Study of the Failure of MJK Clearing, the Securities Lending Business and the Related Ramifications on the Securities Investor Protection Corporation

Table of Contents

Section 1: Executive Summary…..…………….…..……………………………..………**3**

Section 2: Objective, Scope and Approach.……………..…..…………………....………**6**

Section 3: Failure of MJK Clearing……………………………………………….….….**9**

Section 4: Applicable Rules and Regulations………….…………………………..….…...**13**

Section 5: Securities Lending ……………………………………………..………..….**17**

Section 6: Findings……………..…………..…..……………………………..……....**21**

Appendix…………………………..……………..…..……………………………..……**35**

Section 1: Executive Summary

In May of 2002, Deloitte & Touche (D&T) was engaged by the Securities Investor Protection Corporation ("SIPC") to perform a study of certain matters in response to SIPC's concerns related to the liquidation of MJK, a broker-dealer in Minneapolis, Minnesota that failed in September 2001. MJK cleared for 65 introducing broker-dealers and had approximately 175,000 customer accounts. At the time of this study, the liquidation has cost SIPC approximately $110 million.

In its Request for Proposal ("RFP"), SIPC asked for proposals to perform three studies. SIPC requested that Study I cover:

1. The failure of MJK Clearing and the relationship of that failure to Rule 15c3-3;

2. The implications, generally, of the stock lending business with regard to SIPC exposure, including a quantification of that exposure; and

3. The implications of business transactions that could cause a similar failure to meet Rule 15c3-3 requirements.

In the RFP, SIPC requested that Study II be a much more broader and generalized analysis of how SIPC could quantify and manage its risks. Study III was simply a combination of Studies I and II, should the same firm be engaged to perform both. SIPC engaged D&T to conduct Study I and FitchRiskAdvisory to simultaneously perform Study I and to separately conduct Study II. Although FitchRiskAdvisory will be submitting a separate report, we coordinated our work with them and wish to express our gratitude for the degree of cooperation extended by them.

Our study consisted of:

1. Interviewing the MJK trustee appointed by SIPC and the consultants hired by that trustee;

2. Conducting a limited analysis of certain reports and records provided to us by those individuals;

3. Collecting and analyzing data from the New York Stock Exchange, Inc. ("NYSE") and the National Association of Securities Dealers, Inc. ("NASD"); and

4. Discussions with security industry personnel, members of self-regulatory organizations and staff members of the Securities and Exchange Commission ("SEC").

Our observations, findings and recommendations are:

1. MJK may have been in violation of Rules 15c3-1 (Net Capital Rule) and Rule 15c3-3 (Customer Protection Rule) before it failed.

2. When it began having cash flow problems, MJK began to borrow using customer margin securities to finance its proprietary securities lending business. That practice took temporary advantage of the fact that the Rule 15c3-3 Reserve Formula is only required to be computed weekly. The securities industry is not equipped to compute the Rule 15c3-3 Reserve Formula more than weekly, but we recommend additional regulatory surveillance of firms that are in a “spiral”.

3. The data received from the NYSE and the NASD revealed that few firms have leverage similar to that attained by MJK and none of those firms posed significant exposure to SIPC. Nevertheless, we recommend that the SROs, to the extent they have not done so already, establish mechanisms to closely monitor highly levered firms.

4. MJK did not have an effective risk management system. The SEC should propose rules to require clearing broker-dealers to maintain written risk management procedures, covering market, credit, funding, legal and operational risk. The securities industry should propose to the SEC the specific risks that those procedures should address.

5. Although securities lending departments bear many of the characteristics of trading departments at securities firms, it appears that persons that supervise securities lending departments are not subject to the same registration, testing and continuing professional education requirements. We recommend that the SROs consider whether supervisory securities lending professionals be subject to those or similar requirements.

6. MJK and Native Nations agreed not to make collateral adjustments, or “marks to the market” that were communicated through the Depository Trust Company (“DTC”). The suppression of those marks and subsequent nonpayment of collateral to MJK by Native Nations increased MJK’s losses and SIPC’s exposure. The SEC should consider requiring that service bureaus notify the senior management of the securities firm, and possibly the SROs, when significant marks to the market are being suppressed and the securities firm is being exposed to increased counter party credit risk.

Section 2: Objective, Scope and Approach

Objective

On September 27, 2001, SIPC initiated the largest liquidation proceeding in its history. MJK Clearing ("MJK") in Minneapolis, Minnesota cleared for approximately 65 introducing firms and had approximately 175,000 customers. At the present time, the liquidation proceeding has cost SIPC over $110 million. This loss of customer assets raised a number of questions concerning SIPC's risk exposure and the adequacy of its fund to carry out its mission of protecting customers in the event of financial failure of stockbrokerage firms. Our study focused on:

1. The failure of MJK Clearing and the relationship of that failure to Rule 15c3-3;

2. The implications, generally, of the stock lending business with regard to SIPC exposure, including a quantification of that exposure; and

3. The implications of business transactions that could cause a similar failure to meet Rule 15c3-3 requirements.

Scope and Approach

We began our study by meeting with the trustee for the MJK liquidation and the trustee's consultant. The consultant provided us with access to MJK's books and records and in particular, the FOCUS[1] reports and supporting documentation for the months of July and August 2001, the months immediately preceding the initiation of the liquidation proceedings. Although we read a limited amount of other information, our primary focus was the material provided to us for those two months.

The purpose of our meetings and inspection of MJK's records was to gain an understanding of what had happened and to give us a basis to respond to SIPC's concern raised in point number one in the objective section above. The purpose of our visit was not forensic in nature and was not an investigation. We did not conduct an audit or attest engagement under the standards of the American Institute of Certified Public Accountants. Other than reading publicly available filed complaints, we also did not look at documents, agreements and any other materials related to litigation among various securities firms that is currently on going.

To respond to the concerns raised in points two and three above, we collected data from the NYSE and the NASD. Our data collection effort was coordinated with FitchRiskAdvisory. We express our gratitude to those organizations for the cooperation and effort extended by them and we also express our appreciation to FitchRiskAdvisory for their cooperation and effort in assembling the data and preparing the related exhibits.

[1] A "Financial and Operational Combined Uniform Single" report, or "FOCUS" report is a report required of broker-dealers under Rule 17a-5 that includes financial statements, regulatory capital computations and a computation of the Rule 15c3-3 reserve computation.

Primarily we obtained aggregate industry FOCUS reports for the period January 1998 through December of 2001. We selected those dates to provide us with perspective on how industry revenues, capital levels, securities borrowed and loaned and other similar financing amounts changed during a period that covered both prosperity and downturn in the securities industry. We also made specific requests of the NYSE and the NASD with respect to the number of firms that had levels of leverage, in stock lending or similar transactions, in excess of those experienced by MJK. As part of that request, we asked for certain information related to where securities firms maintain their segregated deposits of customer funds required under Securities Exchange Act Rule 15c3-3. Although this request was not made in connection with the concerns raised by the RFP, we believed that the information obtained would be of interest to the SIPC Board and would provide insight into broader, systemic issues.

Section 3: Failure of MJK Clearing

History and Background

MJK Clearing Inc. ("MJK") (formerly Miller, Johnson & Kuehn, Incorporated) was founded in 1981 as a full service, general brokerage firm. It had seven offices in the United States and was headquartered in Minneapolis, Minnesota and had approximately 63,200 retail and 1,800 institutional customer accounts.[2] It was a subsidiary of Stockwalk.com Group Inc., a publicly traded company on the NASDAQ-NMS. MJK also cleared the accounts of other broker-dealers, making it responsible for the custody of investment property for approximately 175 thousand customers.

On September 27, 2001 SIPC filed a Complaint and Application against MJK in the United States District Court for the District of Minnesota, and the court promptly entered an order commencing the liquidation of MJK. Soon thereafter, the SIPC trustee arranged the transfer of the customer accounts to another clearing firm, enabling those customers to quickly access their investment property.

The demise of MJK appears to be principally caused by certain defaults by a particular counter party in its securities lending business. Securities lending will be discussed in greater detail later in this study, but generally it involves borrowing securities from customers, broker-dealers or other persons and lending them to other broker-dealers or others that may need them to satisfy delivery on a short sale or other securities transaction where settlement has been attempted and has failed for other reasons. In a typical securities loan transaction, the borrower of the securities will provide the lender collateral of cash or cash equivalents up to 105% of the market value of the securities that were borrowed. As the market value of the securities moves, the parties exchange payments, known as "marks to the market", to adjust the collateral level back to the level that was set at the time that the loan was established. As it is anticipated that the borrower will invest the collateral and earn an interest bearing return on it, an interest rebate is usually paid to the borrower. The amount of that rebate can vary depending on the marketplace availability and demand for the securities being borrowed.

According to the complaint filed by the MJK trustee in an action against certain officers of the company, in January 1999 the Chief Financial Officer of MJK hired Thomas Brooks to run and grow its securities lending business.[3] In addition to a salary, Mr. Brooks was offered a bonus equal up to 30 percent of MJK's annual income from the stock loan business. Mr. Brooks was hired because of his experience and contacts in the industry. Prior to coming to MJK, Mr. Brooks had worked for the securities lending areas of RBC Dain Rauscher and US Bancorp Piper Jaffray.

Following Mr. Brooks' arrival, MJK's securities lending business grew substantially. At August 31, 2001, immediately prior to its bankruptcy, MJK's balance sheet reflected

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[2] *See* Securities Industry Yearbook, 2000-2001, Securities Industry Association.
[3] *See* Complaint filed by the trustee in: In re: MJK Clearing, Inc. James P. Stephenson, Trustee, for MJK Clearing, Inc. v. Eldon Miller, David B. Johnson, John E. Feltl, Todd Miller, Jeffrey L. Houdek, Thomas Brooks.

$411.5 million of securities borrowed and $456 million of securities loaned[4]. Those amounts constituted 46 percent of MJK's total assets of $888 million. At the same time, the firm had only $24 million of net worth, $22.5 million of total regulatory, or "net" capital and $14.9 million in excess net capital.

Included in the $411.5 million of cash collateral receivables related to securities borrowed were two particularly large receivables from one counter party. At August 31, 2001, MJK's records indicated that it had borrowed 7,211,400 shares of Genesis Intermedia, Inc. ("Genesis") that had a current market value of approximately $17 per share or $124 million total. As disclosed in Genesis's Form 10K for the year 2000, the weighted average number of shares outstanding was 18 million. The collateral that MJK's counter party, Native Nations, Inc. ("Native Nations"), a registered securities firm in New Jersey, was holding against the securities loaned was $130 million, resulting in a credit exposure on this transaction of $6 million, as acknowledged on MJK's records.

At the same time, MJK had another open securities borrowed transaction with Native Nations involving bonds of Imperial Credit Industries Inc. ("Imperial"). MJK had borrowed Imperial bonds with a market value of $45 million, while maintaining cash collateral at Native Nations of $63 million creating an exposure acknowledged in its records of $18 million. Its total receivables from Native Nations related to the two borrowings amounted to $193 million, 46 percent of the total receivable for securities borrowed collateral and 21 percent of its total assets. MJK's total credit exposure to Native Nations for both securities borrowing combined amounted to $24 million**.** Native Nations excess net capital amounted to less than $5 million.

The credit exposure to Native Nations that resulted from the borrowed securities was primarily due to the fact that MJK had not been collecting marks to the market from them. Meanwhile, the counter parties to which MJK had lent those securities were demanding and collecting marks to the market from MJK. At August 31, 2001, MJK was holding $130 million in cash collateral for Genesis securities loaned (for securities with a market value of $124 million) and $47 million in cash collateral for the Imperial bonds (market value of $45 million) it had loaned. Because MJK was paying marks to the market that it was not receiving, its matched securities borrowed and loaned transactions in Genesis and Imperial created a financing need of $16 million as of August 31, 2001.

On September 11, 2001, the securities markets were closed as the result of terrorist attacks in New York and Washington D.C. After the markets reopened on September 17, 2001, the price of Genesis continued to decline. By Friday, September 24 the price of Genesis stock had fallen to $11 per share. MKJ continued to pay marks to the market to the counter parties that had borrowed Genesis and Imperial from it, without receiving offsetting marks from Native Nations. Because of the decline in the prices of Genesis

[4] Under generally accepted accounting principles, broker-dealers record the receivables and payables associated with their obligations to return cash collateral for securities loaned and their right to receive back cash collateral for securities borrowed. Securities movements and obligations to receive and deliver securities are recorded on a separate custodial record know as the "stock record".

and Imperial, according to the Trustee's complaint, MJK had paid out $70 million more in marks to the market than it had received from Native Nations. As $70 million was far more than it had in net worth or regulatory capital, MJK was closed by federal regulators on September 25, 2001 and ceased doing business.

Section 4: Applicable Rules and Regulations

The Net Capital Rule

All broker-dealers registered with the SEC must comply with the Commission's Net Capital Rule, Securities and Exchange Act Rule 15c3-1. The rule sets forth a liquid asset test designed to ensure that broker-dealers will have adequate resources to fund expenses of a self or court supervised liquidation. The rule operates in two parts. First the firm determines how much net capital it is required to have under two alternative tests. Under the "Aggregate Indebtedness Method", the broker-dealer must maintain net capital in excess of the higher of a specified minimum and 6 2/3% of its Aggregate Indebtedness, a defined term that generally means uncollateralized liabilities. Under the "Alternative Method" the broker-dealer must maintain net capital in excess of the higher of $250 thousand or 2% of its "Aggregate Debit Items", a defined term that generally means customer-related receivables.

Next, the firm determines how much net capital that it has. Generally, net capital equals net worth as computed under generally accepted accounting principles, plus certain approved subordinated liabilities, minus unsecured receivables and other illiquid assets and market risk deductions for securities and commodities positions. As securities borrowed and loaned positions pose counter party credit risk to the broker-dealer, the provisions in the rule relating to unsecured receivables address those transactions.

As securities lenders normally receive cash collateral in excess of the market value of the securities that they lend, the rule requires a 100 percent deduction to the extent that the broker-dealer has any credit exposure on a stock loan.[5] Conversely, as securities borrowers normally provide excess collateral to the lender, a no-action letter published by the Commission's Division of Market Regulation allows the broker-dealer to provide excess collateral without incurring a deduction, provided the amount of the excess collateral does not exceed certain parameters. Those parameters require the broker-dealer to deduct the greater of a charge computed on a per counter party basis and a charge computed on the borrower's entire portfolio. The per counter party charge is the greater of: (a) the amount of collateral held by any one lender which exceeds 105 percent of the current market value of the securities borrowed from that lender, and (b) the amount of excess collateral held by any one lender to the extent the excess collateral is greater than 20 percent of the borrower's excess net capital. The portfolio charge is the amount by which the total amount of excess net collateral held by all lenders in aggregate exceeds 300 percent of the borrower's excess net capital.[6]

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[5] *See* Rule 15c3-1 (c)(2)(iv)(B)

[6] *See* Letter to Mr. William J. Young, Chicago Board Options Exchange from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, Securities and Exchange Commission, (Dec. 7, 1983) The rule also requires the broker-dealer to incur a 1 percent charge in computing net capital for securities borrowed for which it has pledged an irrevocable letter of credit as collateral, *See* Rule 15c3-1 (c)(2)(vi)(H).

The Customer Protection Rule

While the Net Capital Rule ensures that the broker-dealer has adequate resources to pay liquidation expenses, the objective of Rule 15c3-3, the Customer Protection Rule is to ensure that investment property of the firm's customers will be available to be distributed in liquidation. The rule can be thought of as having two primary regimens, one protecting customer funds and the other protecting customer securities. To protect customer securities, the rule requires that the broker-dealer obtain and maintain possession or control of the customer's fully paid securities free of any lien. If the customer has not fully paid for the securities, the rule allows the broker-dealer to raise funds by using them, subject to certain limitations.

If a broker-dealer borrows fully paid securities from a customer, generally it must provide collateral consisting of cash or government securities to the customer exceeding the market value of the securities that it borrowed and must make certain disclosures to the customer including that the customer will not be protected by SIPC in a liquidation.[7]

With respect to customer funds, the Customer Protection Rule requires the broker-dealer to make deposits into the "Special Reserve Bank Account for the Exclusive Benefit of Customers" ("Reserve Account") based on its computation of the "Formula for Determination of Reserve Requirement for Brokers and Dealers" ("Reserve Formula"). Under the Reserve Formula, the broker-dealer compares the amount of funds it has received from customers or through the use of their securities ("Credits") to the amount of funds the firm has used to finance customer activities ("Debits"). The amount by which the Credits exceed the Debits is deposited in the Reserve Account. With some limited exceptions, the rule requires the firm to compute the amount of the reserve deposit weekly.

When a broker-dealer finances customer margin accounts by lending out the customer's securities, the broker-dealer would include a Debit and a Credit in the Reserve Formula. The amount of the Debit would be the amount of the margin debit and the amount of the Credit would be the cash collateral received from the securities loan counter party.

When a broker-dealer borrows securities to deliver for the settlement of short sales by customers, the broker-dealer includes as a Debit the cash collateral posted to the securities lender. The amount of the Credit is the market value of the short position plus any cash received as margin from the customer. When the broker-dealer borrows securities to lend out to another broker-dealer, neither a Debit nor a Credit is included in the Reserve Formula.

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7 Congress amended SIPA in 1978, however, among other things, to clarify that lenders of securities who receive collateral or compensation, generally, are not customers under SIPA. *See* SIPA, 15 U.S.C. Section 78lll(2); SEA Release No. 18420, (Jan. 13, 1982). Prior to the amendment of SIPA, some courts ruled that securities lenders were not SIPA customers. *See* SEC v. F.O. Baroff., Co. Inc. 497 F. 2d 280 (2d Cir. 1974); In re Hanover Square Securities, Inc. 53 B.R. 235 (Bkrtcy. S.D.N.Y. 1985).

Regulation T

Regulation T was issued by the Board of Governors of the Federal Reserve ("Federal Reserve") pursuant to the Securities Exchange Act of 1934 to regulate extensions of credit by broker-dealers. For example, under its provisions, broker-dealers are generally required to collect 50 percent of the value of equity securities purchased in a margin account. Securities borrowed transactions are extensions of credit in that the securities lender generally receives cash collateral that exceeds the market value of the securities that were lent. As that amount exceeds the 50 percent limitation imposed on margin lending, Regulation T limits the circumstances under which broker-dealers can borrow securities.

For many years Regulation T allowed broker-dealers to borrow or lend securities only for the purpose of making delivery of the securities in the case of short sales and failure to receive securities required to be delivered. If the broker-dealer borrowed securities to lend to another broker-dealer, it was required to obtain a statement from that broker-dealer that it had a purpose recognized under the rule. During that time, the rule was interpreted to further limit persons other than broker-dealers from borrowing securities without complying with the 50 percent or other applicable margin requirement. More recently however, those limitations have been relaxed as the result of statutory changes and amendments to the rule.

In the National Securities Markets Improvements Act of 1996, the US Congress amended section 7(c) of the Securities Exchange Act to exempt certain broker-dealers from the Federal Reserve's credit regulations. Presumably, to restrict having active traders registering as broker-dealers to escape from the margin rules, the amendment limited the exemption to broker-dealers with a substantial portion of business consisting of transactions with persons other than brokers or dealers. The Federal Reserve subsequently amended Regulation T to establish "safe harbor" guidelines under which broker-dealers could determine whether they could be considered "exempt borrowers" under the statutory change. The Federal Reserve also rescinded the interpretation that only broker-dealers could have a purpose recognized under Regulation T to borrow securities. Those legislative and regulatory changes now mean that: 1) any person may borrow securities from an exempt borrower for any purpose; and 2) broker-dealers that are exempt borrowers can lend securities to any person for any purpose. Exempt borrowers may borrow securities from nonexempt lenders as long as it has a purpose to borrow. As was the case before, lending those securities to another broker-dealer that has a recognized purpose fulfills the purpose requirement with respect to the original borrow. (The exempt borrower needs a purpose for the borrow, not the loan.)

Section 5: Securities Lending

A securities loan is a temporary exchange of securities for collateral consisting of cash and/or other securities. At term, the securities borrower is obligated to return the securities to the lender. Most securities lending transactions transmit legal title of the securities to the borrower for the term of the transaction, but as an economic matter, the transactions bear characteristics of a loan.[8] First, the contractual rights of the borrower are generally similar to those of a beneficial owner of the securities. The lender generally retains the right to receive interest or dividend payments on the securities.

The transfer of legal title, however, is important because it allows the borrower to redeliver the securities, perhaps in another loan or to settle a pending trade. Secondly, it means that the lender receives value in exchange for the title, usually cash or other securities, which serves as collateral for the loan during its term.

Securities lending transactions are economically similar to repurchase transactions ("repos") and sale/buy back transactions. Those transactions are similar in that securities are commonly exchanged for cash or cash equivalents. Repos are typically financing transactions, in which the holder of the securities is seeking to finance the purchase of the securities. Like securities lending transactions, repos tend to be governed under a master agreement. Both sides of the trade, the sale and repurchase for a subsequent trade date, are entered into in a coordinated trade under a written agreement. Sale/buy back transactions, on the other hand, generally involve sales and repurchases of the same security on the same trade date with different settlement dates, without a governing master agreement or legal connection between the two legs of the trade. Sale/buy back arrangements are economically the same as repos, but they do not necessarily enjoy the status the repos do under bankruptcy or other laws.

In the United States, securities are generally borrowed to make delivery on a proprietary or customer short sale, to make delivery on a failed transaction in the securities settlement system, or to lend to another securities borrower. The primary borrowers of securities in most markets are the major securities dealers. In particular, large securities firms that offer "prime brokerage" services can be heavy borrowers of securities. Prime brokerage services enable active traders, whether they be hedge funds or other broker-dealers, to centralize their clearing, custody and record keeping at one or few broker-dealers, while executing trades through others in order to obtain lower commissions, better execution or to conceal their strategies. As most institutional securities lenders have stringent eligibility criteria for borrowers, many hedge funds, or hedge funds registered as broker-dealers rely on their prime broker for access to borrowed securities to cover their short positions.

The primary lenders of securities are institutional investors that are typically long-term holders of securities such as pension funds, insurance funds and mutual funds. Those institutions are generally attracted to the additional revenue that lending the securities

[8] For a discussion of securities lending generally, *see* Securities Lending Transactions: Market Development and Implications, Technical Committee of the International Organization of Securities Commissions, Committee on Payment and Settlement Systems, July 1999.

portfolio offers. Frequently securities owned by institutions are lent by their custodian banks as agent, although the specific identity of the institutional lender may not be disclosed. Also, institutions may sometimes employ the services of small boutiques that act as agents in finding more customized or more beneficial lending opportunities.

Financial firms such as banks and broker-dealers also lend securities. Those firms tend to lend securities that they have borrowed, or in the case of broker-dealers, securities that they are holding as margin collateral. In addition to providing a customer service, financial firms have established substantial proprietary businesses in securities borrowing and lending to take advantage, for example, of a beneficial differential in interest rates.

Securities are loaned either because the borrower needs them to satisfy a delivery need or the holder desires to finance its purchase of the securities or earn a supplemental return on them. As discussed in Section 4 of this study, for many years the Federal Reserve Board restricted the borrowing of securities in effect, to limit the borrowing of securities in the United States to those situations where the borrower has a need to deliver the securities to settle a short sale or a fail to deliver. Recently Regulation T has been relaxed to allow in many, but not all, situations, persons to borrow securities for the purpose of financing their purchase. More specifically, those changes include the statutorily created exempted status of the "exempt borrower" and, more importantly, the Federal Reserve Board staff decision to allow persons other than US registered broker-dealers to borrow securities.[9] More than anything else those two events have caused the US securities lending business to move closer toward the international model. In the international model, other than the fee arrangements, little distinction is made between securities borrowed to make a delivery and securities borrowed to finance a purchase. As a general matter, the risks are the same, an exchange of securities for cash or cash equivalents. But in the market for borrowing securities to satisfy a delivery need, the risks can be quite different.

When a security is difficult to borrow, the lender can enjoy an advantageous return on the loan. Frequently, the security that is hard to borrow is the subject of heavy short sales in the market, thus driving the demand for the borrowing. Here, the classic risk management pay-off analysis takes place. If the firm is borrowing the security to lend to others, will the return it makes on the loan offset the risk it takes on the borrow? The risk equates to the fact that because the security is in so much demand, by definition a predominant number of market place participants believe that the value of the securities borrowed collateral will decrease. In some cases securities that are in heavy demand, or on "special", may be subject to a market manipulation.

Market manipulation consists of manipulative conduct designed to affect a security's price by interfering with the natural forces of supply and demand. The U.S. Supreme Court has described market manipulation as "connoting intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price

[9] *See* New York Stock Exchange Information Memo Number 88-34, November 4, 1988.

of securities."[10] In a market manipulation, the common ploy is to intentionally create a heavy buying interest in a thinly traded stock to raise the price of the stock. This may be done by artificially creating an interest in the stock by planting rumors or otherwise, or attempting to control the supply or both. As the price of the security rises, short sellers frequently begin to realize that there is a disparity between the value of the company and the price that the stock is selling for and start selling short. As short selling will cause the price of the security to decrease, some manipulators increase their attempt to control the availability of the stock, making it difficult for the short sellers to borrow it and make delivery to the buyer. If they are successful, the short sellers will fail to make delivery on their transactions and the purchasers will eventually "buy-in" the short sellers, frequently at a price at or above the current market value. This practice is commonly known as "squeezing the shorts". As the practice by design makes it difficult to borrow the security that is the subject of the manipulation, the amount the borrower is willing to pay to borrow the security is increased to the point where the borrower is willing to forgive any interest rebate on the cash collateral that it paid to the lender. Those securities borrowing pricing arrangements are generally known as securities borrowed transactions that are "on special".

Market manipulations are generally a short-term scheme, as eventually the manipulators must find away to convert their stock holdings to cash at or near the manipulated price. Once they release or lose control of the supply of the stock, subsequent holders, whether they are purchasers, lenders or persons that borrowed the stock, can suffer losses or be exposed to loss to the extent that the amount of their collateral has decreased. As discussed in the Findings section of our study (Section 6), stock manipulation scenarios have been associated with losses to SIPC in cases in the past.

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[10] *See* ESSAY: "You've Got Jail": Current Trends in Civil and Criminal Enforcement of Internet Securities Fraud, Richard H. Walker and David M. Levine, 38 Am. Crim. L. Rev. 405; *See also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

Section 6: Findings

Rule 15c3-3

The RFP asked us to study "[t]he failure of MJK and the relationship to Rule 15c3-3." Although MJK may have been experiencing cash flow or other difficulties before it failed, its collapse was immediately induced by its inability to fund its reserve deposit required under Rule 15c3-3, the SEC's Customer Protection Rule. As discussed above, in August of 2001, MJK had ceased receiving mark to the market payments from Native Nations on the securities it had borrowed from it, but nevertheless continued to pay those marks to the market to its securities lending counter parties. MJK temporarily funded those payments by borrowing against customer margin securities, but was required to later fund its Rule 15c3-3 Reserve Account deposit following its reserve computation later that week. It funded that deposit by further borrowing against customer securities, only to raise the following week's requirement even further. This cycle or "spiral" continued until MJK ran out of customer margin securities to borrow against.

First, any discussion of whether the financial responsibility rules fell short necessarily presumes that the rules were complied with in the first place. When we visited the MJK liquidation site, we were provided MJK's July and August 2001 FOCUS reports as filed with the SEC and the support for those filings. We did not make a determination that those documents represented the complete support for those filings. While we did not conduct a forensic investigation or examination, we did come across handwritten adjustments made to MJK's securities lending record that reduced the amount of the credit that would have been included in the Rule 15c3-3 Reserve Formula.[11] The notations adjacent securities loans of Hain Celestial Group Inc. ("Hain") and NY Fix Inc. ("Fix") indicate that those loans should have been in the "conduit" book, or book of securities loans that were borrowed from other broker-dealers, which are excluded from the Reserve Formula, unlike customer margin securities that are lent out. The total of those two loans amounted to $16.2 million, the amount of the adjustment on the last page of the customer securities loan schedule that effectively reduced customer credits. We looked at the list of the firm's securities borrowings of Hain and Fix from other broker-dealers and found no such borrows. As MJK had reported excess Debit items over Credits of $9.7 million and a reserve deposit of $83 thousand, the manual $16.2 million adjustment, if not made, would have potentially required an additional reserve deposit as of July 31, 2001 of approximately of $6.5 million.

The net capital rule includes deductions for counter party credit related to securities borrowed transactions. One of the provisions requires the broker-dealer to deduct the amount of collateral provided to the lender over 105 percent of the market value of the securities borrowed. The requirement does not distinguish between the liquidity and marketability of the securities borrowed, or if the borrower has borrowed an excessive amount of a particular issue of a security in comparison to the trading volume in that issue. Nevertheless, as MJK failed to collect marks to the market in the securities it had borrowed from Native Nations, we saw no evidence that would indicate to us that the

[11] *__See__* Exhibit 1 in the Appendix.

charge related to the 105 percent test was taken by the firm. As calculated by us, if the charge was in fact not taken, a later adjustment to include it would have eliminated MJK's remaining excess net capital in the month of August 2001.[12] We also calculated the charges as of July 31, 2001 and found that the charge would have been $8,314,690[13]. MJK's reported excess net capital was $14,716,643 at that time.

It also appeared to us that the firm had not reconciled its operating bank account since January 2001. The net capital rule and the customer protection rule both include charges for unreconciled accounts.[14] Although we did not devote the time required to determine those amounts, our expectation would be that if that were done, MJK's net capital would decrease and Reserve Formula requirements would increase in both size and the time period covered.

Perhaps the most direct question raised by the MJK fact scenario is whether the SEC should amend Rule 15c3-3 to require more frequent, or even daily computations of the Reserve Formula. With respect to the weekly Reserve Formula computation, Rule 15c3-3 under one of the original proposals in May of 1972 would have required broker-dealers to compute the Reserve Formula daily.[15] In response to industry comments, the proposal was modified and reproposed to the current weekly requirement because as the Commission stated:

> "It was represented that, although cash and cash related items could be computed on a daily basis, the nature of broker-dealer accounting, clearance and settlement procedures is such that customer transactions could not be individually traced and separated, so that the daily figures would necessarily reflect combined figures for the firm and the customer. Moreover, numerous smaller broker-dealers felt that the cost of computing such figures daily, including the manual reviewing of customer accounts, would be out of proportion with the additional protection intended for customers, and that the costs in some cases might even be prohibitive. It was pointed out that, as to those firms which use outside computer service facilities, they would find it virtually impossible to comply with the daily requirement, because such service facilities could not reasonably generate the required figures on a daily basis for the multitude of brokers which they serve."[16]

Since the rule was adopted in 1972 the securities industry has evolved and, among other things, technological advances have enabled securities firms to enhance and develop new products and become much more efficient in their processing of transactions. Securities firms execute millions of trades automatically and computerized securities index arbitrage trading has become a profitable proprietary and client business line. Transaction processing has improved to the point where the settlement period has been

[12] *See* Exhibit 2 in the Appendix.
[13] *See* Exhibit 2 in the Appendix.
[14] *See* Interpretation Handbook, Volume I, Rule 15c3-1(c)(2)(iv) /02 and /021, New York Stock Exchange Inc. *See also*, Securities Exchange Act Rule 15c3-3a, Item 8.
[15] *See* Securities Exchange Act Release 9622, May 31, 1972
[16] *See* Securities Exchange Act Release 9775, Sept. 14, 1972

reduced from five to three days and a one-day settlement period is under active consideration.

As thirty years have passed and technology continues to improve, it is reasonable to ask whether securities firms can now compute the Reserve Formula daily, or more frequently than once per week. To obtain an understanding of the current capability of the industry, we called a number of firms, focusing on those firms that are most likely to have more difficulty with a more frequent computation.

The responses that we received from the firms differed. As a general rule, firms with a simple processing model (e.g., receipt versus delivery transactions with institutions) can compute the Reserve Formula quicker than firms that conduct a clearance business for other broker-dealers or a retail customer custody business. Another factor is the extent to which the firm has been involved in merger activity. When broker-dealers combine, their systems become more complicated as they pick and choose which to keep and which to link to the systems that they already have. Because of user demands, very few firms have a completely integrated front-to-back office system, and almost all firms manage a continuous stream of system changes.

We find that increasing the frequency of the Reserve Formula computation, over time, could be possible, but costly to the industry. We believe that most firms have not contemplated it, and have not devoted the resources that it would take to regularly compute the formula more frequently. Some firms compute it more frequently to make monies no longer required to be in the Reserve Account available for funding needs. For the most part however, the Reserve Formula process at many firms is an exercise that occupies part of each weekend and the entire day on every Monday.

Although technological advances have improved reporting, the process of computing the formula is somewhat similar to closing the financial books and records of any corporation. In fact, it can be more demanding in that not only do money balances require analysis, but securities on the securities record or a subsidiary ledger also must be examined. That process generally takes time because of the analysis of balances and adjustments made to correct them or to adjust for timing differences in transactions. As many of the balances that feed the Reserve Formula are from the firm's balance sheet, most of Monday is spent in the balance analysis and adjustment process. Because the process is so accelerated, many firms routinely maintain an excess deposit over the requirement to cover mistakes in the process. Indeed, one of the firms we spoke to had an excess deposit in its Reserve Account that exceeded the SIPC fund by three times.

Much of the time spent verifying and documenting balances is done so that regulatory examiners will not question the firm. Many firms currently produce daily financial information for internal reporting purposes. That information includes daily financial statements, net capital computations and funding reports. Firms could compute the Reserve Formula more frequently using reasonable estimates for certain balances, or using weekly numbers for some items and daily for others, but we question whether the SEC could become comfortable with information that lacks precision.

Notwithstanding that, we encourage the self-regulatory organizations to maintain close supervision of firms that are experiencing the Reserve Account spiral. The spiral, again, occurs when a firm hypothecates or uses customer property during the week to finance its operations. The existence of the spiral is a symptom that the firm has funding issues and may have difficulty obtaining proprietary financing. To the extent that they do not do it already, self-regulatory organizations that have examining authority over brokerage firms should use automated or other means to detect firms in the spiral and maintain close supervision over them once they are detected. To accomplish this on a more meaningful basis, self-regulatory organizations might have to require their members to file their reserve computations weekly, as opposed to monthly. We note that when we asked the NYSE and the NASD how many of their members were experiencing the spiral, those organizations queried their FOCUS reporting data systems and reported that none of their members were experiencing the spiral as of the date of the request.

SIPC Exposure and Safety and Soundness of the System

The RFP asked us to study "[t]he implications generally of the stock lending business with regard to SIPC exposure, including a quantification of that exposure." In large part, the RFP came from a concern that the MJK liquidation was unusual compared to previous SIPC liquidations in that previous liquidations "…involved some form of malfeasance, misfeasance, or nonfeasance directly affecting those assets. " The RFP distinguishes the MJK liquidation by stating "…[t]he MJK case, on the other hand, involved an indirect loss of customer assets by reason of the inability of MJK to make reserve deposits required of it under the SEC's customer protection rule (Rule 15c3-3).

As stated in the RFP, many of SIPC's losses have been due to fraud, misappropriation or other malfeasance. At least part of SIPC's interest in hiring us to analyze MJK's demise arose from its belief that that collapse resulted from circumstances that did not involve the factors that were present in its past loss history. Although we did not conduct an investigation, and we are aware that others are, our belief, and eventually our expectation is that our finding will be that the MJK collapse is in fact, not that different from some of the losses that SIPC has experienced in the past.

Some of SIPC's losses in the past involved margin debits that became unsecured due to a dramatic decrease in the value of the securities that were serving as collateral for the debit. Those losses involved alleged market manipulations of securities that declined in value after the scheme collapsed. Again, although we did not conduct sufficient investigative or forensic work to make a determination of whether that type of malfeasance occurred, we are aware in fact that the SIPC trustee for MJK and other firms have filed suit against others claiming that they suffered losses because of the alleged manipulation of Genesis, Imperial and the securities of Holiday RV Superstores, Inc.[17]

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[17] *See* In re: MJK Clearing, Inc., Debtor., James P. Stephenson, in his capacity as trustee for the estate of MJK Clearing, Inc., v. Deutsche Bank AG, Deutsche Bank Securities, Inc., Deutsche Bank Securities Limited, Wayne Breedon, RBF International, Inc., Kenneth D'Angelo, Richard Evangelista, Genesis Intermedia, Inc., Ramy El-Batrawi, Ultimate Holdings, Ltd., Adnan Khashoggi, Bradford Keiller, and John

While the credit risk exposure that has given rise to SIPC exposure in past liquidations [18] has normally manifested itself in the margin debits, in this particular case the same credit exposure appeared in the receivables collateralized by securities that MJK had borrowed. As mentioned earlier, MJK's securities borrowings were heavily concentrated with one thinly capitalized counter party and in particular issues of securities. At one point it had borrowed approximately forty percent of the outstanding shares of Genesis Intermedia, a security that allegedly had been manipulated.[19]

Another direct question raised by the MJK set of facts is whether the securities borrowed deductions in the net capital rule should be amended to address marketplaces blockages in borrowed securities. While the net capital rule does include charges for counter party credit risk, the rule does not make distinctions between the quality of the security borrowed or whether the broker-dealer had borrowed an amount in excess of what could be reasonably liquidated. Broker-dealers frequently borrow securities to cover short positions of their customers. Obviously, if the market believes a stock is over-valued, customers will sell that security short and their brokerage firm will have to borrow it knowing that its value may likely decline. Broker-dealers that we spoke to indicated to us that they will borrow securities that are on special for their customers, but will pay particular attention to the credit quality of the counter party when borrowing those securities, knowing that if the transaction has to be closed out, there is an increased likelihood that it will be closed out at a deficit.

We believe that these issues are better addressed by improving industry risk management processes than by tinkering with the net capital rule. The net capital rule does not currently make distinctions regarding counter party credit quality. It is possible to amend the rule to do that, and indeed that is done internationally. The net capital rule generally treats counter party credit conservatively, and in most cases requires the firm to take deductions for any unsecured counter party credit exposure. It further requires firms to take deductions when counter party receivables are secured by securities that do not have a ready market. That deduction has not been applied to borrowings of securities that do not have a ready market. As discussed above, broker-dealers do not always have control over what securities they are required to borrow. Given that broker-dealers frequently

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Does 1-10, United States Bankruptcy Court District Of Minnesota, Bky. No. 01-4257 (RJK), Adv. No. 02-4185 (RJK)

[18] *See, e.g.* In re Adler, Coleman Clearing Corp., Debtor. Edwin B. Mishkin, as SIPC Trustee For The Liquidation Of The Business Of Adler, Coleman Clearing Corp., V. Daniel David Ensminger, et al., Case No. 95-08203 (JLG), Adv. Proc. No. 97/8423A, United States Bankruptcy Court For The Southern District Of New York 247 B.R. 51; 1999 Bankr. LEXIS 1819

[19] *See* In re: MJK Clearing, Inc., Debtor., James P. Stephenson, in his capacity as trustee for the estate of MJK Clearing, Inc., v. Deutsche Bank AG, Deutsche Bank Securities, Inc., Deutsche Bank Securities Limited, Wayne Breedon, RBF International, Inc., Kenneth D'Angelo, Richard Evangelista, Genesis Intermedia, Inc., Ramy El-Batrawi, Ultimate Holdings, Ltd., Adnan Khashoggi, Bradford Keiller and John Does 1-10, United States Bankruptcy Court District Of Minnesota, Bky. No. 01-4257 (RJK), Adv. No. 02-4185 (RJK)

must borrow securities on behalf of customers, we believe that the SEC should not amend the net capital rule in this area and should instead propose rules to require securities firms to have documented risk management procedures. Our recommendation is discussed further below.

To address the concerns raised in the RFP, we collected data from the NYSE and the NASD on securities lending, among other things. That data revealed that an enormous amount of securities lending transactions are being conducted by broker-dealers, and that the industry has experienced significant growth in the volume of those transactions over the past four years. [20] The data also indicated that, in particular for NASD member firms, that securities borrowing activity has increased in proportion to the total assets of those firms. [21] At the same time, however, the amount of equity as a proportion of total assets for NASD member firms declined, meaning that a smaller amount of equity is supporting a larger amount of securities borrowing activity for those firms.[22]

Although the data is informative, it is far from conclusive. For one, the data does not distinguish between the types of securities borrowed or the credit quality of the counter parties to those transactions. For this reason, we cannot calculate a number that represents SIPC's exposure to securities lending transactions, but given the size of the industry statistics, we would expect that generally the aggregate amount of credit exposure of securities firms related to securities borrowed transactions to be very large. This does not necessarily mean that SIPC is exposed to that extent, however. In analyzing SIPC's exposure generally, however, we believe that there is a balance between losses that SIPC is responsible for covering and the ability of the financial responsibility system to protect against that exposure. Our analysis finds that analysis weighs heavily toward increased reliance on the safety and soundness of the system. That finding is based in large part on the relative success in the past of the financial responsibility system, as it currently exists, in preventing and limiting the size of losses to the SIPC fund.

SIPC's loss experience has indicated that the system does work. This observation is borne out by the size of industry statistics provided to us by the NYSE and the NASD.

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[20] *See* Exhibit 3 in the Appendix.
[21] *See* Exhibit 4. Also note that the NYSE firms transact a large proportion of the securities borrowing volume in the industry. *See* Exhibit 5.
[22] *See* Exhibit 6.

For example, one firm had a Rule 15c3-3 Reserve Formula deposit of $38 billion.[23] We know of another firm (possibly the same one) that had a cushion, or excess deposit over the Rule 15c3-3 requirement, of three times the size of the SIPC fund. Other industry statistics such as revenues, capital, or even the size of the securities loaned and borrowed, are staggering when viewed in comparison to the size of the fund.

We believe that the size of those numbers demonstrates how much SIPC is dependent on the successful operation of the financial responsibility rules and the supervision and enforcement mechanism. If not for that system, SIPC's exposure would necessarily be significantly higher than it is today. With this in mind, we point out that as international financial responsibility regulation is concerned, the US securities system is somewhat unique in its conservatism. Almost all counter party credit risk is treated as if the counter party defaulted and the market risk charges are generally conservative percentages of the value of the positions of the firm, as compared to the international standard, which allows the firm to employ its own "Value at Risk" quantitative models to determine those charges. While the international standards may produce a more satisfying result from the point of view of a trader or risk manager, SIPC, and indirectly, the US Treasury, are most definitely the beneficiaries of the current US model. Any significant change in that model would cause us to rethink our findings, and would likely cause us to change our view with respect to reliance on the system and would lead us to believe that SIPC's exposure to securities lending, and other activities of broker-dealers would be much greater than it is today.

Although we could not gather specific industry wide data related to SIPC's exposure to the securities lending industry, we did ask the NYSE and the NASD to provide us with aggregate industry information. That data indicated generally that MJK's leverage

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[23] *See* Exhibit 7 in the Appendix. Although it is not relevant to our study we also determined where those deposits are located. Largely because the Customer Protection Rule allows securities firms to include U.S. government securities in the Reserve Account, many firms use their government securities clearance banks to hold their reserve deposit. As there are only two clearance banks that broker-dealers use for U.S. government securities, it appears that a concentration exists which poses issues similar to those raised by the recent joint concept release published by the SEC and the FED. *See* SEC Concept Release: Interagency White Paper on Structural Change in the Settlement of Government Securities: Issues and Options Federal Reserve System [Docket No. R-1122] Securities and Exchange Commission [Release No. 34-45879; File No. S7-15-02] RIN 3235-AI48 Interagency White Paper on Structural Change in the Settlement of Government Securities: Issues and Options, May 2002.

Exhibit 8 of the Appendix is an analysis of the change in aggregate Reserve Formula customer credit and debit items over time. The amount by which the credit items exceed the debit items represents the amounts deposited in the Reserve Account discussed immediately above. The chart yields two noteworthy observations. First, the gap between the credit items and debit items begins to significantly widen about the time that the market begins to decline (*See* Exhibit 12). The cause for that separation would be that as customers sell their securities, they pay down their margin debits and leave the remaining funds with the firm as free credit balances. The second observation involves the impact of the September 11, 2001 terrorist attacks. The chart indicates a precipitous parallel decline in both credit and debits items following that date. This decline could be due to a growing reluctance of customers to custody their investment assets at securities firms following the tragedy, or alternatively, customers making fully paid investments in securities, or a combination of both.

exceeded industry norms substantially. MJK's regulatory net capital was slightly over 1 percent of its total assets at a time when the industry average was approximately 4 percent.[24] Much of its leverage was attained through its activities in securities lending and borrowing. The amount of its securities borrowings as a percentage of its total assets was slightly below 50 percent of its total assets. At the same time, the industry average was below 30 percent of total assets.[25]

We also asked the NYSE and the NASD to provide us with the number of firms that had securities lending matched books exceeding the level of leverage attained by MJK. That query revealed thirteen firms.[26] Eight of those firms were NYSE members and five were members of the NASD. Three firms had excess net capital below $50 million. We asked the NYSE and NASD to provide us with some insight as to the nature of those firms and the risk that they posed to SIPC. We learned that none of the firms posed substantial risk to SIPC because of either the size of the firm or the nature of its business. Six of the firms were owned by large banking holding companies that could support the broker-dealer if it needed additional capital. Two of the other firms were very large and well capitalized. Another firm had excess net capital below $50 million, but is owned by a large investment bank holding company.

The four remaining firms are considered clearing firms as a technical matter, but because of the nature of their business do not pose significant exposure to SIPC. Two of them have excess net capital exceeding $50 million and do not carry customer accounts. One firm with less than $50 million of excess net capital is a firm that conducts primarily proprietary trading activities.

The other firm with less than $50 million in excess net capital is an inter dealer broker. Inter dealer brokers can be distinguished from other broker-dealers in that their business almost consists of acting as an intermediary between other broker-dealers that prefer to remain anonymous, at least until the transaction is about to be settled. Counter parties to inter dealer brokers generally know that those firms limit access to their facilities to a confined group of well-capitalized firms. Because those firms know that another well-capitalized firm is ultimately responsible for settlement, the inter dealer broker does not generally need to maintain high levels of capital as a business or credit matter. Inter dealer brokers generally pose little risk to SIPC as they do not carry or clear customer accounts, and their business should be easily liquidated if that became necessary.[27]

The RFP also asked us to study "[T]he implications of business transactions which could cause a similar failure to meet Rule 15c3-3 requirements." In response to this we considered other transactions that are similar to securities lending in that money is owed the broker-dealer pending the delivery of securities. As discussed in Section 5 of this

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[24] *See* Exhibit 9 in the Appendix.
[25] *See* Exhibit 10 in the Appendix.
[26] *See* Exhibit 11 in the Appendix.
[27] Assuming the firm's books and records are accurate, an inter dealer broker can be liquidated by simply identifying the counter parties to the fails and revealing their identities to each other, so they can attempt to make settlement away from the introducing broker-dealer.

report, repurchase agreements are similar in that the counter parties temporarily exchange money for securities. Internationally, the distinction between repurchase agreements and securities lending is primarily based on whether the counter party is interested in borrowing money or securities. In the US however, because of the influence of Regulation T and other factors, the repurchase agreement market consists primarily of financings of US government and other highly liquid debt securities. For this reason, although firms can certainly attain high levels of leverage with these transactions, those transactions should not generally pose the same level of risk to SIPC as do securities borrowings, where the borrowing broker-dealer normally provides the lender cash in the amount of 105 percent of the market value of the securities, which are frequently equity securities. The NYSE reported 10 firms that had matched repurchase agreement books exceeding 25 times the firm's excess net capital. Seven of those firms were primary dealers in US government securities and very well capitalized. Two firms that were not primary dealers were nevertheless very well capitalized and the one firm that had excess net capital below $100 million did business with other broker-dealers and hedge funds, but not public retail customers.

Three of the NASD firms were owned by large banking enterprises that could support the securities affiliate in the event that it experienced financial problems. Another firm is owned by a large non-bank financial institution. Three of the firms are technically considered clearing firms, but do not carry customer accounts. The final firm is an employee owned securities firm that specializes in proprietary trading activities. That firm does have a small customer business, servicing 2,500 accounts.

We also asked the NYSE and the NASD for information regarding firms that had high levels of securities failed to receive and fails to deliver. Fails to receive and deliver represent transactions past settlement date with another broker-dealer. Once the trade finally settles, the broker-dealers will exchange money for securities, as they would in a securities lending transaction. The collateral risk is similar because in failed transactions the collateral is securities that fluctuate in value. They differ however in that for regulatory and business reasons, firms are generally motivated to accomplish settlement of failed transactions. Both the Net Capital Rule and Rule 15c3-3 contain charges that penalize the broker-dealer for aged failed securities transactions.[28] Broker-dealers are frequently anxious to settle fails to deliver to obtain the use of funds that will be received on delivery. For the foregoing reasons, a disproportionately high level of failed transactions is usually an indication that the broker-dealer is experiencing operational problems, rather than intentionally attempting to attain high levels of leverage.

The NASD reported three firms with matched fails that exceeded 25 times the amount of their excess net capital. One of the firms is now out of business. The other two firms had temporary increases in failed transactions that have since been substantially resolved. One of those firms is a small municipal securities firm with approximately 200 customer

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[28] *See* Rule 15c3-1(c)(2)(iv)(E) and (c)(2)(ix). *See also* Rule 15c3-3a. Exhibit A – Formula for Determination of Reserve Requirement for Brokers and Dealers Item 4 (Note D) and Item 12.

accounts. The other is a trust established to handle retirement assets of schoolteachers, consisting of primarily mutual funds and variable annuities.

Although the data we requested from the NYSE and the NASD revealed that few firms had the degree of leverage attained by MJK and those firms that did do not pose significant exposure to SPIC, we recommend that the SROs, to the extent they do not already do, monitor highly levered member firms. The criteria we used were a crude measure of leverage. We would expect that the SROs would develop more sophisticated criteria, and use automated means to detect highly levered firms. Again, we recognize that some SROs may currently conduct surveillance of highly levered firms, but nevertheless encourage those that do not to formally conduct such surveillance to do so.

Risk Management

Although we did not conduct a forensic investigation of MJK, the absolute absence of any formal or informal risk management procedures became immediately apparent. As discussed above in the section that addresses MJK's securities lending balances and financial condition, MJK had a large matched book in relation to its net worth and regulatory capital. In particular it had extended large amounts of cash collateral to a single counter party that had limited capital so that it could borrow thinly traded or securities that were on "special" and ultimately part of an alleged manipulation. Even worse, it had borrowed forty percent of the outstanding stock of Genesis, for which they had given cash collateral to a single thinly capitalized counter party.

In recent years, domestic securities industry regulators have emphasized internal controls and risk management procedures at securities firms. Securities industry regulatory examiners have been instructed to examine and comment on the internal controls and the risk management procedures of the securities firms that they are examining, but they have little formal guidance with which to base their review on. Although both NYSE and the NASD have rules that generally reference controls, supervision and fair business practices, those rules have no explicit standards under which the examiners can use for guidance for their review. The SEC has no rules that set forth the risk management on internal control standards that their broker-dealer registrants must follow.

A regulatory examiner on site at MJK early in 2001 would have had little basis for commenting on its risk management practices. Although the firm had begun to develop an extremely large concentration of securities borrowed transactions with a single thinly capitalized counter party, the rules that the examiners enforce would have given them little basis for comment. Assuming the examiners would have examined MJK's credit risk management procedures without rules to examine for compliance, MJK would have had no legal obligation to respond to any comments or observations that the examiner may have had.

We recommend that the SEC adopt rules that require securities firms to establish and maintain written risk management procedures. Those procedures should cover all risks areas that affect the broker-dealer's business, including market, credit, funding, legal and operational risk. We recognize that while many broker-dealers are subject to the same or a similar set of risks, they can manage those risks in different ways. While we do not recommend that the rules specify how securities firms address risk, the rules should set forth specifically what the procedures should cover in each area. The rules should provide that each broker-dealer's procedures address critical risk concerns in each risk area, but leave the broker-dealer free to address those concerns, as they deem appropriate. For example, procedures that address the credit risk associated with a securities lending matched book may address, among other things, counter party concentrations, the liquidity of the security borrowed, the amount borrowed in relation to the trading volume, and the likelihood that the security is the subject of a short squeeze. Firms would be free to address those risks in any manner they choose.

The rules should further require that the senior management of the firm should have the ultimate responsibility for establishing the procedures and monitoring significant deviations from or exceptions to the policies.

We recommend that a list of what critical risk management concerns must be addressed in each risk area should be developed and proposed to the SEC by the securities industry. Most major securities firms already have sophisticated risk management policies and systems in place, and are in a good position to provide the SEC with the specific details of what the procedures should cover.

We believe that requiring securities firms to establish and maintain written risk management procedures that address specific critical risk management concerns will set a base line for risk management policies for those firms and to the extent they have not focused on all of the risks that are applicable to their business, the exercise of establishing the policies should cause them to do so. The rules should also provide a framework from which regulatory examiners can base their examinations.

Registration, Testing and Continuing Professional Education

A fundamental aspect of any risk management system is that employees that the firm holds responsible for managing and taking risk are competent, knowledgeable professionals. The rules of the NYSE, the NASD and the other self-regulatory organizations ("SROs") generally require that those persons responsible for managing the trading departments of member firms be registered with the SRO, take qualification tests, and undergo continuing professional education

In many firms such as MJK, securities lending is a proprietary business line. A separate department is established, with budgeted revenues and expenses. That department may generate income for the firm from, among other things, a beneficial differential in interest rates between securities borrow and loan transactions. It also can expose the firm to considerable market and credit risk. Although those departments bear many of the characteristics of trading departments, it appears that persons that supervise securities lending departments of securities firms are not subject to the same registration, testing and continuing professional education requirements.[29] We recommend that the SROs consider whether supervisory securities lending professionals be subject to those or similar requirements.

Refusing to Acknowledge the Mark to Market at the Depository Trust Company

As discussed in Section 3, one of the key methods of minimizing counter party credit risk in the securities lending business is the practice of exchanging payments or "marks to market" to adjust the collateral level of securities borrowed or loaned transactions to reflect market movements in the securities. This measure mitigates credit risk by maintaining the collateral held by counter parties throughout the term of the borrow or loan to a value relatively similar to the collateral level established at the initiation of the transaction.

The process of marking the positions on a daily basis is automatically performed when the counter parties are subscribers to stock lending service bureaus that are widely utilized by the securities industry. The marks to the market generated by those service bureaus are included in the daily firm settlement amounts with Depository Trust Corporation ("DTC"). However, prior to the actual settlement of monies at DTC, counter parties may in rare circumstances refuse to acknowledge, or in the industry jargon, "DK" (don't know) the mark. From our conversations with clearing agencies, broker-dealers and others, we understand that a DK on a mark to the market through a service bureau requires consent of the counter party. As described in Section 3, the failure of MJK to receive the mark to market created a financing need due to the fact that MJK continued to pay marks to the market to its securities loan counter parties on the other side of the matched transactions. We recommend that consideration be given to establishing a process under which significant marks to the market that are suppressed by a broker-dealer would be communicated outside the firm's securities loan department. At a minimum, the SEC should consider a rule requiring DTC or the service bureaus to communicate significant exposure created by a DKed mark to the market to the senior management, including the financial operations principal and credit risk manager of the firm involved. The SEC may also consider requiring that the SROs be notified of

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[29] The NYSE generally requires that persons dealing with the public be registered. Securities lending representatives of NYSE member firms are specifically required to be registered under NYSE Rule 345(a). The NASD does not require securities lending supervisors or representatives to be registered, unless they are required to do so as a result of their other duties (e.g. they are a Financial and Operations Principal). ***See*** NASD Rules 1020, 1021, 1030 and 1031. Both organizations require heads of trading departments to take the "Series 7" examination, but do not require supervisors of securities lending departments to take any qualification tests, unless again, they are required to do so by virtue of their other responsibilities. ***See*** NYSE Rule 345.15(5) and NASD Rules 1022 and 1031. NASD Rule 1032(f) requires traders and supervisors of traders of equity securities in the Nasdaq and over-the-counter markets to take the "Series 55" examination, in addition to the Series 7. Both organizations require registered personnel to receive continuing professional education. ***See*** NYSE Rule 345A and NASD Rule 1120. Registered securities lending supervisors and representatives are required to take the "Series 101 Continuing Education General Program". In contrast, securities traders also are required to take the Series 101, but trading supervisors are required to take the "Series 201Continuing Education Supervisor Program". ***See*** NYSE Information Memo No. 00-25, Oct. 13, 2000.

extremely large suppressed marks. In any event, we believe that a notification requirement will make it more difficult for persons responsible for managing the firm's securities loan and borrow transactions to conceal significant credit exposure from those persons responsible for maintaining compliance with the financial responsibility rules and for managing the credit risk at the firm.

Another function that service bureaus provide is the generation of a risk exposure report for their client firms' securities borrow and loan portfolio. In normal course, the exposure report should not reflect significant amounts due to the exchange of marks to market between the counter parties. We understand from conversations with the MJK trustee, his staff and certain records make available to us, the exposure reports provided to MJK reflected considerable amounts of credit exposure as a result of DKed marks to the market on Genesis and Imperial. We recommend that when the SEC considers the specific critical risk concerns to be included in the stock lending component of the risk management procedures recommended above, it should further consider the availability of service bureau-provided exposure/exception reports. It should also be aware that providing those reports to several departments in the firm such as the credit, stock lending, cashiering and operations departments, generally enhances the segregation of duties and checks and balances with in the firm.

Appendix

Exhibit 1
MJK's Record of Customer Securities Loaned Includable as Credits in the Reserve Formula As of July 31, 2001
(names of counter parties omitted)

JAN-03-2003 17:11 DELOITTE&TOUCHE LLP 202 638 7845 P.01/07

Acct Firm Name	Quantity	Contract Amount	Prce	Del-Dt	Rate	Cont Num	Comments	Recv
02???53109 ALPHA INDUSTRIES INC								
	100	3,800.00	38	7/27/01	2.250	212080017		
023135106 AMAZONCOM INC								
	40,500	526,500.00	13	1/03/01	4.750	210030040	DEAL 1.5% 1%	
	16,200	210,600.00	13	4/04/01	4.750	210940011	DEAL 1.5% 1%	
	43,000	559,000.00	13	5/22/01	4.750	211420039	DEAL 1.5% 1%	
	130,000	1,690,000.00	13	6/21/01	4.750	211720037	235 4.5% 148 2%	
	132,300	1,719,900.00	13	6/28/01	4.750	211790006	235 4% 148 2%	
	120,000	1,560,000.00	13	7/31/01	4.750	212120013	DEAL 1.5% 1%	
	70,000	910,000.00	13	7/31/01	4.750	212120029	235 4.25% 101 .5%	
	232,400	3,021,200.00	13	6/19/01	4.750	211700033	2354.5% 148 2%	
	44,700	581,100.00	13	6/27/01	4.750	211780034	235 4.25% 148 2%	
	110,000	1,430,000.00	13	6/29/01	4.750	211800012	5807 4.25% 148 2%	
	100,000	1,300,000.00	13	7/09/01	4.750	211900026	235 4.5% 418 1.25%	
	150,000	1,950,000.00	13	7/10/01	4.750	211910008	235 4.25% 418 1.25%	
	1,189,100	15,458,300.00 ✓						
024768106 AMERICN BUSNESSFINLSVCS INC								
	300	5,400.00	18	3/07/01	2.000	210660001		
	300	5,400.00	18	3/08/01	2.000	210670001		
	400	7,200.00	18	3/13/01	2.000	210720006		
	1,000	18,000.00						
03814F205 APPLNCE RECYCLNGCNTRS/AMRC NEW								
	1,600	8,000.00	5	7/03/01	2.000	211840013		
	100	500.00	5	7/17/01	2.000	211980016		
	1,700	8,500.00						
038213104 APPLIED MAGNETICS CORP								
	1,800	9,000.00	5	6/22/01	4.750	211730004		
040026106 ARENISSOFT CORP DEL								
	400	4,800.00	12	6/21/01	2.000	211720036		
	1,200	14,400.00	12	6/05/01	0.000	211560020		
	1,600	19,200.00						
05275N106 AUTOBYTEL.COM INC								
	100	500.00	5	6/14/01	4.750	211650014		
055622104 BP AMOCO PLC SPNSD ADR								
	3,000	168,000.00	56	2/09/01	4.750	210400005		
087509402 BETHLEHEMSTEEL CP 2.50 CV PR								
	500	4,000.00	8	7/31/01	2.000	212120003		

SWG 06906

Exhibit 1
(continued)
MJK's Record of Customer Securities Loaned
Includable as Credits in the Reserve Formula
As of July 31, 2001
(names of counter parties omitted)

Acct Firm Name	Quantity	Contract Amount	Prce	Del-Dt	Rate	Cont. Num	Comments	Rosa
110415106 BRITESMILE INC								
	300	3,600.00	12	6/12/01	2.000	211630047		
	16,000	224,000.00	14	7/26/01	2.000	212070029		
	16,300	227,600.00						
124269101 BUY COM INC								
	19,300	96,500.00	5	3/21/01	2.000	210800001		
	13,900	69,500.00	5	3/22/01	2.000	210810008		
	100	500.00	5	4/24/01	4.750	211140024		
	65,000	325,000.00	5	6/08/01	4.750	211590002		
	90,000	90,000.00	1	5/07/01	4.750	211270005		
	188,300	581,500.00						
125750109 CMG INFORMATION SERVICES	88,100	440,500.00	5	6/18/01	1.500	211690016		
228903100 CRYOLIFE INC.	100	4,100.00	41	6/27/01	2.250	211780006		
25536K204 DIVERSINET CORP NEW	1,000	5,000.00	5	2/14/01	0.000	210450008		
262241102 DRUGSTORECOM INC								
	3,600	18,000.00	5	5/07/01	2.000	211270018		
	16,400	82,000.00	5	6/25/01	2.000	211760004		
	11,100	55,500.00	5	6/27/01	2.000	211780025		
	300	1,500.00	5	6/27/01	4.750	211780011		
	31,400	157,000.00						
27886U102 ECOM ECOM COM INC.	600	3,000.00	5	5/02/01	2.000	211220002		
284131208 ELAN CORP PLCADR	1,200	70,800.00	59	6/12/01	4.750	211630017		
292827102 ENGAGETECH	300	1,500.00	5	7/11/01	2.000	211920001		
29382P103 ENTREMEDINC	1,100	15,400.00	14	7/13/01	2.000	211940014		
294092308 EQUITEX INC.								
	900	4,500.00	5	3/29/01	2.000	210880042		
	2,000	12,000.00	6	7/16/01	2.000	211970029		
	2,900	16,500.00						

SWG 06907

Exhibit 1
(continued)
MJK's Record of Customer Securities Loaned
Includable as Credits in the Reserve Formula
As of July 31, 2001
(names of counter parties omitted)

Acct	Firm Name	Quantity	Contract Amount	Prce	Del-Dt	Rate	Cont Num	Comments	Reca
297862104	ETOYS INC								
		118,600	593,000.00	5	11/28/00	2.000	203340007		
		10,000	50,000.00	5	4/04/01	4.750	210940014		
		42,000	210,000.00	5	6/06/01	4.750	211570033		
		300,000	300,000.00	1	2/22/01	4.750	210530013		
		540,000	2,700,000.00	5	3/01/01	4.750	210600026		
		60,000	300,000.00	5	4/05/01	4.750	210950042		
		1,070,600	4,153,000.00						
311900104	FASTENAL CO								
		100	6,800.00	68	3/26/01	2.250	210850005		
313549107	FEDERAL-MOGULCORP								
		1,000	5,000.00	5	11/02/00	2.000	203340008		
		16,400	65,600.00	4	10/05/00	0.000	203340048		
		17,400	70,600.00						
37956X103	GLOBECOMSYSTEM INC								
		1,500	21,000.00	14	2/09/01	4.750	210400012		
38348T107	GOTO COMMINC								
		500	13,000.00	26	6/08/01	3.500	211590037		
405217100	HAIN CELESTIAL GROUPINC								
		250,000	6,250,000.00	25	7/30/01	4.750	212110003		
		230,000	5,750,000.00	25	7/30/01	4.750	212110001		
		480,000	12,000,000.00						
444903108	HUMANGENOMESCIENCES INC								
		10,000	530,000.00	53	7/16/01	1.000	211970018		
45245E109	IMAX CORP								
		500	2,500.00	5	6/14/01	4.750	211650015		
492061106	KERAVISION INC								
		400	2,000.00	5	5/18/00	1.500	203340038		
		1,200	6,000.00	5	6/06/00	1.500	203340039		
		1,600	8,000.00						
52729N100	LEVEL 3 COMMUNICATIONSINC								
		150,000	750,000.00	5	6/21/01	4.750	211720001	235 4.5%418 .5%	
		90,000	450,000.00	5	6/22/01	4.750	211730011	148 0.00%	
		120,000	600,000.00	5	6/21/01	4.750	211720040		
		20,000	100,000.00	5	6/26/01	4.750	211770023		
		110,000	550,000.00	5	6/22/01	4.750	211930036	235 4.5% 148 .5%	
		490,000	2,450,000.00						

SWG 06906

Exhibit 1
(continued)
MJK's Record of Customer Securities Loaned Includable as Credits in the Reserve Formula
As of July 31, 2001
(names of counter parties omitted)

JAN-03-2003 17:12 DELOITTE&TOUCHE LLP 202 638 7845 P.04/07

Acct	Firm Name	Quantity	Contract Amount	Prce	Del-Dt	Rate	Cont Num	Comments	Reca
589331107 MERCK& CO INC									
5251	ING	49,000	3,283,000.00	67	5/15/01	4.750	211350003		
591596101 METRICOM INC.									
		17,000	85,000.00	5	2/08/01	2.000	210390024		
		400	2,000.00	5	3/13/01	2.000	210720007		
		300	1,500.00	5	3/15/01	2.000	210740016		
		17,700	88,500.00						
594918104 MICROSOFT CORP									
5251	ING	46,000	3,036,000.00	66	2/28/01	4.750	210590013		
594972101 MICROSTRATEGYINC.									
		2,800	14,000.00	5	5/04/01	2.000	211240024		
		1,400	7,000.00	5	3/06/01	4.750	210650008		
		2,000	10,000.00	5	11/14/00	0.500	203340315		
		2,500	12,500.00	5	11/08/00	0.500	203340316		
		8,000	40,000.00	5	1/08/01	0.000	210080010		
		87,100	435,500.00	5	12/08/00	4.750	203430010		
		26,600	133,000.00	5	2/16/01	4.750	210470017	DEAL 2.5X 1%	
		78,100	390,500.00	5	3/01/01	4.750	210600008	DEAL 2.5X 1%	
		80,000	400,000.00	5	3/07/01	4.750	210660010	DEAL 2.5X 1%	
		60,000	300,000.00	5	3/19/01	4.750	210780013	DEAL 2.5X 1%	
		62,000	310,000.00	5	3/21/01	4.750	210800017	DEAL 2.5X 1%	
		43,000	215,000.00	5	3/22/01	4.750	210810024	DEAL 2.5X 1%	
		75,000	375,000.00	5	3/28/01	4.750	210870011	DEAL 2.5X 1%	
		5,000	25,000.00	5	4/06/01	4.750	210960028	DEAL 2.5X 1%	
		80,000	400,000.00	5	4/11/01	4.750	211010005	DEAL 2.5X 1%	
		88,000	440,000.00	5	4/23/01	4.750	211130019	DEAL 2.5X 1%	
		85,100	425,500.00	5	4/24/01	4.750	211140003	DEAL 2.5X 1%	
		92,800	464,000.00	5	4/27/01	4.750	211170009	DEAL 2.5X 1%	
		10,600	53,000.00	5	5/09/01	4.750	211290019	DEAL 2.5X @1%	
		48,000	240,000.00	5	6/15/01	4.750	211660024	DEAL 2.5X 1%	
		20,000	60,000.00	3	2/21/01	4.750	210520004	235	
		24,600	73,800.00	3	3/16/01	4.750	210750006		
		65,000	195,000.00	3	6/20/01	4.750	211710026	235	
		1,047,800	5,018,800.00 ✓						
631100104 NASDAQ 100 TR									
		70,000	2,940,000.00	42	5/04/01	4.750	211240013		
64115A105 NETSOL INTL INC									
		2,900	14,500.00	5	6/22/01	4.750	211730005		
64122R109 NETZERO INC									
		5,900	29,500.00	5	7/18/01	2.000	211990028		Recall

SWG 06909

Exhibit 1
(continued)
MJK's Record of Customer Securities Loaned
Includable as Credits in the Reserve Formula
As of July 31, 2001
(names of counter parties omitted)

JAN-03-2003 17:12 DELOITTE&TOUCHE LLP 202 638 7845 P.05/07

Acct Firm Name	Quantity	Contract Amount	Prce	Del-Dt	Rate	Cont Num	Comments	Recal
64⁴783101 NEW FOCUS INC								
	1,400	8,400.00	6	6/12/01	4.750	211630018		
670712108 NY FIX INC								
	200,000	4,200,000.00	21	6/12/01	4.750	211630004		
695112102 PACIFICARE HEALTH SYSTEM CL A								
	2,500	32,500.00	13	6/12/01	4.750	211630019		
72919P103 PLUG POWERINC								
	300	3,600.00	12	9/27/00	2.000	203340018		
731095105 POLAROID CORP								
	200	1,000.00	5	7/10/01	2.000	211910009		
	1,400	7,000.00	5	7/18/01	2.000	211990027		
	1,600	8,000.00						
750611402 RADYNECOMSTREAMINC								
	4,000	36,000.00	9	2/09/01	4.750	210400027		
760911107 RESEARCHFRONTIERS. INC.								
	9,000	252,000.00	28	5/04/01	2.000	211240023		
	100	2,300.00	23	6/01/01	2.000	211520006		
	200	5,400.00	27	6/12/01	2.000	211630045		
	300	8,400.00	28	7/26/01	3.000	212070032		
	9,600	268,100.00						
78387G103 SBC COMMINC								
	48,000	2,160,000.00 ✓	45	7/30/01	4.750	212110002		
794093104 SALEM COMMCL A								
	186,000	5,394,000.00 ✓	29	7/20/01	4.750	212010019		
795757103 SALTON INC								
	300	5,100.00	17	6/21/01	4.750	211720018		
803054204 SAP AKIENGESELLSCHAFTADR								
	1,900	70,300.00	37	6/12/01	4.750	211630020		
805147105 SAVE THE WORLD AIR								
	200	1,000.00	5	6/25/01	2.000	211760005		
	200	1,000.00	5	6/27/01	2.000	211780012		
	400	2,000.00						
845224104 SOUTHWESTSECURITIES GROUP								
	2,200	41,800.00	19	6/25/01	4.750	211760001		
	9,000	171,000.00	19	7/06/01	4.750	211870001		
	11,200	212,800.00						

SWG 06910

Exhibit 1
(continued)
MJK's Record of Customer Securities Loaned
Includable as Credits in the Reserve Formula
As of July 31, 2001
(names of counter parties omitted)

Acct	Firm Name	Quantity	Contract Amount	Prev	Del-Dt	Rate	Cont Num	Comments	Recu
86768K106 SUNRISE ASSISTED LIVING INC									
		6,900	213,900.00	31	7/10/01	4.750	211910018		
		30,200	936,200.00	31	6/15/01	4.750	211660023	DEAL 1.5% 1%	
		66,200	2,052,200.00	31	7/10/01	4.750	211910001	DEAL 1.5% 1%	
		100,000	3,100,000.00	31	7/31/01	4.750	212120014	DEAL 1.5% 1%	
		203,300	6,302,300.00 ✓						
874054109 TAKE-TWOINTERACTIVE SOFTWARE									
		1,200	25,200.00	21	7/24/01	3.500	212050024		
879597103 TELIGENT INC CL A									
		1,900	9,500.00	5	3/30/01	2.000	210890007		
		83,000	415,000.00	5	2/15/01	4.750	210460008		
		200	1,000.00	5	10/30/00	0.000	203340348		
		33,900	169,500.00	5	12/22/00	4.750	203570010	DEAL 2.5% 1%	
		119,000	595,000.00 ✓						
885535104 3 COM CORP									
		1,000	5,000.00	5	7/26/01	2.250	212070011		
885783109 3D SHOPPING COM									
		1,900	9,500.00	5	3/29/01	2.000	210880045		
		900	4,500.00	5	7/26/01	2.000	212070030		
		2,800	14,000.00						
92...6107 VICOMINDS. K/C 5/98									
		200	1,000.00	5	4/26/01	0.000	211160035		
94845V103 WEBVANPRP									
		500,000	2,500,000.00	5	4/24/01	3.100	211160001	GOLDMANDEAL	
		155,000	155,000.00	1	5/03/01	4.750	211230017	005 1.5%	
		655,000	2,655,000.00 ✓						
976521104 WIRE ONE TECHNOLOGIESINC									
0005	GOLDMAN, SACHS & CO.	800	4,800.00	6	7/27/01	2.000	212080026		
983764101 XO COMMUNICATIONSCL A									
		1,000	5,000.00	5	7/12/01	2.250	211930012		
		185,800	371,600.00	2	6/22/01	4.750	211730013	074 3.25%	
		150,000	300,000.00	2	7/05/01	4.750	211860006	005 2.625%	
		700,000	1,400,000.00	2	7/11/01	4.750	211920015	5462 3% 418 2.75	
		600,000	1,200,000.00	2	7/16/01	4.750	211970023	235 4.5% 005 3%	
		500,000	1,000,000.00	2	7/17/01	4.750	211980011	235 4.25 607 2.75	
		226,500	453,000.00	2	7/19/01	4.750	212000013	235 4.25 5214 2.75	
		375,000	750,000.00	2	7/30/01	4.750	212110026	235 4.375 005 2%	
		2,738,300	5,479,600.00 ✓						

SWG 06911

Exhibit 1
(continued)
MJK's Record of Customer Securities Loaned
Includable as Credits in the Reserve Formula
As of July 31, 2001
(names of counter parties omitted)

Acct	Firm Name	Quantity	Contract Amount	Proc	Del-Dt	Rate	Cont Num	Comments	Reco
98974P100 2001T	CORP								
		300	2,700.00	9	6/28/01	2.250	211770013		
		100	900.00	9	7/16/01	2.250	211970004		
		400	3,600.00						
	Total Loans	9,030,700	78,363,700.00						
			− 16,200,000						
			$62,163,700.-						

Thomas B. Brook
7/1/01

Act. # 82040868 Debit $52,981,580.04

Loaned Out $62,934,500

118% of debit balance

SWG 06912

Exhibit 2

MJK's Securities Borrowed from Native Nations
Calculation of Net Capital Charge
August 31, 2001
(in Millions)

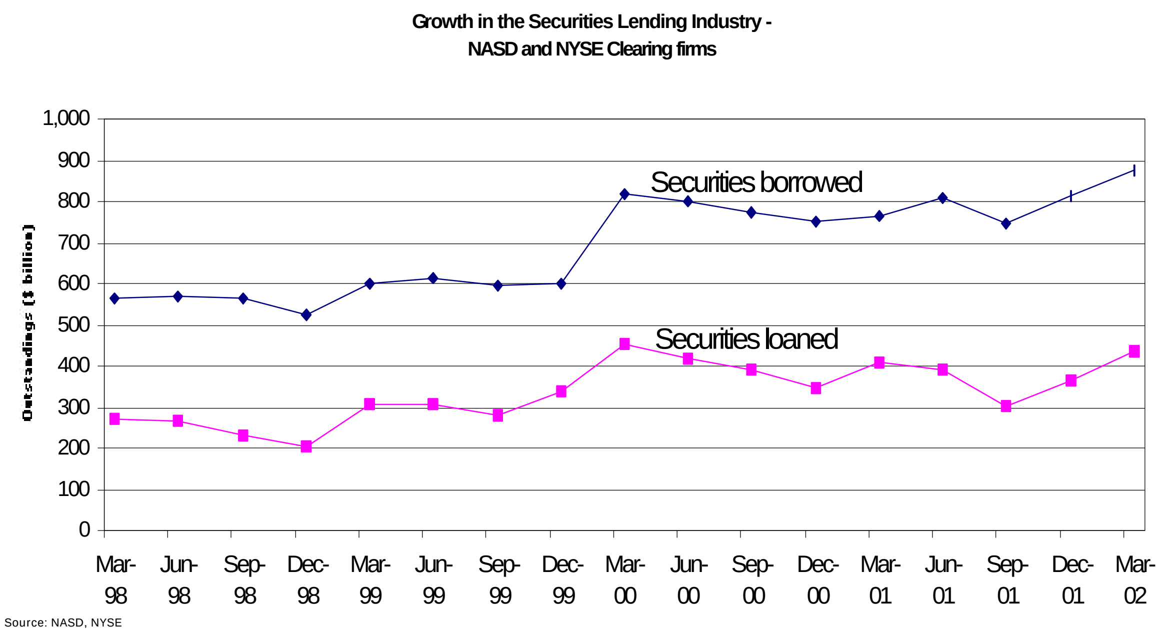
Security	Market Value	105% of Market Value	Cash Collateral given to Native Nations	Net Capital Charge
Genesis Intermedia, Inc.	$23.82	$25	$29.8	$4.8
Holiday RV Superstores, Inc.	$14.4	$15.12	$16	$.88
Imperial Credit Industries, Inc.	$45.1	$47.4	$63.2	$15.8
Total Net Capital Charge Related to Securities Borrowed from Native Nations				$21.48
MJK's Excess Net Capital Reported as of August 31, 2001				$14.9
Difference				$(6.58)

Exhibit 2
(continued)

MJK's Securities Borrowed from Native Nations
Calculation of Net Capital Charge
July 31, 2001
(in Millions)

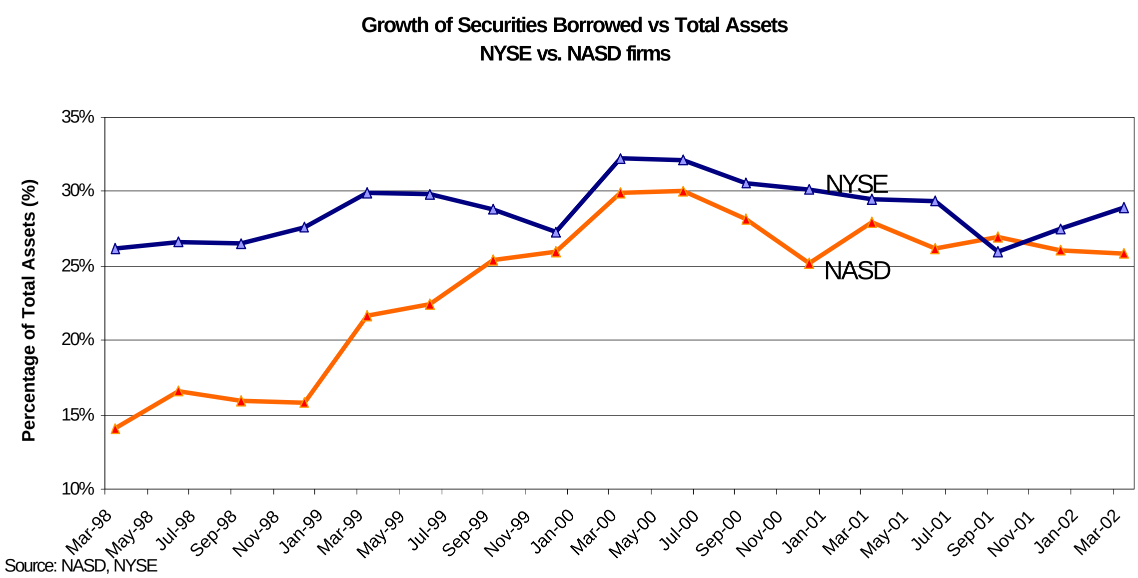
Security	Market Value	105% of Market Value	Cash Collateral given to Native Nations	Net Capital Charge
Genesis Intermedia, Inc.	$18.1	$19	$19	$.0
Holiday RV Superstores, Inc.	$13.4	$14	$16	$2
Imperial Credit Industries, Inc.	$54.2	$56.9	$63.2	$6.3
Total Net Capital Charge Related to Securities Borrowed from Native Nations				$8.3
MJK's Excess Net Capital Reported as of July 31, 2001				$14.7
Difference				$6.4

Exhibit 3*



Observation: The parallel rise in securities borrowing and lending transactions appears to coincide with the decrease in the NASDAQ 100 index. See Exhibit 12.

Exhibit 4*



* Exhibit prepared by FitchRiskAdvisory.

Exhibit 5*

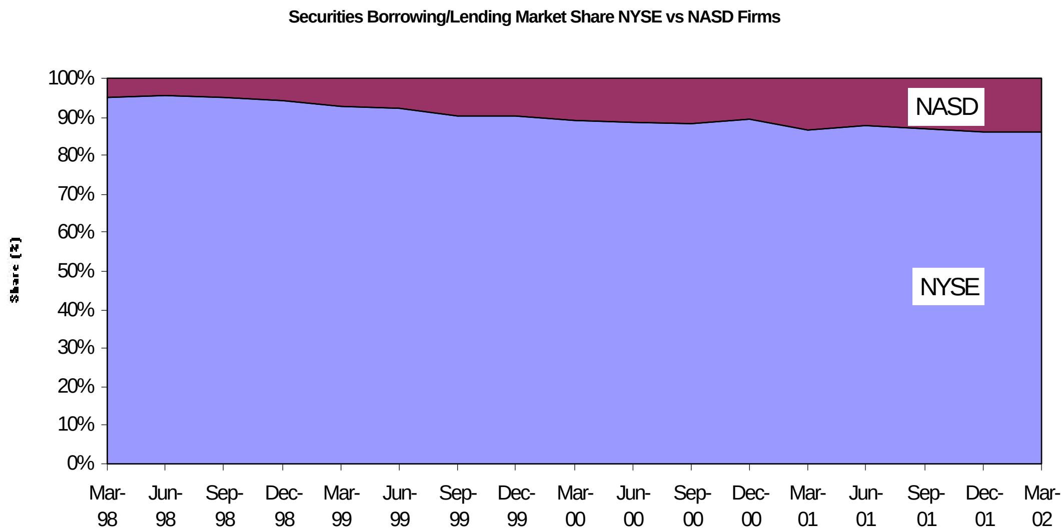
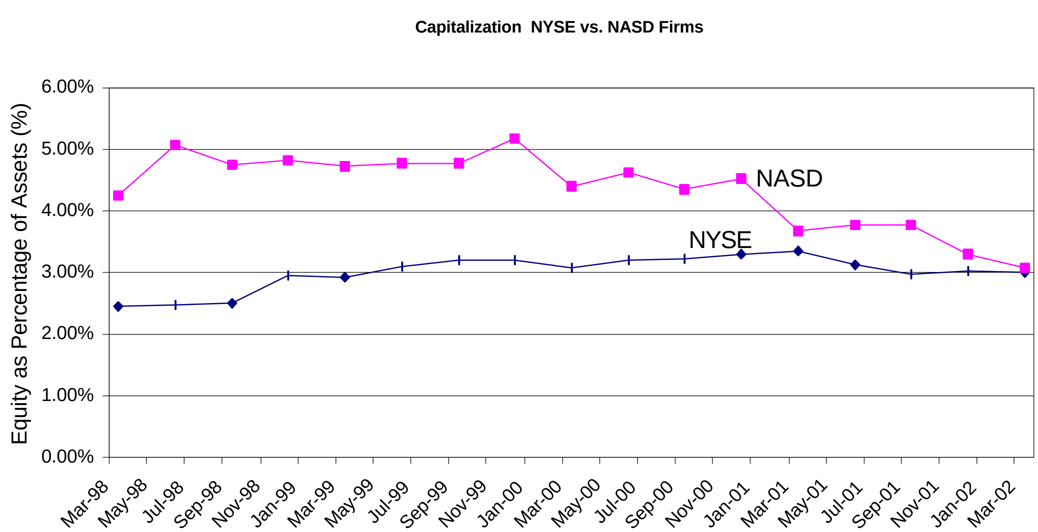


Exhibit 6*



* Exhibit prepared by FitchRiskAdvisory.

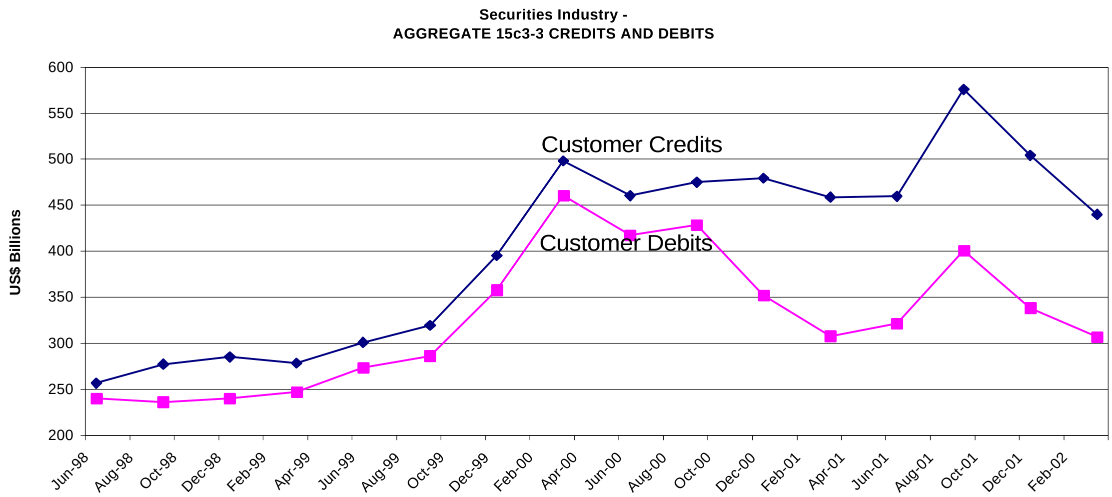
Exhibit 7

15 Largest Reserve Deposits NYSE Firms

May 31, 2002

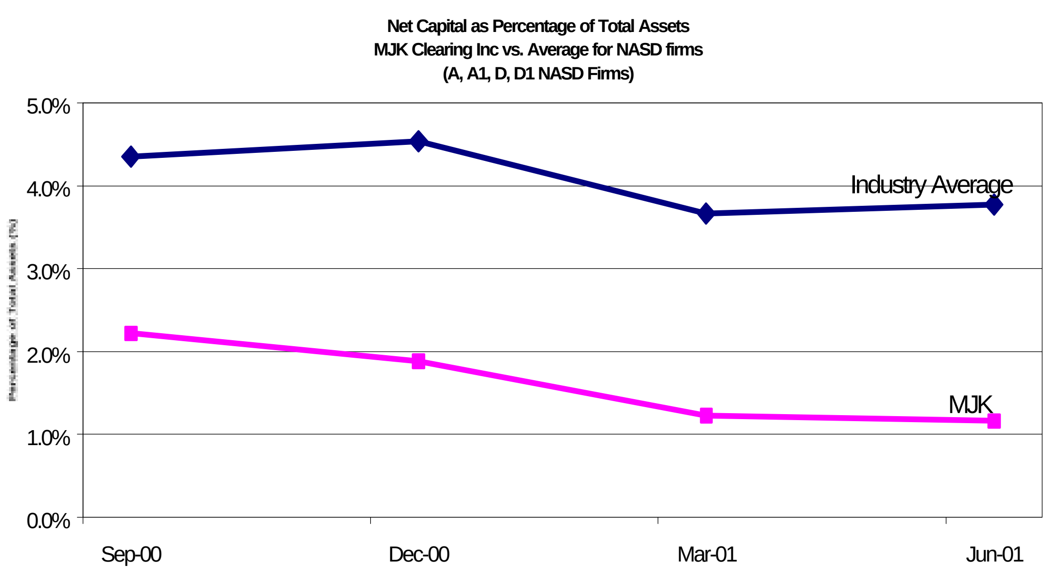
Amount of Deposit (billions)	Bank Where Held
$38.7	Bank of New York
16.1	Bank of New York
11.3	Bank of New York
5.3	JP Morgan Chase
3.9	$3 billion at Bank of New York
3.6	Bank of New York
2.5	Bank of New York
2.3	JP Morgan Chase
2.1	$100 million at Bank of New York
2.1	All First Bank
2.0	JP Morgan Chase
1.8	JP Morgan Chase
1.6	JP Morgan Chase
1.6	JP Morgan Chase
1.6	Citibank
$96.5	Total

Exhibit 8*



Source: NYSE, NASD

Exhibit 9*



Source: Trustee, NASD

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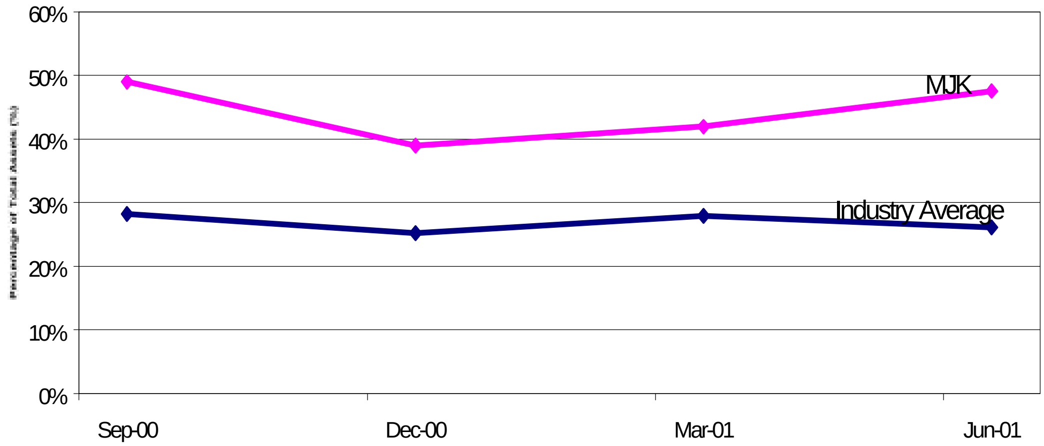
* Exhibit prepared by FitchRiskAdvisory.

Exhibit 10*

Non-customer Securities Borrowing as a Percentage of Total Assets
MJK Clearing Inc vs. Average for NASD firms
(A, A1, D, D1 NASD Firms)



Source: Trustee, NASD

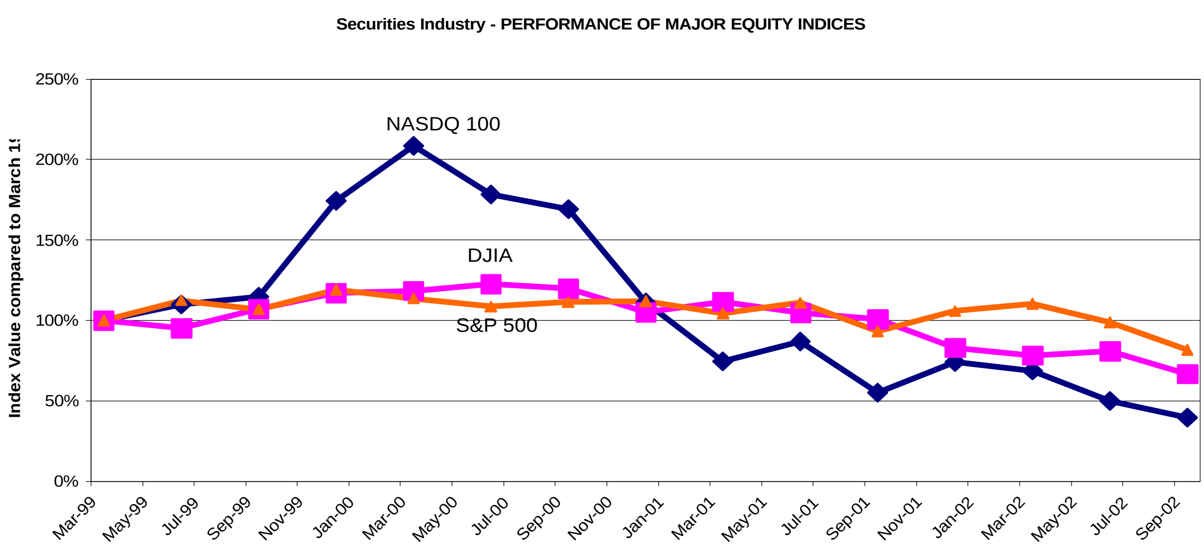
* Exhibit prepared by FitchRiskAdvisory.

Exhibit 11
Clearing Firms With Leverage Exceeding MJK's
(25 times Excess Net Capital)

Securities Lending		Repurchase Agreements		Fails to Receive and Deliver	
NYSE Total	8	NYSE Total	10	NYSE Total	0
NYSE <$100m	4	NYSE <$100m	1	NYSE <$100m	0
NYSE <$50m	2	NYSE <$50m	0	NYSE <$50m	0
NASD Total	5	NASD Total	8	NASD Total	3
NASD <$100m	1	NASD <$100m	7	NASD <$100m	3
NASD <$50m	1	NASD <$50m	5	NASD <$50m	3

Note – dollar amounts in chart refer to the amount of excess net capital that the firm has. For example, "NASD <$50" refers to those NASD member firms that have less than $50 million of excess net capital. Also note that to some extent the numbers are double-counted. For example, a firm that has less than $50 million of excess net capital also has less than $100 million of excess net capital.

Exhibit 12*



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* Exhibit prepared by FitchRiskAdvisory.