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Harold V. Petrillo

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Embezzlements and Defalcations in Brokerage Firms

By HAROLD V. PETRILLO
Partner, New York Office

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of Stock Exchange Firms, New York—March 1960*

ALTHOUGH the subject matter of this brief talk is about embezzlements and defalcations, I shall fall back on an accountant's cliché and mention that the nature of a discussion such as this, however, is necessarily critical.

By that I mean that twelve years ago I spoke to this Division on the same topic, apparently with little or no effect. A dozen years ago I described the average embezzler, the average amounts of shortages, the average years of employment; all statistics have been very capably prepared and made available by the bonding companies.

We haven't learned our lessons very well and, unfortunately, since that time, conditions have deteriorated; they have worsened because we are undoubtedly in a period of moral degradation. This lowering of moral standards is evident when we contemplate the television quiz shows—the finest medium of electronic communication today—foisting dishonor upon us in the guise of entertainment.

There is still another further weakening of our nation's morals, evident in the get-rich-quick promoter and his appeal to our greed for easy profits. This is so serious a problem that in the annual report of the New York Stock Exchange for 1959, G. Keith Funston, President of the Exchange, wrote, "The Exchange Community has waged a continuous fight against the dishonest element on the fringe of the securities business who pose a problem for the investing public and reflect on the responsible members of our industry."

It becomes evident that the Association of Stock Exchange Firms and particularly the Accounting Division can make a tremendous contribution to the future of Wall Street by taking constructive steps in this area. It could be construed that only the reliance the Securities and Exchange Commission places upon the New York Stock Exchange, the National Association of Security Dealers, and other National Securities Exchanges has saved the brokerage industry from more drastic regulation.

Consider the publicity that the last two embezzlements have received and imagine the difficulties of operation if the same type of

control that the State Banking Department exerts over New York State banks were to be exercised over securities brokers. It would be intolerable, for example, if a firm were informed that an office couldn't be opened in another city because of the crossing of state lines.

So it becomes evident that self-policing is the answer and that the Accounting Division can help the industry. The New York Stock Exchange does the best job possible within the framework of rules and regulations laid down by its members. The Securities and Exchange Commission can be given more power; but that is a step to be avoided—less federal regulation rather than more should be the goal.

A FIVE-POINT PROGRAM

Therefore, I propose a five-point program for your consideration, with an urgent request for prompt action on your part.

The first point relates to the annual long-form questionnaires. Accountants' certificates or opinions contain a statement on the review of the system of internal control. I suggest that during this period of high living, the fast buck, evasions of Regulation T, that you request your accountants to check on the operation of internal controls at a date other than the surprise audit. Current reviews would determine if these controls are operating as they appear to be at audit time, when everyone is on his or her best behavior.

Second, I would like to see a check list on operations prepared by the Accounting Division and distributed to all Member Firms. It should cover branch office operations as well, and would be of inestimable value to the brokerage community.

The third point is borrowed, frankly, from the New York State Banking Department. The Department has inferred, unofficially, that every commercial State Bank with assets of \$10,000,000 or more should have an independent internal auditor responsible to the Chairman of the Board. Carrying through on that idea, why shouldn't every member firm of the New York Stock Exchange with assets of, say, \$7,500,000 or more have an independent internal auditing department responsible to the senior partner of the firm (or that dynamic personality known as "The Boss").

Fourth, I believe the Accounting Division should sponsor a subgroup of individuals composed of auditors from those member firms with internal auditing departments. This group would be similar to the National Association of Bank Auditors and Controllers and with

the guidance of the Accounting Division could, in time, be as strong as that fine organization.

Fifth, I would stress continued efforts on the part of the Chief Examiner's staff of the New York Stock Exchange to help member firms. The Exchange has invited firms to discuss operating procedures with field examiners. I suggest that firms take advantage of the invitation even if this does ultimately result in further implementation of the Examiner's staff.

VALUATION OF SECURITY POSITIONS

I have outlined a five-point program. However, Mr. George E. Doty, Chairman of the American Institute's Committee on Audits of Securities Brokers and Dealers has an excellent idea which I want to leave with you. It relates to the valuation of certain securities positions in the answers to the financial questionnaires.

Certain valuations in Part I of the questionnaire, if erroneous because of a mechanical or typographical error, would never be noticed. Other valuations, if omitted entirely, would not affect the answers or the financial condition of the member firms one iota.

The Committee has suggested the elimination of certain valuations in the answers to the questionnaires. If the public accounting profession, in general, could be relieved of the time and effort now spent in preparing such valuations, some savings would result. These savings could be used to expand the scope of brokerage examinations in more productive areas.

CONCLUSION

I would like to conclude with the following:

1. We can no longer rely on insurance as a solution to our problem. Bonding companies are refusing insurance coverage and anyone who has experienced an embezzlement knows of the jump in insurance premiums.
2. Electronic equipment has received much erroneous publicity lately. However, one of the magazines distributed by a computer manufacturer has the following "Man's Prayer" which I have excerpted for the benefit of all of us concerned with the securities business:

"Teach me that 60 minutes make an hour, 16 ounces a pound, and

100 cents a dollar. Help me to live so that I can lie down at night with a clear conscience and unhaunted by the faces of those to whom I may have brought pain. Grant that I may earn my meal ticket on the square, and in earning it I may do unto others as I would have them do unto me. Deafen me to the tingle of tainted money."