fact which alone would prevent my giving such particularized opinions. In the second place, the whole problem is too complex for such cursory treatment. But what I do want to make unmistakably clear is that the prohibition against raising market prices in the over-the-counter market for the purpose of inducing others to purchase the security is just as much a violation of the fraud and deceit provisions of the law as it would be if the manipulation were conducted on an organized stock exchange. And this is true regardless of the fact that the codifying Rule X-10B-4 has not become effective as to the counter market.

And now I should like to turn to a more pleasant subject -- Rules X-8C-1 and X-15C2-1 -- regulating the hypothecation of securities carried for the account of customers which go into full effect on this coming February 17.

Any attempt to summarize rules as technical as the Commission's new hypothecation rules which apply to so complex a subject as the banking operations incidental to the securities business presents not only difficulty but some danger of over-simplification. On the other hand, merely to read to you now the rules and the Commission's explanatory memorandum as they are printed in Securities Exchange Act Release No. 2690 would make my talk both boring and profitless. Caught on the horns of this dilemma, I am taking the chance of perhaps oversimplifying the rules in my summary of their salient features. But I want to reduce the risk by warning you that my discussion of the rules must, because of time limitations, be too brief to be entirely accurate or all-inclusive. Each of you should carefully read not only the full text of the rules but also the summary memorandum of explanation which is printed in Release No. 2690, copies of which you can get from our regional office at 120 Broadway.

Perhaps the best way to introduce my discussion of the rules would be to describe the way they were "sweated" into existence by Mr. Irving Turman of the Commission's staff and myself. As I mentioned at the outset, the rules started off to be extremely simple. The first draft which was submitted to the industry for comment was less than one page long. It contained only the three simple and all-inclusive provisions in the very language in which the Congress had given its directions to the Commission. Under that first draft you couldn't commingle customers' securities under a loan without their consent. You couldn't commingle customers' securities with your own securities under a loan, regardless of the customer's consent. Finally, you couldn't borrow more on your customers' securities than your customers owed you on their securities. The provisions of that first draft did no more than effectuate the Congressional standards for handling customers' securities — standards which we thought were already pretty generally recognized as proper brokerage practice. And I may say that over 95% of the representatives of the securities industry to whom we sent that first draft for comment thought the same thing. By and large they said it was fine and seemed pleasantly surprised at the simplicity and clarity of this draft. The N.A.S.D. Technical Committee, however, quickly proceeded to shoot our three all-inclusive prohibitions full of holes. They soon revealed the existence of three dozen problems, all knotty, which were raised by that simple draft.

During our conferences with the representatives of the N.A.S.D. and the New York Stock Exchange, Mr. Turman and I were eventually educated to the necessity and reasonableness of certain exceptions to the three basic general principles of the statute. These exceptions for the most part are designed to take care of certain kinds of temporary financing, sudden reductions in customers' indebtedness before the broker or dealer

could reduce his bank loans proportionately, clearing house liens and similar matters. We also found that we had to define explicitly various important terms used in the rules such as "customer", "securities carried for the account of any customer", the "aggregate indebtedness" of customers to the broker, etc.

Representatives of the New York Clearing House banks doing a substantial loan business with brokers and dealers were also most helpful. They gave the Commission every cooperation in its effort to formulate rules that would safeguard customers' securities as the Congress had said they should be safeguarded and yet which would not disrupt the existing mechanisms by which legitimate day-to-day business is done.

Turning to the details of the rules, I should first explain why there are two of them. Section 8 (c) of the Act, and rules under that Section, apply only to members of exchanges and to brokers and dealers who transact a business through the medium of members. Rules under Section 15 of the Act, on the other hand, apply, broadly speaking, to all brokers and dealers in respect of business done in the over-the-counter market. In order to achieve uniformity in the equal application of the rules to all brokers and dealers, they were adopted under both sections of the Act. However, Rule X-8C-1 and Rule X-15C2-1 are both identical in their substantive provisions. So compliance with either one automatically constitutes compliance with the other. And, one or the other will be applicable, generally, to all brokers and dealers regardless of whether they are exchange members or deal only over-the-counter, and regardless of whether they carry margin accounts or do exclusively a so-called "cash business".

Next, I should like to take up the definitions. The term "customer" is most important. It does not include any partner, whether general or special, or any director or officer of the broker or dealer or any participant, as such, in a joint, group or syndicate account with the member, broker or dealer or any partner or officer or director thereof. The term "customer", unlike certain other rules of the Commission, does include other brokers or dealers. Also, it includes "cash" as well as margin customers. Other brokers and dealers are treated as "customers" because securities carried by one broker-dealer for the account of other brokers and dealers must receive the same safeguards as do those of other customers, if the customers of these brokers and dealers in turn are to be adequately protected.

The rules operate with respect to all securities which are "carried for the account of any customer". Consequently, the definition of this expression is of the very greatest importance since no security falling within this term can be hypothecated except under the circumstances permitted by the rule. "Securities carried for the account of any customer" is defined to include three general categories: (1) Securities received by or on behalf of the broker or dealer for the account of any customer. This, of course, includes all securities bought upon the execution of brokerage orders regardless of whether the customer may have yet paid the broker all or any part of the purchase price. It also includes any other securities which are received into a customer's account; (2) Securities sold by the broker or dealer as a principal to customers as soon as the securities sold are earmarked or otherwise appropriated to a customer. Here let me interpolate to say that under the law of sales, when securities to fulfill the contract of sale are set aside or otherwise appropriated to the contract, the property in these securities is usually regarded as passing to the customer, unless a different intention appears. Therefore, as soon as you tag the securities sold to the customer with his name or put them in an evelope for him, or enter the certificate numbers, on the customer's ledger or to his account in your blotter or otherwise identify the particular securities which have been sold to the customer, they become securities "carried for the account of" a customer for purposes of the rule and must be treated as customers' securities; (3) The third classification of securities "carried for the account of any customer" comprises securities sold, even though they are not yet appropriated, if the customer has made any payment on account, at least to the extent that the dealer owns and has received like securities. Let me illustrate. Suppose the dealer has sold 15 Southern California Edisons to 10 customers who have made part payments on the purchase price. If the dealer has on his shelf 20 of the bonds, 15 of them -- and it doesn't make any difference which 15 -- must be treated as belonging to customers and, therefore, can be hypothecated only in accordance with the rules. If, however, these 20 bonds are pledged with a bank at the time either that the customers make a part payment or the dealer, by reason of entering the certificate numbers to the accounts of the customers either on the blotter or the customers' ledgers or by some other act, appropriates 15 of the bonds to the customers concerned, they do not become "securities carried for the account of customers", and, therefore, do not have to be treated as customers' securities pending their release from the bank's lien as promptly as practicable. However, the dealer is under an obligation to take 15 of the bonds out from under the pre-existing lien just as soon as may be practicable under the circumstances. If the buying customers delay in taking delivery of the bonds so that the dealer has to finance them overnight or for a longer time, he must, because of paragraphs (a) (2) and (a) (3) of the rules, put them under a loan collateralized only by customers' securities, notifying the bank in accordance with the rules that they are securities carried for the account of a customer and that their hypothecation does not contravene the provisions of the rules. When the bonds first become carried for the account of customers, if the dealer fails to take them out from under their pre-existing lien which, presumably, also covers other securities of the broker or dealer pledged with the bank, he would be violating paragraph (a) (2) of the rules which prohibits the pledging of customers' securities under the same lien with his own. Furthermore, he would probably be violating paragraph (a) (3) of the rules since, by leaving customers' securities under the same lien with his own, he would be subjecting them to the lien for his own bank loan which would normally be for an amount greater than customers' aggregate indebtedness to him.

The next consideration is that of the computation of "aggregate indebtedness". And here I should emphasize that the third general provision of the rules governs only the relationship between the aggregate indebtedness of the customers to the broker or dealer and the total amount for which customers' securities are pledged. The rules do not affect customers' free credit balances nor the loaning of customers' securities. They are not concerned with the indebtedness of the broker to his customers, but only with the indebtedness of customers to the broker or dealer on their securities to the end of preventing the broker or dealer from pledging customers' securities for more than the total that he has loaned to them on their securities. In computing "aggregate indebtedness" under the rules, related guarantor and guaranteed accounts are to be consolidated. In figuring the debit balance of an account containing both long and short position, the cover value of securities short in such mixed accounts is to be treated as debit. Furthermore, uncleared checks do not reduce customers' indebtedness until they do clear. Thus, to compute the aggregate indebtedness of your customers in respect of their securities you can start with debit balances in all fully and partly secured long and mixed accounts of customers, consolidating related guarantor and guaranteed accounts and debiting the cover value of securities short in mixed accounts. Add to this the total cost of any securities bought for the account of customers but not yet debited to their accounts to the extent that you have taken delivery, or otherwise acquired such securities for the account of such customers. Finally, you can add the debit balance in the "Fail to Deliver" account to the extent that the proceeds due from others on securities which you "failed to deliver" have already been credited to customers' accounts. You can also add to this the amount of uncollected customers' checks which have already been credited to customers' accounts since, under the rules, uncollected items do not reduce "aggregate indebtedness" of customers until they clear. However, you can not include the amounts due from customers' indebtedness on securities subject to exempted clearing corporation liens. I shall refer to this exemption in more detail later. You must be careful not to include any balances in "aggregate indebtedness" which does not properly constitute an amount owing to you by customers on their securities. To do so may lead to a violation.

The other half of the equation consists of the total of liens on securities carried for customers' accounts. This total is made up of all your borrowings from others, collateralized by customers' securities. The total of liens would, therefore, normally include all bank loans, including day loans, overnight loans and similar temporary loans the lien of which extends to customers' securities. Also, you must include all debit balances in accounts carried with other brokers and dealers which contain customers' securities as well as any other borrowings on which customers' securities are pledged. You can, however, exclude liens of any clearing corporation of a national securities exchange for which there is an exemption.

I turn, now, to the exemptions, the first one of which takes the form of the exception embodied in paragraph (a) (3) of the rule, which paragraph, as I have mentioned, prohibits the pledging securities of customers for a sum in excess of the total of all indebtedness of all customers to the broker or dealer in respect of securities carried for customers' accounts. Generally speaking, brokers and dealers should have no difficulty in preventing

the total of their liens from exceeding the aggregate indebtedness to them of their customers. Good brokerage practice alone would make it desirable for a broker or dealer always to borrow substantially less on customers' securities than customers owe him with the result that the broker's or dealer's own capital loaned to customers serves as a desirable "cushion" between the total of customers' debits and the amount of bank and other loans on customers' securities. Conservative operation under the rules requires that this "cushion" should be sufficient in size to absorb any reasonably anticipated reductions in customers' aggregate indebtedness to the broker.

However, customers' indebtedness may occasionally be suddenly reduced because of substantial payments made by customers at about the same time with the result that until customers' securities can be released from bank loans, the liens on customers' securities may be greater than customers' aggregate indebtedness to the broker or dealer. To take care of this situation, even though it be unusual, there is an exception to the general prohibition against pledging customers' securities for more than customers owe you, under which this prohibition shall not be deemed to be violated if the total of liens on customers' securities should come to exceed customers' indebtedness because -- but only because -- of a reduction in the aggregate indebtedness of customers on the particular day in question. Furthermore, this exception is applicable only if funds in an amount sufficient to pay off any such excess of liens are either paid or placed in transfer to pledgees -- and it doesn't make any difference to which pledgees -- in order to reduce the liens on customers' securities as promptly as practicable after the reduction of customers' indebtedness occurs. Since "as promptly as practicable" is a more or less flexible standard, the rule also fixes a deadline beyond which any excess of liens over customers' indebtedness must be paid off. Thus, the rules require that any such excess of liens over customers' indebtedness must be paid off before the lapse of one-half hour after the commencement of banking hours on the next banking day at the place -- and place means city -- where the principal banking of the broker or dealer is conducted and, in any event, before the broker or dealer on that next day obtains or increases any bank loan collateralized by customers' securities, whichever is first in point of time. Let me illustrate this. Let's assume that at 2:15 P.M., Pacific Coast Time, which would be 6:15 P.M., New York Time, several big customers of a large wire house pay off half a million dollars of debits by depositing certified checks to the firm's account at the firm's San Francisco bank by which the checks are certified. This would, of course, effect an immediate reduction of customers' indebtedness in the amount of one-half million dollars, since the checks would clear immediately. And let's further assume that the firm's principal banking is done in New York City and that it carries no bank loans in San Francisco and, hence, cannot reduce any bank loans on the Pacific Coast that afternoon, even though the West Coast banks are still open. We can also assume that there would be no transfer facilities in operation so late in the day so that the firm could not get credit at its New York bank in the amount of $500,000 with which to reduce its collateral loans in New York until the next day. Now let's still further assume that the one-half million dollar reduction in aggregate indebtedness is so great as to result in excess of liens in customers' securities over the amount that customers owe the firm. Even so unusual a situation as this is taken care of by the exemption. For the rule, as drawn, is complied with provided that funds are placed in transfer on the Pacific Coast for the purpose of reducing the liens on the firm's customers' securities held by New York banks before 10:30 A.M., Eastern Standard Time -- the time zone in which the firm carries its largest principal amount of loans.

The rules provide that customers' aggregate indebtedness shall not be reduced by uncollected checks, thus giving a time lag of from one to several days during which a firm can reduce its bank loans in advance of anticipated reductions of customers' indebtedness. Nevertheless, the representatives of the securities business urged that there had to be even greater flexibility in the operation of paragraph (a) (3) to take care of what was described in our drafting conferences as the "minute-to-minute problem" that is, preventing daily fluctuations in customers' aggregate indebtedness from causing unwitting violations of the rule because of the mechanical difficulties, where a firm is borrowing right up to the hilt, of reducing bank loans at the same time that customers reduce their indebtedness to the firm. Therefore, both before and after reductions in the aggregate indebtedness of customers to the broker actually occur, the broker will have an ample period of time within which to reduce his bank loans collateralized by customers' securities to the extent necessary to avoid violation of the rules.

The next exemption, and perhaps the most important from your point of view, is the limited exemption from paragraph (a) (1) of the rule applicable to so-called "cash transactions" that is, cases where a security is bought for or sold to a special cash account within the meaning of Section 4 (c) of Regulation T of the Board of Governors of the Federal Reserve System. Generally speaking, such a special cash account is an account in which funds to cover the transaction are already held or where the transaction is executed in reliance upon a good faith agreement that the customer will promptly make full cash payment for the security. The rules provide that the prohibition against commingling customers' securities under a loan without their consent shall not apply in the case of securities bought for or temporarily carried in these special cash accounts provided that at or before "the completion of the transaction", within the meaning of the Commission's rules, written notice is given or sent to the customer concerned stating that his securities are or may be hypothecated under circumstances which will permit the commingling thereof with securities carried for the account of other customers. Under the Commission's rules, a transaction is considered to be completed when the customer makes any payment when such payment is due, whether payment is effected by a bookkeeping entry or otherwise. As a practical matter, the condition to this exemption that notice shall be given to the customer can be most easily complied with by putting a legend on the confirmation stating, in substance, that the customers' securities are or may be pledged under circumstances which will permit their commingling with securities carried for the account of other customers. This exemption, it was urged, was necessary to take care of cases in which cash customers, particularly institutions and fiduciaries, consider that they cannot properly give a consent to the hypothecation, even temporarily, of securities bought for their accounts. And, of course, in connection with the pick-up and delivery of securities which are bought on a brokerage basis for so-called cash customers, hypothecation under a day loan or even under an overnight loan may often be necessary pending delivery of the securities to the customer against payment. In situations of this type the N.A.S.D. Technical Committee and certain other representatives argued that it would be an adequate safeguard if the customer were informed of the fact that the securities bought for his account are or may be hypothecated with securities of other customers. Before leaving this exemption, however, I want to emphasize that it exempts so-called cash transactions only from the

requirement that customers' securities can't be commingled with other customers' securities under a loan without their consent. It is not an exemption from the prohibition against pledging customers' securities with your own or from the prohibition of pledging customers' securities for more than the total amount that customers owe you on their securities.

A further exemption is given in respect of liens of a clearing house or corporation of any national securities exchange for a loan made and to be repaid on the same day if the lien in question is incidental to the clearing either of securities or of loans through the clearing house. The clearing house exemption is broader than the so-called cash account exemption just mentioned. Clearing house liens are exempted from the prohibition against commingling a customer's securities with those of the broker, and also from that against pledging customers' securities for more than customers owe the broker. Thus, for all practical purposes, a broker or dealer in operating under the rule can disregard his pledges of customers' securities under clearing house liens. However, as I mentioned before, in computing aggregate indebtedness in order to determine whether or not the total of liens exceeds the total of customers' indebtedness, any indebtedness in respect of securities which are subject to an exempt clearing house lien must be disregarded.

The rules also require that, with the exception of pledges made under a day loan or in an omnibus account, the broker or dealer can't hypothecate any securities of a customer unless at or prior to the hypothecation he gives written notice to the pledgee that the security pledged is carried for the account of a customer. Such notice to pledgees is, of course, necessary in order that the banks can avoid putting customers' securities under a lien for loans made to the broker or dealer on his own securities. Furthermore, the broker or dealer must give written advice to the bank in each instance that the hypothecation does not violate Rule X-8C-1 or Rule X-15C2-1. In the case of an omnibus account, however, the broker or dealer for whom the account is being carried need only furnish at the outset a signed statement to the broker carrying the account that all securities in the account will be customers' securities and that hypothecations will not contravene the rule. Furthermore, these notice and certification requirements do not apply to day loans which are to be repaid on the same calendar day on which they are made. I understand that the banks' loan envelopes or collateral slips will contain a form for signature by the borrower which will comply with the notice and certification requirements of the rule.

Now we come to the banking problems which had to be met in drafting the rules. Let's take the regular collateral loan first. The banks' loan agreements which have been in general use up until now provide that the bank shall have a lien on all securities deposited by the broker to cover any indebtedness of the broker to the bank, regardless of whether they are customers' securities or the firm's own securities. Of course, each loan is primarily backed up by the collateral listed on the collateral slip given with the loan. However, the general lien created by the loan agreement is the bank's anchor to windward in case anything goes wrong. But when the rule becomes effective, the hypothecation of customers' securities urder such a general lien would result in violating paragraph (a) (2) of the rule, since customers' securities would thus be commingled with the firm's own securities under a single lien.

Last week Regulation U of the Board of Governors of the Federal Reserve System, which applies to bank borrowings of members, brokers or dealers, was amended in order to reconcile the former provisions of Regulation U with the Commission's hypothecation rules. The amendment to Regulation U, in effect, facilitates banks in relinquishing their liens against customers' securities as additional collateral for other loans made on the broker's or dealer's own securities. It will become effective on February 17, 1941, the effective date of the Commission's rules. The amendment to Regulation U brings that regulation into harmony with the Commission's rules by providing, broadly speaking, that any indebtedness of a broker or dealer that is secured by customers' securities shall be treated separately by the bank from any other indebtedness of the broker or dealer.

A Committee of the New York Clearing House Association is presently engaged in working out revisions of the bank's basic loan agreements in such a way that the bank's liens for loans which are made against the securities of non-customers will not run against securities which the bank is notified are carried for the account of the broker's customers.

Similarly, under the day loan agreement which has generally been in force the bank has had a lien for the total amount of the loan on all securities taken up with the proceeds of the loan, regardless of whether they are securities bought for the firm's own account or its partners or for the account of customers. Here, again, the banks are now engaged in revising their loan agreements in such a way that the lien of the day loan, insofar as it will attach to customers' securities, will be for an amount no greater than the amount of that and other loans which, in fact, was used to take up securities for the account of customers. Now that Regulation U has been amended, this bank committee should soon complete its work on changing the general loan agreement as well as the day loan agreement forms.

Thus, the proposed revision of the banks' day loan agreements, as well as of their collateral loan agreements, will enable the broker to prevent not only the commingling of customers' securities under the same lien with those of the broker in violation of paragraph (a) (2) of the rule but also to prevent any banks from having a lien on securities which it is advised are customers' securities except for loans which are made against such securities. I doubt if it would be particularly helpful for me to go into the technical details of the proposed revisions in the banks' loan agreements. I do strongly urge this, however, that each one of you get from the bank with whom you are doing business, as soon as you can, a copy of its proposed revision of its collateral loan and day loan agreements and have it checked, either by your own counsel or by the interpretative staff of the Commission's regional office, or with us in Washington, to make sure that hypothecations of customers' securities under those revised loan agreements will not involve violations by you of these hypothecation rules.

Although so far I have been talking about loan agreements with banks and the necessity that the bank shall have no lien upon customers' securities except for loans made against customers' securities, the same is equally true of the agreements under which you may carry accounts containing customers' securities with other members, brokers and dealers. The most frequent illustration of this type of pledge is the case of omnibus accounts carried with exchange members. If, in addition to the omnibus account containing only customers' securities, you also carry with a member firm any account in which credit has been advanced to you on your own securities by the member firm, you must likewise see to it that the member firm has no lien upon customers' securities in the omnibus account for the debit balance in your own account.

Another feature of the rules that I want to make clear in connection with this discussion of their effect on banking practices is that under the revisions of their collateral loan and day loan agreements which the banks will soon make, and, in the case of omnibus accounts, under the similar changes in the customers' agreement under which it is carried, your mechanical operations in taking out loans and in withdrawing and adding collateral, so far as we can anticipate, will be just about the same as they have been heretofore. The only exception is that on each hypothecation of customers' securities you will have to notify the bank that they are securities carried for the account of customers and that the hypothecation does not violate the requirements of the rule. The same will be true in the case of omnibus accounts once you have assured yourself that the loan agreement and liens of the carrying broker are limited as will be the banks' liens. When you have notified the member with whom you may be carrying an omnibus account that only securities carried for the account of your customers will be contained in the account (taking out of the account any securities which you may be carrying for your own account or the account of your partners, officers or directors, or a joint account) and have notified the member carrying the account that only securities carried for the account of your customers will be kept in the account and that hypothecations in the account will not violate the provisions of the rule, the mechanical operations in handling this account will be exactly similar under the rules as they have been heretofore. But you must bear this in mind you cannot borrow on customers' securities, whether from a bank or from the member firm carrying the omnibus account, amounts which in total will be greater than the amounts owed to you by your customer.

You may have noted that when I just said that your mechanical operations under the new revisions of the banks' loan agreements and agreements covering omnibus accounts will be just the same as they have been heretofore, I mentioned only taking out loans and withdrawing and adding collateral. Your practices in substituting collateral will be different. As I told you the banks are going to revise their loan agreements to the general effect that securities carried for the account of customers will not be subject to any lien which they may have for loans made against securities of the firm, its partners, its directors or officers or participants with it in joint, group or syndicate accounts, but in the converse situation, where there may be a deficiency in the margin on loans made on customers' securities, the banks can have a lien against securities of the broker, its partners, officers and directors, etc. Paragraph (e) of the rule which creates an exemption for certain liens on securities of non-customers thus permits what we may describe as a "one-way lien" against the broker's own securities as additional collateral for loans made against customers' securities. To this end, the rules provide that the broker may use his own securities as additional collateral, both for day loans and for regular collateral loans which are "made against securities carried for the account of customers". For the purpose of this exemption, however, a loan is considered as being "made against securities carried for the account of customers" only where the loan is obtained or increased solely on the basis of securities carried for the account of customers. Thus, the broker, although he can add his own securities as additional collateral to a loan on customers' securities, and although he can substitute other customers' securities for collateral in the loan, cannot substitute his own securities for securities carried for the account of customers which are in the loan without violation of paragraph (a)(2) of the rule. Therefore, you should be

particularly careful in substituting collateral in loans which are made against customers' securities to see to it that only securities of other customers are used as substitute collateral.

Finally, it may be helpful if I sum up this discussion of the hypothecation rules with just a few words on their basic purpose and philosophy. The new rules are not intended to alter the substance of law of debtor and creditor relating to pledges and the foreclosure of pledges nor do they attempt to amend or supplement existing insolvency causes. They are designed to achieve the Congressional mandate of safeguarding customers' securities by preventing some of the causes of brokerage insolvency under circumstances that customers suffer a loss. As Congress itself put it, Section 8(c) of the Act "means that a broker cannot risk securities of his customers to finance his own speculative operations." To this end, the rules are designed to prevent insolvency by requiring brokers not to risk customers' securities under liens of pledges for any amount greater than that necessary to finance a customers' concern. It is our hope that in achieving this objective the new rules will result in a minimum of interference to existing legitimate methods of doing business.

I am, of course, deeply appreciative for the patience and good will with which you have listened to my effort to explain in every day language rules which are in reality complex and technical. I hope that what may be an oversimplification of their provisions will not mislead you and, to guard against this, I urge each of you to study the text of the rules themselves in the light of your own business. Think over the problems which will arise in your shop and then call upon the Commission for the service which it is only too glad to render. Call our Regional Administrator and ask him any questions which are troubling you. I am sure that he will have the answers at the tip of his fingers and if he hasn't he can get the answer from us in Washington very quickly. And, in any event, please remember that whatever your difficulties may be under the rule all of us at the S.E.C. are eager to assist you in your effort to comply with these new safeguards for customers' securities.

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