# MARGIN REQUIREMENTS AS AN INSTRUMENT OF CREDIT CONTROL IN SECURITY SPECULATION

Thesis for the Degree of M. A.

Gary H. Fisher

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# CHAPTER I

# INTRODUCTION

## DEMAND FOR FEDERAL INVESTIGATION OF SECURITY SPECULATION

The public's attention was focussed on the securities exchanges by the collapse of the inflated security values following September 1929. The market collapse was closely associated by the general public with the depression which followed. As a result, it was evident that there was much public demand for government investigation of stock exchange practice and speculative trading in securities. This demand was made known through the press and through telegrams to those in responsible government positions. The President stated, in a letter to the Senate Committee on Banking and Currency that

> "...the condition which prevailed after the stock market crash of 1929 led to much popular demand for the restriction of the use of the exchanges for purely speculative purposes."[1]

The President further stated that he did not feel that the public "would be satisfied with anything less than drastic restriections."[2]

It is probable that the demand for federal investigation of stock exchange practices and speculative trading in securities was the outcome of nationwide losses sustained through the rapid deflation of security values after September 1929. The following figures indicate the extent of the decline in security values. The total value of stocks listed on the New York Stock Exchange shrank from eighty-nine billion dollars, or an average price of

1. The President's letter to the Senate Banking and Currency Committee,
2. Ibid

eighty-nine dollars a share, at the peak of the market in 1929, to less than sixteen billion dollars, or about twelve dollars a share at the low point of 1932.[3] Bonds listed on the Exchange shrank in value by eighteen billion dollars, declining from forty-nine billion dollars in September 1930 to thirty-one billion dollars in April 1933.[4] The collapse of security values following 1929 was one of the aggravating causes of the closing of at least six thousand banks in the United States involving total deposits of three and a half billion dollars.[5] This led to the feeling on the part of the public that speculation on the securities exchanges was an important cause of the depression which followed the rapid deflation of security values.

Excessive speculation in securities was held to be the cause of the great increase in security prices. The general public entered the market to speculate. That is they buy and sell in order to make a profit out of the fluctuations in the market price of their holdings. They operate almost like gamblers with little or no knowledge of the real value of the issues in which they dealt. This was a big factor in bringing about the speculative 'boom' in securities.

Credit was widely used for carrying on security speculation. Speculators bought shares of stock on margin and then, as their securities increased in value, they pyramided their holdings on the basis of the increase of value. The practice of pyramiding on a rising market had a tendency to still further inflate security prices. Thus the use of credit allowed speculators to in-

3. Twentieth Century Fund, Stock Market Control, Appleton-Century Company, New York. p. 7
4. Ibid
5. Ibid, p. 9

crease greatly the size of their operations and was an important factor in bringing about a general increase in security values.

## INVESTIGATION OF THE SECURITIES EXCHANGES

The investigation of stock exchange practices and speculative trading in securities by the Senate Committee on Banking and Currency had its beginning in Senate Resolution Eighty-four. This resolution was adopted in April 1932. Its scope was such as to confer upon the committee the power to investigate stock exchange and banking practices with respect to the buying and selling and the borrowing and lending of listed securities.

Early in the life of the Seventy-third Congress a minor crisis developed when the powers of the committee were challenged while it was attempting to investigate individual transactions for income purposes.[6] In order to increase the powers of the investigating committee the Senate adopted Regulation Fifty-six and Ninety-seven. These resolutions empowered the committee to

> "investigate the matter of banking operations and practices, transactions relating to any sale, exchange, purchase, acquisition, borrowing, lending, financing, issuing, distributing, or other disposition of, or dealing in, securities or credit by any person or firm, pardnership, company, association, corporation, or other entity, with a view to recommending necessary legislation under the taxing power of other federal power."[7]

As a result of the preliminary investigation of the securities exchanges two groups were selected by Senator Fletcher, Chairman of the Committee on Banking and Currency and of the Subcommittee on Stock Exchange Practices, to undertake the responsibility of drawing up a regulatory bill. One of these groups was

6. Senator Duncan U. Fletcher, "Our Financial Racketeers", Liberty Magazine, March 5, 1934.
7. Senate Resolutions 56 and 97.

headed by Ferdinand Pecora, and the other by Mr. Landis, a commissioner of the Federal Trade Commission. Various government officials who assisted in these groups were Eugene Black, Governor of the Federal Reserve Board, Dr. E. A. Goldenweiser and Woodlief Thomas, both of the Division of Research and Statistics of the Federal Reserve System, Thomas G. Corcoran, counsel for the Reconstruction Finance Corporation, and Tom K. Smith, Assistant Secretary of the Treasury. The members of the Federal Reserve gave special attention to the credit control provisions of the bill. The provisions for the protection of investors from evils in market machinery were drafted by Ferdinand Pecora's staff. The provisions for the protection of investors in the market from corporate insiders were drafted by Mr. Presley, manager of one of the biggest investment trusts in New York City, and a professional investor who invests for twenty thousand stockholders.

The consideration of the administration bill was conducted by the Sub-committee on Stock Exchange Practices of the Senate Committee on Banking and Currency.[8] These hearings are popularly known as the "Pecora Investigation" due to the important part

8. The Sub-committee on Stock Exchange Practice was made up of the following members:

Duncan U. Fletcher, Florida, Chairman
Carter Glass, Virginia — Peter Norbeck, South Dakota[2]
Alben W. Barkley, Kentucky[1] — John C. Townsend, Delaware
Edward P. Costigan, Colorado — James Causens, Michigan
Alva B. Adams, Colorado

1. Alternate, Thomas P. Gore, Oklahoma
2. Alternate, Phillips Lee Goldsborough, Maryland

Robert E. Bulkley, Ohio, Williams Gibb McAdoo, California, Robert D. Carey, Wyoming, and Hamilton F. Kean, New Jessey, who were members of the main Senate Committee on Banking and Currency displayed an active interest in the investigation.

The investigating committee made use of the services of Ferdinand Pecora, counsel to the committee, Julius Silver and David Saperstein, Associate counsel to the committee, and Frank Meehan, chief statistician to the committee. Ferdinand Pecora had won considerable recognition through conducting earlier federal investigations.

taken by Ferdinand Pecora in conducting them. This investigation and consideration of the administration bill lasted from February 26 to April 5, 1934. During the course of the hearings opportunity was given for all interested parties to give their views on the bill.

The findings of the "Pecora Investigation" have been published in a series of volumes. The volumes which are used as the main source of information for this study are Parts Fifteen and Sixteen of the published report of the hearings before the Committee on Banking and Currency of the United States Senate during the first session of the Seventy-third Congress.[9] These two volumes comprise a total of one thousand three hundred and thirty-seven pages.

While the administration bill would affect banks, businesses, investors, and the organized exchanges throughout the nation, the New York Stock Exchange representatives were the most active in offering objections to the bill. Fundamentally the issues which were raised and discussed in the hearings were those which were argued between the drafters of the bill and the representatives of the New York Stock Exchange. The most active representatives of the Exchange were its President, Richard Whitney, and its counsel, Roland Redmand. Small stock exchanges were largely represented by district representatives of a group of exchanges.

Business men were not particularly active in the hearings and expressed their opinions in letters and telegrams. The Vice-president of the National Manufacturers Association was present.

Certain members of the Committee showed an active and constructive interest in the proposed legislation. Senators Kean and

9. These volumes will hereinafter be referred to as Senate Hearings, Part 15 or Part 16.

McAdoo questioned the feasibility of attempting to regulate security speculation by law. Senator Bulkley backed a plan for the elimination of margin trading. Senator Glass expressed views in regard to federal credit control. Senator Fletcher was a determined critic of speculation on the securities exchanges.

The Twentieth Century Fund Market Survey

Just previous to the "Pecora Investigation" the securities market survey staff of the Twentieth Century Fund, Incorporated, completed a non-partisan, scientific study of the securities markets from the point of view of the interests of the American public. This study is of importance because some of the ideas of the Twentieth Century Fund committee were used in the preparation of the administration bill.

The director of the investigation which resulted in the Twentieth Century Fund market survey report was Alfred L. Bernheim. The report was drafted by a staff of thirty market specialists and investigators. The senior members of the staff were as follows: N. R. Danielman, Instructor in Economics, Harvard University, Paul D. Dickens, Department of Commerce, Wilford J. Eiteman, Associate Professor of Economics, Albion College, G. Wright Hoffman, Professor of Insurance, University of Pennsylvania, Frederick W. Jones, formerly managing editor, Journal of Commerce, and William Howard Steiner, Chairman of the Department of Economics, Brooklyn College, and George Soulé, Director of the National Bureau of Economic Research and Editor of the New Republic. A digest of the findings of the staff and their recommendations for federal regulation of the markets, published in book form under the title Stock Market Control, by the Appleton-Century Company of New York, was formally submitted to the members of the Senate Sub-committee on Stock Exchange Practice.

## FEDERAL REGULATION OF SECURITY SPECULATION

Most proposed and attempted methods of controlling stock market speculation have been directed at the supply and cost of funds for such speculation. This task has been undertaken by the Federal Reserve System. Through the use of open-market operations and the rediscount rate the Federal Reserve Banks can increase or decrease the supply and cost of reserve funds available to member banks. Since the expansion and contraction of street loans by banks reflect changes in their surplus funds, it is said that control over the surplus is all that is needed. Experience has shown, however, that once a speculative movement has begun it may not be easily halted. The withdrawal of bank funds results in an increase in money rates, and not only banks but other lenders are attracted to the market. This proved to be the case when the speculative movement was not checked by limitations on the supply and cost of money in 1928 and 1929.[10] Brokers at this time obtained loans from non-bank lenders. The indications seem to be, then, that when there are opportunities for large profits, speculators are not checked by high money rates.

### The Banking Act of 1933 and the Securities Act of 1933

The Banking Act of 1933 and the Securities Act of 1933 were designed, partly, for the regulation of security speculation. These acts give the federal government additional powers over the control of credit for speculative purposes and provide a standard for issuing securities. The provisions of these two acts which pertain to security speculation will be discussed here.

10. Woodlief Thomas, "Credit in Security Speculation", American Economic Review, Vol. XXV, No. 1, March,1935, p. 25

The Banking Act of 1933, which was introduced during the first session of the Seventy-third Congress provides means for the Federal Reserve control of the use of credit for speculative purposes. This is brought about by placing limitations upon the lending and borrowing powers of member banks.

Section Three of the Banking Act of 1933 is relative to control of credit for security speculation. It provides that

> "each Federal Reserve Bank shall keep itself informed of the general character and the amount of the loans and investments of its member banks with a view to ascertaining whether undue use is being made of bank credit for speculative trading of/or trading in securities, real estate, or commodities, or for any other purpose inconsistent with the maintenance of sound credit conditions."

In determining whether to grant or refuse advances, rediscounts, or other credit accomodations, the Federal Reserve Bank officials "shall give consideration to such information." The Chairman of the Federal Reserve Bank shall report to the Federal Reserve Board any such undue use of bank credit to any member bank to-gether with his recommendations. Whenever, in the judgement of the Federal Reserve Board any member bank is making such undue use of bank credit, the Board may at its discretion and after reasonable notice and an opportunity for a hearing suspend such member bank from the use of credit facilities of the Federal Reserve System for a time.

There are some other important protective devices in the Banking Act of 1933. Member banks are forbidden to act as agents in placing loans to brokers for non-banking corporations or persons. This is a blow to bootleg loans. Banks are forbidden to pay interest on demand deposits. This is a blow at the pratice of out-of-town banks sending funds into the New York Money market to pile up there at interest and to be used in the market while there. However, there is nothing in the law, apparantly, which will prevent

a member bank in New York from placing funds in brokers' loans for out-of-town banking corporations under an agency agreement.

The movement for federal control of security markets was advanced by the passing of the Securities Act of 1933. This Act provides for the registration of securities with the Federal Trade Commission.[11] Certain information is required before securities can be registered. This information is for the purpose of protecting the purchasers of securities and makes it possible for the purchaser to consider the real value of a security. Such consideration will tend to discourage the type of security speculation which may be called gambling.

The mechanism for the control of credit for security speculation by the Federal Reserve System possessed certain weaknesses prior to the enactment of the Banking Act of 1933. The control of the supply of funds for security transactions could be exercised only by making stock market activity the principal guide of credit policy. The use of such a policy of increasing the cost of credit in order to check its use in security operations increased the cost of credit to agriculture, trade, and industry.

The Banking Act of 1933 makes it possible to control the amount of credit for use in security speculation. It is possible to exercise a restraint on security speculation without limiting the supply or raising the cost of credit to agriculture, trade, and industry. This means of control also makes it possible to exert a restraining influence on the use of credit for speculation in the stock market before it has reached a stage at which the general business and credit situation is unfavorably affected.

It might be observed, then, that the Federal Reserve System possessed mechanism for the control of the use of credit for secu-

rity speculation but it would have to make the stock market the chief basis for its policy. This should not be done because it is undesirable that the general credit policy of the country should be based upon the fluctuations of security speculation. In order to control security speculation pressure must be exerted early in the development of the speculative movement and at a time when the general business situation may indicate no need for restriction. The control of security credit needs to be exerted over that portion of the supply of credit that is being used for undue security speculative activity.

The Securities Act of 1933 is in the nature of federal control over security collateral. By providing a standard for the issuing of securities, the quality of collateral is improved. This places a check on the use of credit for the flotation of securities which might not be considered sound.

The Fletcher-Rayburn Bill

The administration bill, which was popularly known as the Fletcher-Rayburn bill, for the regulation of securities exchanges was introduced in the second session of the Seventy-third Congress. The demand for regulation was because of certain evils which were asserted to exist in the securities exchanges. These evils concerned margin trading, short selling, and pool operations. It was contended that speculative excesses are encouraged by easy margin requirements. It was further believed that short selling dislocates the market and disturbs business generally, and that it produces violent declines out of proportion to the intrinsic values of securities. Finally, the charge was made that pool operations are permitted to manipulate prices and to unload stocks upon the public

at unwarranted high prices. The Fletcher-Rayburn bill, was accordingly designed to remedy these evils.

The bill proposes to bring the securities exchanges under federal regulation through the use of the commerce powers of the national government. This is accomplished by compulsory registration of all securities exchanges doing an interstate business. In order to acquire such registration an exchange must submit certain data and agree to comply with federal regulations.

The bill gives the federal government added powers of control over the use of credit for security speculative purposes. The Banking Act of 1933 is strengthened by prohibiting brokers from borrowing upon any listed security from any source save a member bank of the Federal Reserve System or a non-member bank which agrees to comply with rules of the System with reference to market loans and loans on securities. This is designed to rule out the whole system of non-bank or bootleg loans. This makes it possible for the Federal Reserve System to restrain the amount of credit going to the market.

The use of credit for security speculation is still further restrained by the federal determination of margin requirements. By the use of such requirements the collateral value of securities can be controlled. This is a continuation of the movement for the selective control of credit. The control of the total supply of credit for speculative purposes is accomplished through the Banking Act of 1933. Through the federal control of margins the amount of credit which may be used in the purchase of a security is determined. The use of securities as collateral in a margin transaction is still further restricted by providing that such securities must be registered on a nationally registered securities exchange.

Other provisions of the bill are for the purpose of eradicating the evils of manipulative practices and short selling, and other evil practices on the securities exchanges. The prevention of manipulation in the securities exchanges is accomplished by prohibiting the organization of pools and the circulation of false reports. The regulation of short selling is entrusted to a commission. Penalties are provided in order to enforce these and various other provisions of the bill which are for thepurpose of eradicating securities exchange evils.

The regulation of the over-the-counter trading in securities is placed in the hands of a commission. This regulation is important because of the relationship of the over-the-counter markets to the organized exchanges. If the over-the-counter markets were left free of regulation and the organized markets were subject to severe regulation there would be danger of a flight of securities from the organized exchanges.

## SCOPE OF STUDY

This study is limited to the controversial issues arising in the "Pecora Investigation" concerning the provisions of the Fletcher-Rayburn bill having to do with the contemplated use of margins as a device for limiting security speculation. Since the subject of the study is controversial, the problem is to determine the issues, indicate the stand taken by various groups, and marshal the arguments supporting the various views in regard to the issues which arose. In doing this it is necessary to deal largely with opinions of those who took part in the Senate Hearings. As far as possible the attempt will be made to show the weight of opinion backing various viewpoints. It will not be possible to

give a concensus of opinion. Such a consensus would be impossible to give because particular individuals were asked to speak on certain parts of the bill, only, in order to avoid too much repetition. Also, other individuals were official or unofficial representtatives of groups. The attempt will be made, however, to quote enough authorities to show the trend in regard to the various controversial issues which arose in the hearings.

Of the various means of federal control of security speculation, this study is limited to the regulation of speculation by credit control. It has been noted that there are several means for federal control of credit. This study is further limited to the control of security credit through the use of margins. It has been noted, also, that the purpose of federal control of the exchanges is to prevent excessive speculation. The use of margins, as a device for the control of security credit, was but one of the means provided in the Fletcher-Rayburn bill for the federal regulation of security speculation.

## CONTROVERSIAL QUESTIONS OF MARGIN CONTROL OF SECURITY CREDIT

Several controversial questions arose, in the hearings, as a result of the contemplated use of higher margins as a means for the control of security credit. The purpose of this control was to prevent excessive security speculation. There were many objections to such a use of margins. As a result of these objections the margin provisions of the bill as finally passed were considerably changed. The controversial questions relative to the use of margins for the control of credit for security speculation will be outlined below.

Purpose of Federal Control of Margins

The Fletcher-Rayburn bill was proposed for the purpose of preserving to the market the useful functions of speculation and protecting the market against its abuses. It was asserted that the effective operation of the securities exchanges was prevented by excessive speculation. 'Booms' and the panics which follow, are said to be due to excessive speculation and they have adverse effects on investors and national institutions.

The possibility of successful legislative control of security speculation was refuted. It was contended that security speculation cannot be regulated by law. It was predicted that the attempt to do so by passing the administration bill would result in the destruction of the organized security exchanges and the development of an unorganized market to the detriment of the nation.

Method of Federal Control of Security Credit

The administration bill is predicated on the assumption that excessive security speculation develops because of too free use of credit and that it can be brought under control by granting the federal government greater credit control. The bill provides a means for the control of credit by making it possible to regulate the collateral value of securities through the use of margins.

The federal determination of margins as a device for the limitation of the use of credit in security trading was opposed. It was asserted that additional control should be found through the use of federal powers already existing for the control of the general supply of credit. It was further contended that the proper margins cannot be fixed by rules of law or by a government commission The determination of proper margins should be left in the hands of the security brokers and the organized exchanges.

Method of Fixing Margins

The standard of margin requirements were stated in law in the proposed bill. The margin requirements were so designed as to exert an automatic restraint on speculative trading by imposing a higher margin requirement on securities having a rapid rise than on more stable securities. The power to raise margin requirements above the statutory requirements was granted to a commission.

The feature of the bill which fixed margins by law was opposed. It was held that it would be impossible to pass a regulation rigidly controlling the collateral value of securities. If margin requirements are to be regulated by the federal government such regulation should be by a commission rather than by a statute. The reason for this is that credit conditions are constantly changing and margin requirements should be subject to constant review and change. This could be accomplished by a regulatory commission but a law could not be readily changed.

The Location of Discretionary Control of Margins

The question of the location of discretionary control over margin requirements was considered important. The exercising of this power was placed in the hands of the Federal Trade Commission by the bill. There was a great deal of opposition to granting such control to that body. The market authorities favored the setting up of a body upon which they would be given some representation. If such a body could not be set up they favored the granting of discretionary control over margin requirements to the Federal Reserve Board. There were many others who favored this body because it is a credit control body and the control of margins is in the nature of credit control.

The Elimination of Margin Trading

There was some support for the complete elimination of all margin trading. The proponents of this idea were of the opinion that credit for security trading might better be obtained through the banks. This could be done through security traders arranging loans on securities directly with bankers. The government authorities on credit agreed that this might eventually be a wise move but they were of the opinion that it would be too radical a move to make at the present time.

Registration of Securities

The bill required that securities must be registered on a national securities exchange in order to be eligible for margin trading. Certain securities were exempted from listing requirements by the bill. The federal listing of securities would make it possible to regulate them. The granting of margin trading privileges to unlisted securities would be deemed unwise. By refusing such privileges to unlisted securities an incentive for the listing of securities would be provided.

The refusal of margin trading privileges to unlisted securities was opposed by those who were interested in securities which because of their nature could not be listed on a nationally registered securities exchange. It was contended that the value of unlisted securities would be impaired by not making them eligible for margin trading.

Changes Made in the Original Bill

There were many changes made in the proposed bill before it was enacted. The altered form of the bill may be attributed to

the attacks which were made on it by those who would be most affected by it. These changes were made in various parts of the bill. The changes which had to do with margin provisions concerned the size of margins, the exemption from registration requirements, and the administration of margin requirements. The result of these changes was to do away with some of the most undesirable features of the bill.

In the Act as passed loans are permitted up to one hundred per cent of the lowest value for the preceding three years instead of eighty per cent of such value as stated in the original bill, but a maximum limitation of seventy-five per cent of the current market value is established instead of eighty per cent. In the Act fifty-five per cent of the current market price may be loaned in any case instead of forty per cent.

All loans on exempted securities and loans by banks on securities other than equity securities are specifically excepted from the margin provisions of the Act.

Under the Act, as contrasted with the orginal bill, banks are not subject to prescribed margin requirements, except that when a bank makes a loan on an equity security, any excess over the amount that a broker could loan is subject to such rules and regulations as the Federal Reserve Board may prescribe, to prevent the use of such excess for the purchase or carrying of securities.

Under the terms of the original bill the administration of margin requirements was vested in the Federal Trade Commission, which could increase but not decrease margin requirements. Under the Act, control over margin requirements is placed under the Federal Reserve Board, who may increase margin requirements and, under certain extraordinary circumstances, they may also decrease them.

# CHAPTER II

## PUBLIC POLICY IN REGARD TO REGULATION OF SECURITY SPECULATION

The Fletcher-Rayburn bill proposed to bring the control of the exchanges under the federal government. In the past the exchanges have been self-regulated. The proposed change from private to government control was opposed strongly by the market interests. It was asserted by government authorities that government control of the exchanges is rendered necessary in order to regulate security speculation. Such regulation is necessary because the exchanges have failed to regulate security speculation properly.

The purpose, then, of federal control of the securities exchanges is to control security speculation. The public importance of such speculation lies in the fact that it may inflict damage upon several million investors who do not speculate and upon the economic security of the whole country. The objective of federal regulation of the securities exchanges, therefore, is to protect the bona fide investors and economic society from the harmful results of security speculation.

## SECURITY SPECULATION

There is considerable difference of opinion concerning the place of security speculation in economic society. Those who favor federal regulation of security speculation generally concede that such speculation performs a useful function in economic society. When security speculation becomes excessive, however, it is harmful. Speculation may be considered harmful when it does not perform its true function on the securities exchanges. It will be the purpose of federal regulation to eliminate excessive speculation but to

preserve to the markets the economicly useful functions of speculation. The market authorities held that this purpose would be impossible of accomplishment. The question of the proper function of security speculation and the possibility of its regulation by the federal government will now be discussed.

Relation of Speculation to Market Functions

Security speculation may be defined as any operation in which one buys or sells securities with the design to make a profit out of the changes in the market price of such securities. An investor, on the other hand, takes a chance in the success or failure of an enterprise and not in the change in value of the securities. Security speculation becomes 'mere gambling' when people with no special knowledge of factors affecting security prices undertake to speculate.

The objective of government regulation is stated by Tom K. Smith, Assistant Secretary of the United States Treasury, in evidence before the Senate Sub-committee, as an attempt to prevent the ill-effects of excessive speculation without hindering the proper economic function of the market.[1] The ideal market should (1) register prices for securities which are as closely as possible in line with present and future earnings; (2) furnish securities the marketability and price continuity necessary to serve the needs of investors; and (3) induce the most productive flow of savings into the nation's economic activities. If these desirable results are to be accomplished a certain amount of speculative trading is necessary. It was the opinion of Mr. Smith that the real question is to determine the amount of speculation necessary and to find means to prevent excessive speculation.[2]

1. Senate Hearings, Part 15, p. 6734.
2. Ibid.

Other things being equal investors would prefer that the market price of a stock deviate as little as possible from its trend so that in case of forced liquidation they would be able to obtain an amount very near that which they would receive if they could sell at leisure. It is claimed that speculation reduces this deviation and, by so doing, performs a service for the investor.

Speculation contributes to marketability and price continuity. In the performance of this function the principal requirement is a large and continous volume of transactions. For stocks and bonds to be readily marketable at all times there must also be buyers and sellers ready to trade. Insofar as speculators are active on both sides of the market they assist in maintaining a liquid and continous market. The investor, on the other hand, because his transactions are less frequent, might be supposed to contribute less to the market's liquidity.

Security speculators contribute to the flow of savings into the nation's economic activities. The investor who is seeking security and stability of income is unwilling to assume the risks involved in financing new and untried enterprises. Without the speculators willing to risk large losses in the hope of large profits, young enterprises would find it difficult to secure capital. The performing of this service by the speculator makes his activity useful.

Excessive Security Speculation

The question as to what constitutes excessive speculation and as to what its harmful effects are will be discussed here. There are two features of excessive speculation which may be noted. Security speculation becomes excessive if it is carried on in such

volume that the market price of securities are inflated above their true value. The market value of a security should reflect its present and probable future earning power. Such speculation, in a huge volume, is made possible through the use of credit.[3] As the price of a security advances, it becomes the basis for additional credit to finance new security purchases. This practice, known as pyramiding impedes the proper evaluating function of the market.[4]

The other type of security speculation which may be characterized as excessive and harmful is that carried on by the uninformed public. Such speculators do not buy securities because they have carefully considered the possibility of benefiting from the increased prosperity of the industry in which they are buying participation. They buy, rather, like they would buy a lottery ticket, or a number in a number game. This type of speculator buys without informing himself of market conditions but with the hope that the securities may be disposed of at a profit. Such speculators serve no useful social function. On the contrary, it performs a "very dangerous part in our economic machinery", and is distructive and disastrous to many individuals and also to the prosperity of the country as a whole.[5]

The harmful results of excessive security speculation are not confined to the speculators, or to investors. The entire prosperity of the country is involved through its effects on the business and credit structure. Speculation on the securities exchanges is held to be a very direct and important factor in

3. Woodlief Thomas, evidence before Senate Hearings, Part 15, p. 6439.
4. Evidence of Dr. E. A. Goldenweiser, Director, Division of Research and Statistics, Federal Reserve Board, Senate Hearings, Part 15, p. 6439.
5. Alfred L. Bernheim, evidence before Senate Hearings, Part 15

the progression and the regression of business activity. Dr. E. A. Goldenweiser states that

> "unregulated speculation in securities was one of the most important contributing factors in the artificial and unwarranted 'boom' which had so much to do with the terrible conditions following 1929."[6]

The Use of Credit For Security Speculation

very easy facilities existed for obtaining credit for purchasing securities. Much of this credit was obtained by buying stocks and bonds on margin. A purchaser might provide twenty or twenty-five per cent of the purchase price of a security and borrow the remainder, using the stock certificate or bond as collateral. These funds, which may be called brokers' loans to customers, were borrowed from brokers. The brokers had easy access to funds through the New York money market which was supplied with the surplus funds of banks and corporations throughout the country.

The New York Stock Exchange bulletin contains statistics indicating the relationship of the volume of brokers' loans, stock values, and call loan rates during the development and collapse of the securities 'boom'. These statistics are useful in reflecting the degree of connection between the stock market and the credit system.

The figures for brokers' loans on the New York Stock Exchange shows that from 1927 to 1929 these loans increased from three billion dollars to eight and one half billion dollars.[7] Brokers' loans subsequently decreased to less than a half billion dollars in 1932.[8] This panic shrinkage of brokers' loans greatly disturbed the credit system of the country. In this connection Woodlief

6. Senate Hearings, Part 15, p. 6442.
7. See chart No. I at the end of this chapter.
8. Ibid.

Thomas, of the Federal Reserve Board, Division of Research and Statistics, stated that the use of a "moderate and relative stable volume" of credit cannot be severely criticized.[9] The danger arising from the use of credit in stock market speculation grows out of the extreme fluctuations that characterize the security markets.[10]

The total market value of stocks listed on the New York Stock Exchange rose from about thirty-four billion dollars in 1925 to about ninety billion dollars in 1929.[11] When the break in security values came in 1929, the value of securities collapsed very rapidly to a low total value of about eighteen billion dollars in 1932.[12] It is asserted by Dr. E. A. Goldenweiser that the rapid rise in security values, with the great volume of brokers' loans supporting them, which preceded 1929, was an important contributing factor toward the over-expansion of business activity and the stimulation of speculation in many fields.[13]

The increase from four per cent to eleven per cent during 1928 and 1929, in the New York Stock Exchange renewal rate for call loans, indicates the increased demand for funds for security trading.[14] In 1928 and 1929 the supply of funds available to banks was reduced by the Federal Reserve open-market operations and banks withdrew funds from street loans and sold some of their investments.[15] This withdrawal of funds was followed by increased call loan rates. The supply of funds for brokers' loans was then continued by non-bank lenders. Thus, new credit was drawn into use for security speculative purposes.

9. Senate Hearings, Part 15, p. 6441. 10. Ibid.
11. See Chart No. II at end of this chapter. 12. Ibid.
13. Senate Hearings, Part 15, p. 6438.
14. See Chart No. III at end of this chapter.
15. Woodlief Thomas, "The Use of Security Credit in Speculation", American Economic Review., March, 1935, pp. 660-665.

The large and unnecessary volume of speculative activity which took place previous to 1929 was made possible by the use of credit. The use of credit enables the trader to conduct larger operations than would be possible if he were restricted to the use of his own resources. It has been further contended that the use of credit in margin buying absorbs credit which would otherwise go into productive industrial uses and that, by magnifying speculative activity, it hinders the markets in performing their proper functions. The report of the stock market survey committee of the Twentieth Century Fund contains a discussion of the relationship of the use of credit in security speculation to the business and credit structure.[16] A summary of this discussion will be given here.

The use of credit in margin trading disrupts the nation's credit mechanism. The normal flow of savings into investments, and of bank credit into commerce is interrupted. The result is that short-term bank credit is improperly drawn into long-term investments, and the volume of bank credit is abnormally inflated. Such a use of bank credit is of questionable economic soundness.

It cannot be proved that the use of bank credit for security trading results in a withdrawal of funds from business. This is true because the total lending powers of the banks of the country is not a fixed sum but is capable of expansion. It can be shown, however, that the inflation of credit due to speculative demand for funds had unfortunate results for banks themselves, for industry, and for business.

It is the chief function of commercial banks to advance short-term funds to finance self-liquidating loans. The termination of such loans automatically provides the funds for the repayment of the

16. Twentieth Century Fund, Stock Market Control, Appleton-Century Company, pp. 89-95.

bank loan. Brokers' loans do not meet this requirement. Such a loan is terminated by the buyer-borrower selling to another buyer-borrower. The result is that when for any reason individual and corporate lenders withdraw their funds from the market the banks must take over the loans in order to protect the values of the securities which they are holding as collateral.[17] Thus, it will be seen that there is a close connection between bank and stock exchange activity through the money market.

A large part of the proceeds of brokers' loans goes into the purchase of new issues or into the purchase of other old issues. Another portion goes directly into expansion of plant and equipment by those sellers who are corporations or owners of business concerns. Still a third goes to the purchasing of consumer goods. This takes place when security owners withdraw their profits. Thus, the stock exchange becomes the mechanism for making bank credit available to finance increased capital equipment and plant expansion, and for the purchase of consumer goods. Such a use of commercial bank credit is questionable.

Increasing the volume of brokers' loans and rising stock prices, out of proportion to productive activity, has an inflationary effect. When the increased credit is used to increase plant expansion and for the purchase of consumer goods during the development of a business 'boom' the movement is still further accentuated. Business suffers further because of the inflation of values, because of high prices for raw materials, and because of high interest rates. These were the main evils which come about due to the excessive use of credit for security speculation according to the Twentiety Century Fund report.

17. See Chart No. IV at the end of this chapter.

## THE QUESTION OF PUBLIC REGULATION OF SECURITY SPECULATION

It has been pointed out that the results of excessive security speculation are harmful and widespread. While speculation has a useful place in the proper functioning of the market, it is rendered harmful by excess. The result of excessive speculation is that the useful function of the market is impaired. Furthermore, such security speculation results in 'booms' and panics. It follows from this that public policy requires that security speculative activities be brought under control. The objectives of this control should be to see that security speculation adds to and does not detract from the valuable functions which the security exchanges are designed to perform; and so that such activities will no longer create credit disturbance and other maladjustments throughout our economic structure.

The view of security speculation which has been discussed above was that taken by the government officials and Congress. It is upon this view that the public policy of federal regulation of the securities exchanges is based. The market interests were not in favor of federal regulation of the exchanges. Their objection to such regulation was based upon a different view of the effects of security speculation. The arguments upon which their opposition to regulation were based will now be discussed.

Richard Whitney, President of the New York Stock Exchange, opposed the plan to regulate security speculation on the exchanges by the federal government.[18] He contended that it is yet to be proved that speculation is the cause of 'booms' and panics, and,

18. Senate Hearings, Part 15, p. 6732.

further, that the elimination of all speculation or its curtailment will not prevent 'booms' and panics. Any attempt to regulate security speculation by statute would be impossible to accomplish, according to Mr. Whitney, because rules of law, which would be effective today, would be worse than useless under changed circumstances in the future. In order to indicate the need for speculation and to show the folly of attempting to regulate it by law, Mr. Whitney quoted statements of former Justice of the United States Supreme Court, Oliver Wendell Holmes as follows:

> "People will endeavor to forecast the future and to make agreements according to their prophecy. Speculation of this kind by competent men is the self-adjustment of society to the probable. Its value is well known as a means of avoiding or mitigating catastrophes, equalizing prices, and providing for periods of want. It is true that the success of the strong induces imitation by the weak, and the incompetent persons bring themselves to grief by undertaking to speculate in their turn. But legislatures and courts generally have recognized that the natural evolutions of a complex society are to be touched only with a very cautious hand, and that such coarse attempts at a remedy for the waste incident to every social function as a simple prohibition and laws to stop its being are harmful and vain."[19]

The protection of investors is a part of the public policy of the Fletcher-Rayburn bill. It was asserted by Mr. Whitney, in this connection, that the bill would legislate against the best interests of investors rather than protect them.[20] This would be true because the bill would impair the collateral value of securities by seriously decreasing the amount of trading in the organized exchanges thus reducing their liquidity. Since approximately one hundred billion dollars, of the nation's wealth of about three or four hundred billion dollars, is in listed securities the investors should receive considerable consideration.[21]

19. Senate Hearings, Part 15, p. 6734.
20. Ibid, p. 6605.
21. Ibid.

The advisability of attempting government regulation of the securities exchanges was questioned by Edwin F. Chinlund, Representative of the Controllers Institute of America.[22] It was his opinion that the greater benefits to the American people might be secured through the evolutionary process of reform, rather than by government regulation. The process of reform should be continues through "education of public, security dealers, brokers, and issuing corporations."[23] He further stated that "setting up stringent regulations" would result in a setback to the real progress which has been made.[24] Eugene Thompson, President of the Associated Stock Exchange Firms of Washington, D. C. was of a similar opinion and did not believe that "practical and accepted habits and customs" should be discarded in favor of the "theories and experimentation" of persons who have had little contact with the exchanges and its problems.[25] It was his opinion, further, that the proponents of government regulation of the exchanges were opposed to anything "conventional or institutional" and that they have a "vague" idea that the exchanges should be so classified.[26]

Senator Gore, a member of the investigating committee, did not believe that any kind of speculation can be prevented by law because it is human nature to speculate.[27] The Eighteenth amendment was cited as an example of the folly of attempting to regulate human behavior by law. This has led to such evils as the Florida land 'boom' and land speculation in farm states. The desire to gain through gambling results in lotteries doing a thriving business in this country, although they are forbidden by law. "It is imposs-

22. Senate Hearings, Part 15, p. 7087.
23. Ibid.
24. Ibid.
25. Senate Hearings, Part 15, p. 6981.
26. Ibid.
27. Senate Hearings, Part 15, p. 6488.

ible to protect the fool against his folly" by passing laws.[28]

Another objection, which was raised to government regulation, was that such regulation would run the risk of destroying the securities exchanges. W. G. Paul, Secretary of the Los Angeles Stock Exchange, asserted that this would occur upon the date of adoption of the Fletcher-Rayburn bill.[29] The result of the stringent regulations would be that the investors who could not deal through the regular market channels would be forced into the hands of bootleggers. This would result in undisciplined dealings which could never be regulated. Mr. Paul was of the opinion that the present open, free, and public market in securities is much to be preferred over such a condition.[30]

A phamphlet entitled, "German Regulation of Stock Exchanges 1896-1908." by J. Edward Meeker, was submitted to the investigating committee by Roland Redmand, Attorney for the New York Stock Exchange.[31] This pamphlet set forth the unsuccessful results of the German government to regulate speculation of the securities exchanges by legislation. The legislation was introduced following the collapse of a speculative 'boom' in the German securities markets. Many requests flooded the Reichstag asking for intervention by the government to halt speculative abuses. A careful study of the situation was made and the "Exchange Law of 1896" was passed to regulate the Boerse. It had been the feeling in the Reichstag that there were three principal evils in connection with speculation on the exchanges: (1) the manipulation of commodity prices against the interests of producer and consumer alike; (2) the manipulation of security prices; (3) speculation by inexperienced persons of small

28. Senate Hearings, Part 15, p. 6488.
29. Senate Hearings, Part 15, p. 6773.
30. Ibid.
31. Senate Hearings, Part 15, pp. 7158-7165.

means, who almost always lost money in the end. To minimize or obviate these real or alleged evils the Exchange Act of 1896 accordingly resorted to three principal provisions; (1) dealings in grain and flour on the German exchange on credit were forbidden; (2) similiar transactions on the German exchanges on credit in certain classes of shares(speculative) were forbidden; (3) a "Stock Exchange Register" was established, wherein all speculators entering into exchange transactions of a speculative character must incribe their names.

The German attempt to halt speculation did not achieve its purpose. It simply led to other and more roundabout methods of conducting it. Exchange brokers left the Boerse and set up business elsewhere. Trade degenerated into a crude "over-the-counter" market with direct settlements and less actual regulation than had been in force before the Exchange Act of 1896 was passed. The results were soon felt and led to the discovery on the part of the government of the value of organized speculation.

A great many detrimental results of the law soon became apparant. Transactions in German securities were driven into foreign markets. Speculative manipulation was facilitated rather than curtailed. The Berlin money market was strained and demoralized The law proved to be a grave obstacle to business activity.

The results of several studies by experts in Germany and the United States resulted in condemnation of the law.[32] Attacks on the law gained in force and resulted in unsuccessful attempts to amend it in 1904 and 1906. These early attempts at revision, though unsuccessful, laid the way open for its eventual repeal.

32. Professor Henry C. Emery of Yale, phamplet, "Ten Years of Regulation of the Stock Exchange in Germany."
The Hughes Commission of 1908.
Dr. Wachler in German Bank Inquiry of 1908-1909.

The Committee of the Federal Counsel, which was hostile to speculation and which had originally passed the Act of 1899, stated in its report on the bill proposed in 1904:

> "The dangers of speculation have been increased, the power of the market to resist one-sided movements has been weakened, and the possibilities of using inside information have been enlarged."

As a result of the many attacks on it, the Boerse Law of 1896, as it related to security dealings was considerably changed in certain stringent provisions. The Exchange register provision was repealed entirely. This action, as the Hughes Commission Report states, proves conclusively that

> "Insofar as the Reichstag in 1896 had aimed to prevent small speculators from wasting their substance on the Exchange, it not only failed, but***added a darker hue to evils previously existing."

The previous restriction against industrial security futures was also withdrawn, although these contracts were still made subject to the discretion of the State. By a law passed in 1908, the Government might, in its discretion, authorize speculative transactions in industrial and mining securities of companies capitalized at not less than $5,000,0000.

It is our opinion that the alleged failure of the German attempt to regulate security speculation by law should not be accepted as conclusive evidence of the probable failure of such an attempt in the United States. It is true that we should benefit from the experiences of government regulation in other countries. It is not always possible to make a fair comparison between countries, however. This is due to a variation in the institutional developments in different countries.

In defense of security speculation it has been asserted that it is not the cause of the evils attributed to it. Any attempt to regulate security speculation by law would be impractical and would run the risk of doing more harm than good. The enactment of the proposed bill would do a great deal of damage. Investors in securities would be harmed rather than benefited by it. The business structure would be harmed[33] and recovery would be retarded.[34] Security trading might be forced off the organized exchanges and into the over-the-counter markets. Finally, the failure of the German attempt to regulate speculation by law was urged as evidence of the impracticability of undertaking to pass a regulatory law in this country.

The question of the proper public policy in regard to security speculation has been discussed. It is apparent that there were two fundamental and inter-related issues involved in the question of public policy relative to security speculation. The first of these was the question as to the results of security speculation. The second issue, which is based on the first, was the question of the regulation of security speculation on the exchanges. The government and market authorities were divided by these two issues. The government authorities asserted that security speculation is rendered harmful by excess only. Consequently, since the general public is concerned, the government should regulate the securities exchanges to prevent excessive speculation. The market authorities asserted that speculation is necessary to the proper functioning of the markets, the destruction of which would be detrimental to the whole country. Furthermore, since speculation cannot be regulated by law the exchanges should continue to be self-regulated.

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34. Evidence of A.W.Sewall, Pres. Gen. Asphalt Co.Senate Hearings, Part 15, p. 7166. 35. G.H.Huston, Vice-Pres. Nat'l Manf. Assoc. Senate Hearings, Part 15, [illegible]

## ALTERNATIVE FORMS OF REGULATION OF SECURITY SPECULATION

The federal regulation of security speculation on the exchanges requires that the government provide a plan for regulation. In all of the various plans for regulation of the securities markets two features are included.[35] One of these plans is that the market itself shall be an exchange which shall be autonomous within limits set by the government. This autonomy would include responsibility to the government for the immediate policing of the exchange. In the other plans some government agency would supervise the securities markets with varying degrees of authority. The latter of these two features is embodied in the Fletcher-Rayburn bill.

It has been noted that the market authorities desired to have the control of margin requirements remain in the hands of the brokers and the organized exchanges rather than to be controlled by the federal government as contemplated by the administration bill. It has further been indicated that the ease of obtaining funds for security speculation by means of borrowing on the margin has resulted in excessive speculation. This condition indicated a need for making margin trading for speculative purposes more difficult. Such a condition might be brought about by requiring higher margins on such transactions. The question as to how the margin requirements should be determined was a point about which there was considerable disagreement. The market authorities took the position that if margins are to be determined by the government, they should be determined by a commission. The government authorities, on the other hand, favored a statutory formula for determining margin requirements.

35. Flynn, John T., Security Speculation, Harcourt, Brace and Co., p. 279.

The whole question of determining margin requirements might have been settled by simply doing away with all margin trading. Such a proposal was made during the course of the Pecora hearings. The description of this plan, the arguments supporting it and the arguments against its adoption, and the feasibility of adopting such a plan will be discussed here.

The Proposal to Prohibit Margin Trading Through Brokers' Loans

The proposal to prohibit margin trading on the securities exchanges was introduced into the hearings by Senator Bulkley who continued to give the plan his support throughout the hearings. It is not to be supposed that the proposal was rejected without the investigation and examination of it. There was considerable support for the plan and qualified government officials were called upon to discuss it. Woodlief Thomas, who had studied the English system of financing security transactions, stated that "the proposed plan is much like that in use in England."[36] With the help of Dr. E. A. Goldenweiser he compared the English system of financing security operations and the financing of security operations by the use of margins. Eugene Black, Governor of the Federal Reserve Board, gave an opinion concerning the advisability of adopting the proposed plan. Alfred L. Bernheim, director of the market survey of the Twentieth Century Fund, made several criticisms of the plan to prohibit margin trading.

The proponents of the plan to do away with all margin trading criticized such trading because of the lack of any direct credit relationship between the borrower of funds and the lender of those funds. In order to carry on a margin transaction a borrower does not need to make any personal contact with the broker lending the

36. Senate Hearings, Part 15, p. 6440.

funds. Brokers have no means of selecting and of determining the credit standing of their clients.[37] Security loans are automatically made, and, if more funds are not supplied when additional margin is necessary, they are automatically called.

The result of a lack of any direct credit relationship between a broker and his client is that margin trading is made entirely too easy. This encourages speculative trading in securities. A margin trader "needs no credentials...or line of credit."[38] All that he needs is "a few dollars to put up as margin" and the rest of the funds are supplied by the broker who has "very easy, perfect access to the credit reservoir through the banks."[39]

One who borrows funds should feel liable for the return of those funds if the collateral for the loan fails. This is not the case with margin traders who are not made to feel any such liability. The funds supplied for the margin is considered only as "evidence of good intentions."[40] It was the opinion of Dr. E. A. Goldenweiser that the margin trader is not aware

> "that he is really signing up for a very large loan, and if the broker is not able to dispose of his security in time, he has a liability to discharge."[41]

The trading in securities by borrowing on the margin is carried on "like a game."[42] If stocks go down the trader loses and if they go up he wins.

An interesting moral argument for prohibiting margin trading was made by Federal Judge William Clark. It was the opinion of Judge Clark that bankruptcies, embezzlements, and suicides may

37. Evidence of Dr. E. A. Goldenweiser, Senate Hearings, Part 15, p. 6440. 38. Ibid. 39. Ibid 40. Ibid.
41. Senate Hearings, Part 15, p. 6441.
42. Ibid.

often be traced to speculating in securities on the margin. He cited experiences, as a federal judge, which indicted the practice of margin trading. Judge Clark related:

> "I have had to send men to prison because they had used the money entrusted to them by poor depositors to 'protect' margin accounts. The district attorney for my district advised me that about half of our national bank emblezzlements in the last five years are the result of stock speculation.
>
> There has been since 1929 an increasing number of suits in my court on insurance policies where, under the terms of the standard policy, the issue was; accident or suicide? The company has been, therefore, obliged to establish a motive, and in nearly every instance the motive has been, 'wiped out in the stock market'.
>
> In 1930 and 1931, I conducted with the aid of the Yale Law School and the Department of Commerce, what we called a ' 'Bankruptcy Clinic"...We examined a large number of persons who had filed petitions in the New Jersey court for the purpose of discovering the whys and wherefores of their unfortunate condition...We were shocked to find the large number of individuals, both business men and wage earners who had taken a 'fling' in the market as a sideline, with, of course, fatal results.
>
> My knowledge of these things led me to the conclusion that margin trading in an unconscionable number of cases led to either death, dishonor, or distress. I have been endeavoring for several years now to impart that conclusion to the stock-exchange authorities themselves."[43]

Thomas G. Corcoran, in the office of counsel for the Reconstruction Finance Corporation states two common justifications for margin trading.[44] The first of these is that the use of margins makes purchases of securities on the instalment plan possible. When security prices are low and there are prospects for an increase, it is possible for an investor to make a down payment and to pay the balance later. The second justification is that margin trading makes an active market. If the market is to be a liquid market it must be an active market. To be an active market it must be a speculative market, because a market of investors, alone is not active enough. To have a speculative market it is necessary to have a margin market.

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43. Senate Hearings, Part 15, p. 6928.

44. Senate Hearings, Part 15, p. 6484 and p. 6499.

These two justifications for margin trading were criticised by Mr. Corcoran. The difficulty of the instalment plan of buying securities is that, on a rising market, human nature is such, that investors never pay for the securities as they advance in price. The investor becomes a speculator and pyramids on his profits by purchasing more securities. The argument that margin trading is necessary in order to have speculation and a liquid market, is a controversial question. Its merits rests with the purely pragmatic question of how valuable speculation is in the market. This question has been discussed above.

The Plan for Prohibiting Margin Trading

Certain of the evils existing in the credit relationship between brokers and their clients in margin trading operations have been indicated. We will now proceed to describe the means by which security transactions would be financed under the plan urged by those desiring the prohibition of margin trading. The most important change that would be brought about by prohibiting margin trading would be that brokers would be taken out of the banking business and all transactions on the securities exchanges would be placed on a cash basis.[45] A purchaser of securities, if he wanted to borrow funds, would have to go to a bank. This would establish a direct credit relationship in place of the indirect credit relationship which exists in margin borrowing.

Senator Bulkley pointed out many advantages which would flow from the financing of security trading through the banks.[46] Under this arrangement bankers could secure necessary credit information before making a loan to a security trader. The credit needs of borrowers could be considered and borrowers would not

45. Evidence of Senator Bulkley, Part 15, p. 6484. Senate Hearings
46. Ibid, Part 16, p. 7426.

escape responsibility for repayment of a loan if their collateral fails.

In regard to the federal control of security credit, Senator Bulkley believed that bank loans on securities might be controlled through the Federal Reserve System. He also felt that "banks would be moved by a greater degree of social and economic consideration than brokers" would be in making loans on securities.[47]

A great deal of the support for the financing of security transactions through banks rather than by means of margin borrowing was based on the more desirable credit relationship which would be established. This relationship was rather fully discussed by Woodlief Thomas.[48] He made a comparison of the responsibility of borrowers, the protection of lenders, and the effect on a rising and falling market, which would come about through the use of either of the two methods for securing funds for the purchase of securities.

The responsibility of borrowers from bankers and the responsibility of borrowers from brokers was compared by Mr. Thomas. In the case of a bank loan the borrower must sign a note for the amount borrowed and if he increases his commitments he has to sign a new note. In the case of a brokerage house, long commitments are simply entered as a debit in the books of the broker, and short commitments are entered as a credit. The principal requirement in the case of a brokerage house is that the account be properly margined.

According to Mr. Thomas, bankers who make security loans are better protected than brokers. This is true because banks, generally, deal only with their customers who maintain a deposit balance in addition to their collateral. They are also likely to require

47. Senate Hearings, Part 16, p. 6592.
48. Senate Hearings, Part 15, pp. 6449-52.

larger margins than brokers. Also, bankers are more particular in arranging credit transactions for the purpose of stock market trading than brokers who do not select their customers.

It was the opinion of Mr. Thomas that bank loans for financing security transactions have a better affect on the market than loans by brokers. A close check is kept on the market by brokers who do not hesitate to sell out accounts that are undermargined. This makes rapid sales necessary on a declining market and tends to make the market more erratic. On a rising market brokers encourage clients to increase their commitments. This encourages pyramiding.

Undermargined accounts are likely to be carried longer by banks than by brokers. The bankers can do this because they are protected by the customers' note, a larger margin an additional deposit, and a knowledge of the customers' credit standing. on a rising market bankers do not encourage the extension of speculative loans. The result is that pyramiding is not encourage by bankers, while it is by brokers.

It was pointed out by Mr. Thomas that the adoption of the plan to prohibit margin trading would bring about a credit situation in security transactions similiar to that in England. It was his opinion that the plan "should not be adopted without a study of the English plan."[49] Eugene Black was of a similiar opinion. He stated that although it might "ultimately be a good thing" it would be "too drastic" to adopt without considering the English practices and the probable results of their adoption in this country.[50]

49. Senate Hearings, Part 15, p. 7188.
50. Senate Hearings, Part 16, p. 7427.

The English System of Financing Security Trading

In the discussion of the English system for financing security trading it was revealed that "in London margin trading of the kind and to the extent prevalent in New York is unknown."[51] Woodlief Thomas stated that "the facilities for margin trading seemed to be very difficult" and that "he could not find a broker who would admit that he did a margin business."[52]

The method of securing funds, in England, for security trading was described by Dr. E. A. Goldenweiser. He stated that in England a security trader "must establish a line of credit" with a bank or broker in order to secure funds.[53] This would bring about a direct credit relationship. In establishing the line of credit the "needs and the financial responsibility of a borrower are considered" and the "mere possession of security collateral" is not enough.[54] A client's request "must go before the board of directors" of the lending institution and it must "be approved" before the client's line of credit can be increased.[55] This method of financing security trading would not be susceptible of the two criticism which have been made of margin trading in the United States. Namely, these criticism, which were made earlier in the chapter, are that the borrowing of funds on the margin is made too easy and that in a margin transaction no direct credit relationship is established.

51. Evidence of Woodlief Thomas, Senate Hearings, Part 15, p. 7188
52. Ibid.
53. Senate Hearings, Part 15, p. 6440.
54. Ibid.
55. Ibid.

Opposition to the Prohibition of Margin Trading

The market authorities, evidently, did not fear that the plan to eliminate all margin trading would be adopted. This may be inferred because of the lack of participation by market authorities in the discussions concerning the plan. It must be inferred, However, that they would have objected to its adoption even more than they objected to the adoption of the administration bill. This is probable because its result would be to entirely elminate margin trading; whereas, the result of the administration bill would be the reduction of margin trading only.

The most active criticism to the immediate adoption of the plan came from the credit representatives of the government. Likewise, the results of the survey of the securities exchanges carried on by the Twentieth Century Fund were not favorable to the plan to prohibit margin trading.

Among the objections to the prohibition of margin trading was the assertion that it would not accomplish its intended results. Alfred L. Bernheim did not believe that

> "borrowing on security collateral directly from banks instead of from brokers could be expected to reduce the volume of speculation materially."[56]

An important reason why the measure might not be effective in accomplishing its intended result was the possibility that security traders might find some new means of securing funds. It might be impossible to control this new source of credit and hence a bootleg loan market of huge proportions might be developed. The danger of the development of such a market was foreseen by Roland Redmand "if in an extreme effort to stop speculation on borrowed

56. Twentieth Century Fund, Stock Market Control, Appleton-Century Company, New York. p. 177.

funds all collateral loans were made illegal."[57] It should be observed that there are many banks which are not members of the Federal Reserve System and that their loans on security collateral could not be federally controlled. In addition, there would be danger of the organized exchanges setting up private banks for financing security trading.

Another objection to the prohibition of loans on the margin was that it would result in the impairment of the collateral value of securities. This, it was asserted, would be unfair discrimination against a certain class of property. It would seem unwise to prohibit the purchase of securities on credit or their use as collateral when other property is not so restricted.[58] It is probably true that many loans on security collateral are made for purposes other than further security purchases. The lenders of such funds could not be expected to exert effective control over the use borrowers made of the funds advanced to them on security loans.

The curtailing of credit by the probition of margin trading was further objected to because of the danger of destroying the proper function of the securities markets. It was pointed out in this connection that if the market is to perform its proper function it must be a speculative market. The drastic curtailment of credit which would come about as a result of the prohibition of margin trading might so reduce the amount of trading that the liquidity of the market would be impaired.[59]

The marketing of new securities by corporations is an important means of securing new funds. If margin trading were to be prohibited the marketing of these new securities might be made difficult. The representatives of business contended that because of this corporation financing would be made difficult.

57. 73d Senate Hearings, Part 15, p. 7199.
58-59. Twentieth Century Fund, Stock Market Control

Compromise Policy in Public Regulation of Security Credit

The Fletcher-Rayburn bill is a compromise between those who desired to have margin trading remain unregulated by the government and those who favored the complete elimination of margin trading. The drafters of the bill did not wish to risk destroying the liquidity of the securities market by doing away with all borrowing.[60] It was thought, by them, to be a better plan to reduce, rather than to prohibit margin trading.

The plan to finance all security trading through the banks which would have been brought about by a law prohibiting margin trading doubtless has certain merits. Its results, if adopted, in this country, would be questionable. Although the plan may work in England it should be observed that our credit practices and the customs followed in our securities exchanges are not like those employed in England. Furthermore, the change from the margin practices which have long been followed to an entirely different practice would be a drastic change. If the elimination of margin trading is desirable it might be wiser to make the change gradually.

The Fletcher-Rayburn bill provides for less drastic changes in the use of margin trading than would be brought about by the prohibition of such trading. It is obvious that it would not be as likely to have harmful results. The bill can be expected to eradicate many evils pointed out by the critics of margin trading by providing for higher margins. In addition, the bill may be expected to have a tendency to discourage margin trading and bring about more financing of securities through the banks. This would be true because the margin regulations will make such trading more difficult. The increased difficulty of margin trading through accounts with brokers may result in traders going to banks to secure funds.

60. Evidence of Thomas Corcoran, Senate Hearings, Part 15, p. 6484

CHART NO. I. N. Y. S. E. MEMBER TOTAL BORROWINGS ON COLLATERAL

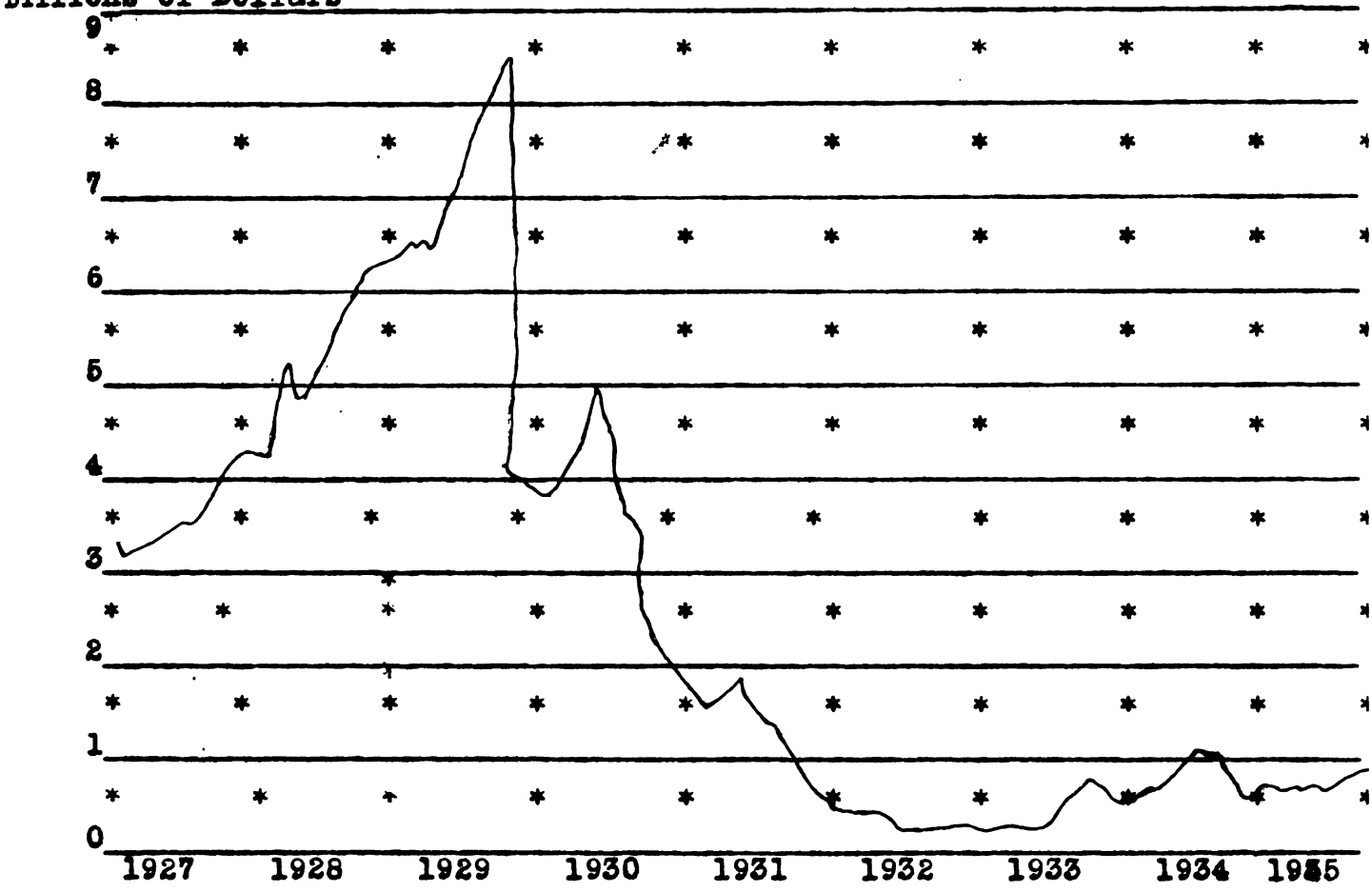


CHART NO. II. N. Y. S. E. TOTAL MARKET VALUES OF LISTED SHARES

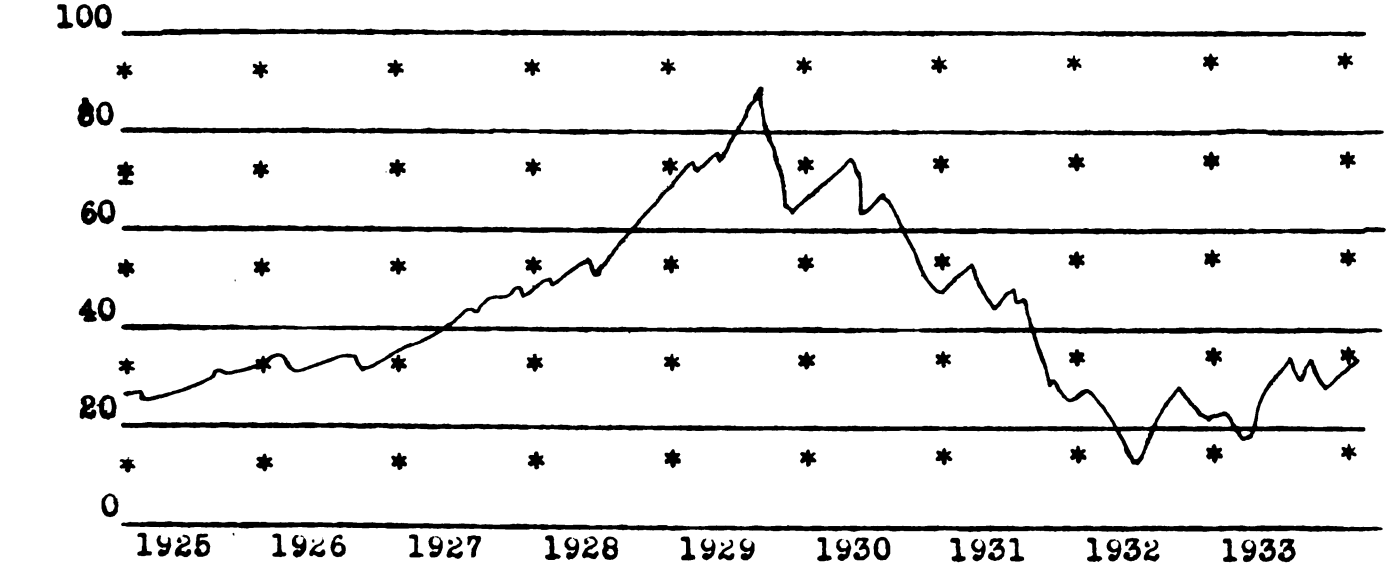

CHART NO. III.

N. Y. S. E. MONEY DESK‡CALL LOAN RENEWAL RATES
(Monthly Averages)

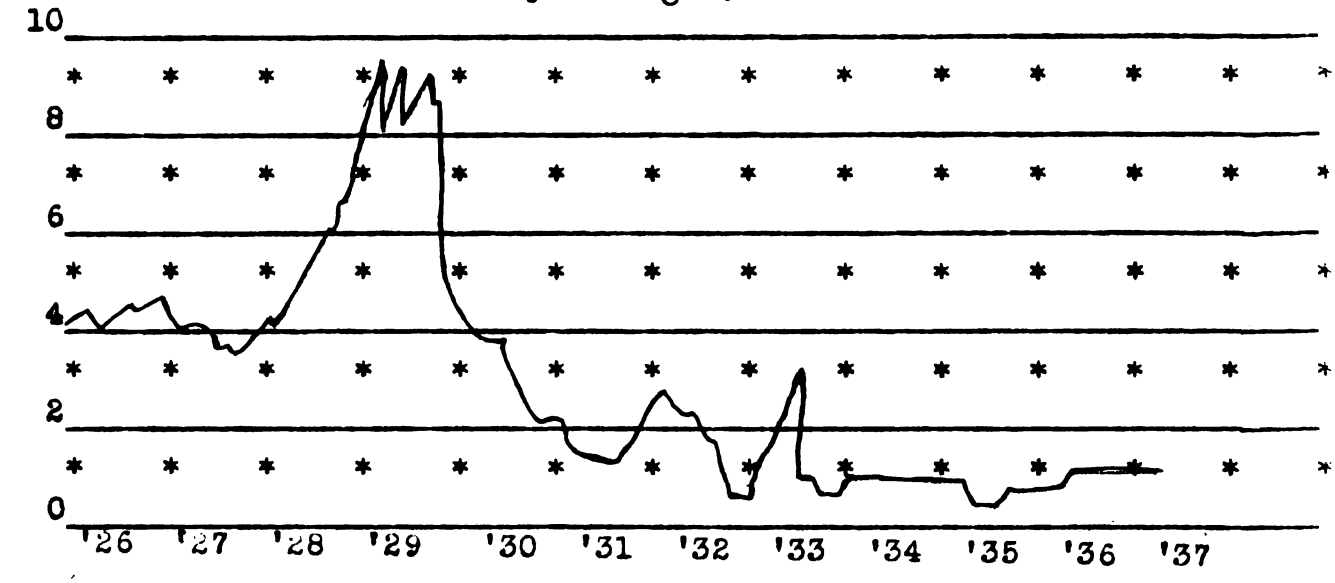


CHART NO. IV.

ALL FEDERAL RESERVE MEMBER BANKS‡LOANS TO CUSTOMERS(Except Banks)
ON SECURITIES

| Call Date | Loans on Securities (In millions of Dollars) |
|---|---|
| 1928-Oct. 3 | 5,796 |
| Dec. 31 | 6,373 |
| 1929-Mar. 27 | 6,526 |
| June. 29 | 6,813 |
| Sept. 29 | 7,170 |
| Dec. 31 | 8,685 |
| 1930-March 27 | 7,024 |
| June 30 | 7,242 |
| Dec. 31 | 7,266 |
| 1931-Mar. 25 | 6,848 |
| June 30 | 6,602 |
| Sept. 29 | 6,321 |
| Dec. 31 | 5,899 |
| 1932-June 30 | 5,009 |
| Sept. 30 | 4,828 |
| Dec. 31 | 4,608 |
| 1933-June 30 | 3,752 |
| Oct. 25 | 3,631 |
| Dec. 30 | 3,606 |
| 1934-Mar. 5 | 3,480 |
| June 30 | 3,309 |
| Dec. 31 | 3,110 |
| 1935-June 29 | 2,931 |
| Nov. 1 | 2,885 |
| Dec. 31 | 2,881 |

# CHAPTER III

## EFFECTIVENESS OF HIGH MARGINS AS A DEVICE FOR FEDERAL CONTROL OF SECURITY CREDIT

In the preceding chapter the evils of excessive security speculation were discussed. As a result of these evils the need for adopting a public policy of federal regulation was indicated. One of the means for such regulation is the granting of additional federal control over security credit. It has been asserted that too free use of credit has been a major cause of excessive security speculation. The existing means of federal credit control have not proved effective in regulating such speculation. The Fletcher-Rayburn bill provides for additional powers of regulation through the use of higher margins as a device for federal control of security credit. The question of the effectiveness of such control provides the issue with which this chapter is concerned.

### THE PLAN FOR MARGIN CONTROL OF SECURITY CREDIT

The Fletcher-Rayburn bill provides a plan for the regulation of security speculation by means of federal credit control. The bill limits the use of security credit through the federal control of margin requirements. The power to fix margins makes it possible to limit the collateral value of securities for margin trading by regulating the size of margin requirements. It differs from other means of credit control in that it affects directly the effective demand for credit rather than available supply or cost. It is the purpose of the bill to fix margin requirements which will exert a restraining influence on the use of credit for speculation in the stock market so that the business and credit structure will not be

unfavorably affected.

The proposed bill contained a statutory formula on which margin requirements would be based.[1] It was provided that a commission might prescribe higher requirements if conditions made it necessary to do so.[2] The statutory formula would provide in effect that a loan on a security must not be greater than whichever is the higher of:

(1) 80 per centum of the lowest price at which such security has sold during the preceding three years; or
(2) 40 per centum of the current market price.

The theory on which the statutory margin formula was based was to provide a constant increase of restraining influences as the price of a tock advanced above their lowa. The operation of this formula will be discussed in greater detail in the next chapter.

The bill provides for the selection of collateral which may be used in margin trading. In order to be eligible as collateral in a margin purchase a security would have to be registered on a nationally registered securities exchange.[3] The registration of securities and exchanges was a necessary measure for the administration of the margin formula. Securities which were not registered would not be eligible as collateral in margin trading. The problem of these unlisted securities will be dealt with in a later chapter.

## Objections to Relating Margins to Market Price

An objection to the computing of margins on the basis of market price was raised by Alfred L. Bernheim, director of the securities markets survey of the Twentieth Century Fund.[4] This organization had undertaken an exhaustive survey of the securities markets to determine what evils were present and how they should be eliminat-

1. Fletcher-Rayburn bill, Section 6(b). 2. Ibid.
3. Ibid, Section 6(a).
4. Senate Hearings, Part 15, p. 6936.

ed.[5] They agreed that minimum margins should be set sufficiently high to discourage excessive speculation but they were of the opinion that the earnings of a security rather than its market price should be used as a means of determining margins. Mr. Bernheim stated that

> "the principle of relating collateral loans solely to market values is essentially unsound, no matter at what point the margin is set. This margin permits a pyramiding process. It makes possible higher loans as prices are rising and accelerates liquidation when prices are dropping. This is particularly true under the alternative devices provided in the bill which will serve to permit pyramiding during the later stages of a 'bull-market' when it is most dangerous, while it will impede the flow of credit into the market during the early stages of recovery when, if ever, speculation in stock is helpful. Only by relating collateral loan values to the earnings of a security can these unfortunate results be prevented."[6]

A table was submitted to illustrate the fallacy of relating the loan value of a security to the market price of the security.[7] The table shows the loan values of four common stocks compared with the market values. A comparison of loan values of the stocks is made as they would be computed under the proposal made by the Twentieth Century Fund committee, by the proposed bill, and by the New York Stock Exchange margin requirements. The prices and loan values for September 3, 1929, June 1, 1932, and February 1, 1934 are shown.

It was suggested by Mr. Bernheim that the maximum loan value of a share of stock be twice the aggregate net earnings applicable to it over the five years preceding the date of the loan.[8] The qualification was added, however, that the collateral value should never exceed sixty per cent of the current market value of a security.

Several objections to the plan were pointed out by Roland

5. Senate Hearings, Part 15, p. 6936.
6. Senate Hearings, Part 15, p. 6941.
7. Table included at end of chapter. Chart No. VII.
8. Senate Hearings, Part 15, p. 6941.

Redmand, attorney for the New York Stock Exchange.[9] The plan could not be put into operation without considerable delay due to the necessity of determining a security's earnings. In operation the plan would involve much detail and expense. The fact that earnings of many securities fluctuate greatly would further invalidate the plan. No provision is included in the plan for figuring the margin on securities of new enterprises.

Opposition of Market Authorities to Federal Margin Control

The market interests were opposed to the use of margins as a device for the federal control of security credit as contemplated in the Fletcher-Rayburn bill. They favored, rather, the indirect control of the volume of credit. It was contended, in this connection, that the Federal Reserve Board have sufficient powers to enable them to properly regulate security speculation.[10] It was agreed that the Board had not succeeded in regulating security speculation previous to 1929. However, it was asserted, bankers had learned by that experience.[11] Likewise, the enacting of the Banking Act of 1933 has greatly increased the power of the Board for the express purpose of preventing the undue diversion of funds into speculative operations.

The theory followed in the proposed legislation for the use of margins to prevent excessive security speculation seemed to be that permanent margins should be fixed sufficiently high to keep any great amount of borrowed funds from entering the market. This in turn would prevent the development of any speculative 'boom'. Experience has shown that the time to check such a 'boom' is before it

9. Senate Hearings, Part 15, pp. 6944-6947.
10. Evidence of Howard Butcher, Vice-President, Phila. Stock Exchange, Senate Hearings, Part 15, p. 6969, and of John C. Legg, broker-dealers firm in Baltimore, Part 15, p. 6919.
11. Evidence of Richard Whitney, President of the New York Stock Exchange, Senate Hearings, Part 15, p. 7033.

gets under way. If this is not done, it will gain such force, after it gets under way, that raising margins will not be an effective measure to stop the speculative movement.

In opposition to the above plan for the use of margins, it was contended that low margins do not cause security speculation. Margin requirements should be low enough to allow the use of credit in security transactions. These margin requirements should not be permanently fixed but should be determined according to current conditions. If it appears that security speculation is becoming excessive, raising margins will exercise some restraint. The market authorities and brokers have followed this procedure and since they are best acquainted with market conditions they are well qualified to determine when margins should be raised.

## EFFECTIVENESS OF HIGH MARGINS IN PREVENTING SPECULATION

There was a difference of opinions concerning the effectiveness of high margins in regulating security speculation. The supporting arguments of those who were opposed and of those who were favorable to the statutory plan for the regulation of security speculation through the use of high margins will now be discussed.

The argument that low margins are not a cause of security speculation was advanced by Frank Altschul, chairman of the committee on stock list of the New York Stock Exchange. [12] He asserted that "normal margin requirements do not unduly foment speculation." He felt that the temptation to speculate is or is not "inherent" in the situation. Low margin requirements are not in themselves

12. Senate Hearings, Part 15, p. 6708.

a temptation to speculate. It was his opinion that high margins should not be permanently fixed but they should be tightened as speculative waves develop.

It was argued by Richard Whitney, President of the New York Stock Exchange, that the history of the use of high margins on the New York Stock Exchange does not seem to indicate that they will be effective in curbing security speculation.[13] The use of high margins did not prove effective in 1929. The New York Stock Exchange had minimum margin requirements and brokers raised their margin requirements as security prices began to soar in 1929. Statistics taken from the member's questionnaires over the first six months of 1929 showed margins in customers' accounts averaging forty per cent on their debit balances with brokers. In a speech, January 25, 1930, Mr. Simmons, who was at that time president of the New York Stock Exchange stated:

> "I need scarcely point out how enormous these margins were. Never had margins in the New York brokerage business averaged anything like such high figures."[14]

The history of high margins, then, does not seem to indicate that high margins will stop speculation just at those times when it should be checked.

The history of the use of margins, previous to 1929, as a means of controlling security speculation was interpreted in a different light by Ferdinand Pecora.[15] It was his opinion that the reason why increased margins proved ineffective to reduce or control the excessive speculation that went on prior to 1929, was that margins had not been raised soon enough. The speculative movement was well under way before margins were increased. The speculative movement should not be allowed to develop. The desir-

13. Senate Hearings, Part 15, p. 6708.
14. Ibid.
15. Senate Hearings, Part 15, p. 6710.

able thing would be

> "not to let the economic machinery to reach that dangerous rate of speed where the sudden application of brakes would be ineffectual...and dangerous."[16]

The situation which developed in the market previous to 1929 was compared by Senator Fletcher to the situation which developed in business during the same time.[17] The proposed use of margins was compared to the use of the discount rate as a means of controlling business credit. In this connection, it was admitted, by the Federal Reserve Board, that they were late in raising the rediscount rate in order to check the undue inflation of business credit. It was Senator Fletcher's opinion that if the Board had raised the discount rate earlier they might have prevented the inflation of credit.[18] The implication of Senator Fletcher's comparison seems to be that undue use of security credit may be checked by fixing margins permanently high.

Protection of the Investor

The use of high margins as a means of limiting credit for security speculation will protect the investor. Considerable difference is made by requiring a sixty per cent rather than a twenty per cent margin. When the market price of a security drops below the required level the investor must put up more funds or be sold out. This can be shown best by an illustration.

If an investor held ten thousand dollars worth of a listed security on which he had borrowed four thousand dollars in a margin transaction, unless a drop of sixty per cent occurred, he would not be 'wiped out'. In case it became necessary to put up more margin and he found it inconvenient to raise the necessary

16. Evidence of Ferdinand Pecora, Senate Hearings, Part 15, p. 6710.
17. Senate Hearings, Part 15, p. 6710.
18. Ibid.

funds, it would be possible to sell a part of his holdings of the security, and with the funds, it would then be possible to bring his margin on the remainder up to the required level. If the investor had borrowed seven thousand dollars on the ten thousand dollar purchase of the security, a drop of thirty per cent in the market price of his security would make adjustment difficult by causing the loss of the entire sum invested.[19]

Size of Margin Requirements

For the purpose of indicating the extent to which margin requirements would be raised by the proposed bill, a tabulation was submitted by Thomas G. Corcoran.[20] The tabulation shows the comparative operation of the margin rules prescribed by the New York Stock Exchange, and those embodied in the Fletcher-Rayburn bill. The tabulation shows that, in general, margin requirements would be raised by the proposed act.[21] As a result of this, credit for security speculation would be decreased and the small investor would be better protected against the loss of his investment.

The aim of the drafters of the proposed bill in providing minimum margin requirements was to set margins high enough to prohibit excessive security speculation and to provide protection for investors. If the increase in margins provided for was to have any material influence in limiting the amount of credit for security speculation and in protecting the investors, a small increase in margin requirements, such as five percent, would be insufficient. Margins must be increased sufficiently to limit security credit materially or they will not be effective.

19. See tabulation at end of this chapter. Chart V.
20. Senate Hearings, Part 15, p. 6474.
21. See tabulation at end of this chapter. Chart V.

The attacks on the margin provisions of the Fletcher-Rayburn bill resulted in the margin requirements being softened in the form in which it was finally adopted in the Securities Exchange Act of 1934. The extent of this change is revealed by Chart VI at the end of this chapter.

During the summer of 1934 a survey of the position of margin accounts showed that under the 1933 rules of the New York Stock Exchange the average margin requirement was about twenty-five per cent of the current market price of the security.[22] The average margin required at that time in accordance with the statutory formula approximated twenty-eight per cent.[23] This may seem to be a very small increase. It must be remembered, however, that security prices were not high at this time. Also, margins had been raised by the New York Stock Exchange. In the future, if securities advance in price the automatic feature of the statutory provisions of the bill will operate to increase margins.

The major question of controversy in regard to the use of margins as a device for controlling security credit is whether that control will be effective in prohibiting excessive security speculation. The answer to this question is, at present, largely a matter of opinion. Conclusions concerning the effectiveness of such control can be formed from an observation of their effectiveness in operation. Such conclusions must not be too hastily drawn. The Act was instituted when there was little speculation of any kind. For more final conclusions, a period when there is speculation in other fields an an increase in business activity is needed. This question will be considered further in the final chapter.

22. The Federal Reserve Bulletin for October, 1934.
23. Ibid.

Chart No. V. MARGINS

(1) Margin Rules

(a) Present New York Stock Exchange rules: maintain margin of 50% of debit balance-equivalent of permiting broker to lend 66 2/3% of value of securities; applies to all accounts where customer "puts up" less than $2,500.

(y) On accounts with debit balance of more than $5,000, customer must maintain margin of 30% of debit balance-equivalent of permitting broker to lend 77% of value of securities: applies to all accounts where customer puts "up" $2,500 or more.

(B) Rule proposed by Fletcher-Rayburn bill;
The broker may not lend more than whichever is the higher of-

(a) 40% of the current value of securities-equivalent to the customer's putting up 60% of the market value of securities purchased or 150% of the debit balance (i. E., the broker's loan of 40% of the market value); or

(B) 80% of lowest price within three years-equivalent to customer putting up 20% of the market value of the securities purchased or 25% of the debit balance (i.e., the broker's loan of 80% of the market value).

(2) Comparative Table Illustrating Operation of Margin Rules

| | A | B | C | D |
|---|---|---|---|---|
| N. Y. S. E.-debit of less than $5,000--- | 66 2/3% | 33 1/3% | 3 | 50 % |
| N. Y. S. E.-debit of more than $5,000--- | 77% | 23% | 4 1/3 | 33 % |
| Fletcher-Rayburn-40% loan value on speculative securities---------- | 40% | 60% | 1 2/3% | 150% |
| Fletcher-Rayburn-80% loan value on stable securities---------- | 80% | 20% | 5% | 25% |

A. Maximum % of value of securities broker may lend.
B. Minimum % of value of securities customer must put up as margin.
C. Maximum number of times his deposit customer can buy in market value of securities.
D. Minimum % of debit balance customer must put up as margin.

(3) How Much Stock Can a Customer Buy With a Given Deposit?

With a $2,500 deposit a customer can buy the following values of securities:

(a) $7,500-under present New York Stock Exchange rule.
(b) $4,100-under Fletcher-Rayburn 40% speculative loan rule.
(c) $12,500-under Fletcher-Rayburn 80% stable loan rule.

With a $10,000deposit:

(a) $43,333-under present New York Stock Exchange rule.
(b) $16,666-under Fletcher-Rayburn 40% speculative loan rule.
(c) $50,000-Fletcher-Rayburn 80% stable loan value rule.

Chart No. V. (Continued)

(4) Protection Afforded Margin Trader by Larger Margin

(a) Suppose a trader without resources to meet additional margin buys 100 shares X stock at 100 on New York Stock Exchange margin-putting up $2,300 on $10,000 market value of securities

Account reads: Market value long position, $10,000; debit, $7,700.

If stock drops suddenly to 77 where market value equals debit customer's margin is wiped out.

(b) Suppose the trader buys the same 100 shares of X's stock at $100 on the Fletcher-Rayburn 40-percent loan-value margin. He will have to deposit $6,000 on $10,000 market value of securities and his account will stand:

Market value long position, $10,000; debit, $4,000

If the stock drops to 77 the trader can still readjust the account to the required margin on a smaller number of shares without additional cash. By selling 20 shares at 77 for $1,540 and applying the proceeds to the debit balance, the trader can reestablish his account on the following basis:

Market value long position, $6,160; debit, $2,460

By the drop in the market the trader will have lost part of his investment, but not all.

(c) Suppose that with the same down payment of $2,300 referred to in the first case above, the trader buys the maximum number of shares of the same stock at the same price which the broker will be permitted to carry for him under the Fletcher-Rayburn 40% loan-value margin rule. He will be able to buy 38 shares of a market value of $3,800 and his account will stand:

Market value long position, $3,800; debit, $1,500.

If the stock drops to 77, the trader can still readjust the account to the required margin on a smaller number of shares without additional cash. By selling 8 shares without additional cash, by applying the $616 proceeds to the debit balance, the trader can reestablish his account on the following basis:

Market value long position, $2,310; debit, $884.

By the drop in the market the trader will have lost approximately 1/3 of his original investment but he will still have an equity in an account and may be able to recoup with a rise in the market.

Chart No. VI. SUMMARY OF MARGIN PROVISIONS, ORIGINAL BILL AND ENACTED SECURITIES EXCHANGE ACT OF 1934.

| | Original Bill | Act Passed |
|---|---|---|
| 1. Maximum loans, when based on lowest price: | % | % |
| (a) Initial loan(percentage of low) | 80 | 100 |
| (But not more than(percentage of market) | 80 | 75 |
| (b) Maintained loan(percentage of low) | 80 | 100 |
| But not more than(percentage of market) | 80 | 85 |
| 2. Maximum loans, when based on current market price: | | |
| (a) Initial loan(percentage of market) | 40 | 55 |
| (b) Maintained loan(percentage of market) | 40 | 60 |
| 3. Period from which lowest price is to be selected: | | |
| (a) Until July 1, 1936 | 3 years | Since July 1, 1933 |
| (b) After July 1, 1936 | 3 years | 3 years |
| 4. Exemption for existing accounts | None | Exemption to Jan. 31, 1939 |
| 5. Power to exempt securities | Limited | Discretionary |

LOAN VALUES OF FOUR COMMON STOCKS COMPARED WITH MARKET VALUES

| | Sept. 3 1929 | June 1 1932 | Feb. 1 1934 |
|---|---|---|---|
| **F. W. WOOLWORTH COMMON** | | | |
| Market price (average) | $99.50 | $25.25 | $51.25 |
| Loan values: | | | |
| Twentieth Century Fund | [a] $29.44 | [b] $ 15.15 | [b] $30.75 |
| Fletcher-Rayburn Bill | [b] $38.40 | [d] $18.18 | [b] $20.20 |
| New York Stock Exchange: | | | |
| (debits under $5000) | $66.00 | $16.82 | $33.63 |
| (debits over $5000) | $77.00 | $19.44 | $38.89 |
| **U. S. STEEL COMMON** | | | |
| Market price (average) | $259.00 | $26.62 | $57.00 |
| Loan values: | | | |
| Twentieth Century Fund | [a] $90.58 | [b] $15.97 | [a] $23.84 |
| Fletcher-Rayburn Bill | [b] $103.00 | [c] $20.20 | [b] $22.80 |
| New York Stock Exchange: | | | |
| (debits under $5000) | $172.49 | $17.73 | $37.96 |
| (debits over $5000) | $199.43 | $20.49 | $43.89 |
| **AMERICAN TELEPHONE AND TELEGRAPH COMMON** | | | |
| Market price (average) | $300.00 | $88.00 | $120.25 |
| Loan values: | | | |
| Twentieth Century Fund | [a] $89.54 | [b] $52.80 | [b] $72.15 |
| Fletcher-Rayburn Bill | [b] $120.00 | [c] $68.00 | [c] $56.19 |
| New York Stock Exchange: | | | |
| (debits under $5000) | $200.00 | $59.00 | $80.00 |
| (debits over $5000) | $231.00 | $88.00 | $92.00 |
| **GENERAL MOTORS COMMON** | | | |
| Market price (average) | $72.00 | $9.00 | $40.62 |
| Loan Values: | | | |
| Twentieth Century Fund | [a] $37.74 | [b] $5.43 | [b] $24.38 |
| Fletcher-Rayburn Bill | [b] $28.80 | [c] $6.80 | [b] $16.25 |
| New York Stock Exchange: | | | |
| (debits under $5000) | $48.00 | $6.00 | $27.06 |
| (debits over $5000) | $55.44 | $6.93 | $31.28 |

a. Based on earnings adjusted for changes in capitalization.
b. Based on current market price.
c. Based on lowest price for preceding three years, adjusted for capitalization.

# CHAPTER IV

## STATUTORY VERSUS DISCRETIONARY CONTROL OF MARGIN REQUIREMENTS

There are three possible plans which might have been adopted for government regulation of margin requirements. Margins might have been fixed by rigid statutory provisions. Such margins would be permanent and would need to be relatively high. Less rigid statutory provisions for determining margins might be provided for lower margins and granting to a government agency the power to prescribe higher margin requirements according to circumstances. Finally, the whole responsibility for determining margin requirements might be left to some government commission. This plan would provide a more flexible means of determining margin requirements.

Under the terms of the proposed bill, margin requirements would be determined by means of a statutory formula and a government agency would be granted authority to prescribe higher requirements. The market interests contended that too high margins would be required under the terms of a statutory formula. Also, this plan for determining margin requirements would be rigid and inflexible. It was their desire that federal control of margin requirements, if such control was to be adopted, should be placed in the hands of a commission. The commission should not be unnecessarily hampered by statutory limitations. This plan would provide flexibility and would make it possible to regulate margin requirements according to current conditions. A further description of these two plans and their relative merits and limitations will be the subject of this chapter.

## OBJECTIVES AND OPERATION OF THE STATUTORY PLAN

The objectives and operation of the statutory plan for determining margin requirements, which was provided for in the proposed bill, will now be considered. The standard of margin requirements stated in the bill was designed to exert a restraining influence on speculative trading. By imposing higher margin requirements on securities that have had a rapid rise than on more stable securities the prescribed requirements would make credit less freely available for trading in speculative stocks. By limiting the extent to which speculative profits might be used as margins for further speculation the practice of pyramiding would be prohibited. If securities advance in price so a point where pyramiding of profits becomes possible, higher margin requirements might be prescribed by the commission.[1]

Under the plan for statutory fixing of margins the market price over a base period of three years prior to the date of purchase of a security would be used to determine the amount which could be borrowed on the security.[2] If the market price of a security showed little variation over the base period its loan value would be correspondingly high, but if there was a wide fluctuation in the price of a security its loan value would be correspondingly low. This condition would be brought about by the margin formula provided in the proposed bill.[3] The margin requirements, imposed by the statutory formula, were drafted in collaboration with officials of the Federal Reserve System, with a view to placing a premium for margin purposes on securities that keep stable over a

1. Fletcher-Rayburn bill, Section 6(b).
2. Ibid.
3. Ibid, Sections 6(a) and 6(b).
4. See page 47.

period of time.[4] The bill relates to minimum margin requirements only, and a broker may, of course, have an arrangement with his customer to refuse to carry the account unless securities are more heavily margined.

Securities would naturally fall into two classes under the terms of the bill. If the loan value of a stock was greater under the eighty per cent rule the margin for it would be computed on that basis. Such stocks would be those which had had little rise in price or had declined in price during the preceding three years. Securities which would be included in this category are termed stable securities. On the other hand, securities which had appreciated considerably in price, or had declined greatly and then climbed back again, would naturally be computed under the forty per cent rule as it would give them greater collateral value.

The implication of the bill seems to be that great fluctuation in the price of a security is an indication of speculative activity in that particular security. Since the avowed purpose of the bill is to curb excessive speculation by limiting credit on the more speculative issues the collateral value should, logically, be comparatively lower on such an issue. In periods of low or declining prices liberal margins may be allowed while in times of high or rising prices prohibitively high margins are fixed. This is, according to Thomas G. Corcoran, counsel for the Reconstruction Finance Corporation, the "correct result to keep the market from running away on the upside."[5]

An example to show the application of the stable security and the volatile security feature of the bill will serve to clarify its interpretation. To illustrate the eighty per cent provision of the bill a bond which has a par value of one thousand dollars may

4. Evidence of Thomas G. Corcoran, counsel for the Reconstruction Finance Corporation, Senate Hearings, Part 15, p. 6472.
5. Ibid, p. 6481.

be taken. The bond declines in price to eight hundred dollars and then rises to par at one thousand dollars. Computed in the eighty per cent rule six hundred and forty dollars could be loaned on this security, whereas; only four hundred dollars could be loaned under the forty per cent rule. It will be observed that the amount which can be borrowed is not eighty per cent of the current market value but eighty per cent of the lowest value in three years previous to the date of the transaction. In the case of a stable security the percentage of the current market price which is reached on the eighty per cent computation will be higher than forty per cent of the current market price.

The forty per cent rule is applied to volatile stocks which would have a lower loan value under the eighty per cent provision due to wide price fluctuations. A stock which, it is assumed, is of a speculative nature drops during a three year period from forty-nine dollars per share to seven dollars a share and then rises again to a market value of forty dollars a share. Under the provisions of the bill the allowable loan could be computed on the basis of eighty per cent of seven dollars or forty per cent of forty dollars. Obviously, the forty per cent provision would provide a higher loan value, so a broker would loan sixteen dollars a share. That means that the customer would have to provide the difference between sixteen dollars and forty dollars or twenty-four dollars a share.

## OBJECTIONS TO THE STATUTORY PLAN

The statutory formula provides a mechanical means of determining margins for restraining security speculation. The market authorities asserted that this rule would not work and that it would be rigid and inflexible.[6] They did not feel that it would be

6. Published Statement of the New York Stock Exchange, Senate Hearings, Part 15, p. 6627.

possible to hake a hard and fast rule for determining margin requirements.

The fixed minimum margin requirements, it was asserted, would operate in such a way as to be detrimental to the public. In periods of low and declining prices margins would be extremely generous and in times of high or rising prices margins would prove prohibitive.[7]

The stock exchange authorities were of the opinion that the margins, which would be fixed by the proposed bill, would be too high. It was pointed out that considerable confusion has arisen because of the different methods used in computing margins by laymen and brokers.[8] Laymen compute margins by using the market price and the amount put up, thereby arriving at a percentage. Brokers use the debit balance or amount unpaid and the amount put up. The result is that margins as computed by brokers are higher than margins as computed by the method used in the bill. On the basis by which brokers compute margins one hundred and fifty per cent margins, would,,in some instances, be required by the bill. Richard Whitney, President of the New York Stock Exchange, asserted that this "would not be a margin requirement at all" but that it would "totally prohibit what is known as margin trading."[9] The following example was given to illustrate the broker's method of computing margins:

> "If a security like General Motors, which has within 3 years sold at $7 a share and is today selling at $40 a share, should be presented to the broker as margin after the affective date of the proposed act, the broker could only lend $16 a share upon the stock because the 80 per cent provision would be rendered nugatory by the low price which General Motors reached at the worst period of the depression. In this case the broker would have 150 per cent margin, ile. he would advance $16 against a stock selling at $40, and the difference between these two, or 424, would represent one and one half times the amount owed him by his customer."[10]

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8. Published Statement of the New York Stock Exchange, Senate Hearings, Part 15, p. 6627. 8. Ibid.
9. Evidence of Richard Whitney, Senate Hearings, Part 15, p. 6601.
10. Ibid.

It was further contended by Richard Whitney, that the power given the commission to raise margins would not go far enough to permit real flexibility.[11] There is no power given to the commission to provide that any one security should have a lower loan value than the rest of the class. In actual practice banks and otherlenders of money always judge each loan according to its individual mirits.

In addition, the objection was raised by A. W. Wetsel, of the Wetsel Advisory Service, New York City, that the power of the commission to raise margin requirements would inject an element of continuing uncertainty into all loans against collateral in the form of listed securities.[12] In a declining market Mr. Wetsel felt that two influence would operate: Brokers and bankers holding listed securities as collateral would be compelled to dump them as soon as the loan was in excess of the marginal ratios; and the disposition to exercise discretionary power to lower loan values would probably be greater in a declining than a rising market. The fear of such action would be a further depressing influecne, and together with the other influence might precipitate a panic.

## RESULTS OF THE STATUTORY PLAN

There was a marked difference of opinion as to the results which would be brought about by the statutory fixing of margins under the terms of the bill. In general, it can be stated that the drafters of the proposed legislation believed that the bill would disturb the market but little in its functions. Those who were

11. Senate Hearings, Part 15, p. 6630.
12. Senate Hearings, Part 15, p. 7142.

opposed to the legislation took the extreme view that the bill would destroy the market.

A much debated point was the extent to which security speculation would be eliminated. The stated purpose of the bill was the elimination of excessive speculation. It was held that the bill would not stop speculation entirely but only decrease it. In this connection Thomas G. Corcoran declared that as a result of the suggested margins "only a diminuation and not an entire strangulation of speculation "would take place."[13]

Opponents of the proposed statutory margin requirements contended that as a result of their adoption speculation in securities would be entirely eliminated.[14] Without speculation the markets would be ruined from the point of view of liquidity. This was the opinion of Richard Whitney, who stated:

> "If the bill is enacted it will result in panic and a complete breakdown of the security markets of this country, naturally to the great detriment of those investors holding listed securities."[15]

Thomas Corcoran did not agree that the decrease in security speculation would have a very serious effect upon the liquidity of the market.[16] Although there might be a broader element between the bid and the asked in securities, the market would not be seriously upset. The margin trading business, however, would be cut in half by the proposed statutory limitations of margins and this would result in fewer commissions for brokers or the so-called 'flight of commissions'. This was held to be the real cause of the market authorities' antagonism toward the proposed legislation.[17]

13. Senate Hearings, Part 15, p. 6733.
14. Dean Witter, of Dean Witter & Co., San Franisco, Senate Hearings, Part 15, p. 6755.
    Roland Redmand, Senate Hearings, Part 15, p. 6485.
15. Senate Hearings, Part 15, p. 6601 and 6734.
16. Senate Hearings, Part 15, p. 6499.
17. Ibid.

The attempt to regulate the flow of credit by a fixed law brought forth the criticism of business representatives. It was felt that the bill would go beyond its purpose of regulating the national securities exchanges and that, taken with the Securities Act of 1933, it would effectually bar the flow of private capital in to American business.[18] It was believed that it would be a mistake to forbid a free flow of credit into brokers' loans by "arbitrarily imposing a heavy restriction on margins."[19]

## THE CONTROL OF MARGINS BY A COMMISSION

The possible detrimental results of the statutory fixing of minimum margin requirements have been set forth as seen by the opponents of the proposed legislation. The market authorities believed that these detrimental results could be avoided without endangering the operation of the public policy of the Fletcher-Rayburn bill.[20] They were of the opinion that a middle course should be taken which would grant something to both sides. An authority for determining margin requirements should be set up. This authority or commission should not be hampered by placing too little power in its hands through the fixing of rigid statutory margin requirements. The commission should have the power to fix the amount of margins which exchanges must require and maintain; they should have the power to adopt rules to prevent dishonest practices which unduly foment speculation; and they should be given the power to regulate listing requirements.[21] In order to bring this condition about an amendment was offered by Roland Redmand which would do away with the statutory provisions for

18. Evidence of George H. Husted, Vice-President, National Manufacturerss Association, Senate Hearings, Part 15, p.7253.
19. Evidence of Robert Owen, American Telegraph and Telephone Co,, Senate Hearings, Part 15,p. 7278.
20. Evidence of Richard Whitney, Part 15, p. 6743.
21. Ibid.

determining margin requirements and place the whole matter in the hands of a commission.[22]

The chief criticism which was advanced against the statutory plan for determining margin requirements was that it would not be flexible. It was felt that rigid and inflexible rules for margins could not be drawn without destroying the functions of the exchanges.[23] It would be impossible to set a line which would not need to be changed in the future.[24] The real margin requirements will necessarily be shifted from day-to-day.[25] Rules of law which would be effective today would be worse than worthless tomarrow, and the harm that would be done before Congress could assemble and amend them would be beyond repair.[26] A commission, if it found the established margins to be unwise, could meet with little delay and fix margins according to the need.[27]

The attempt to control security credit under the statutory plan was further attacked on the grounds that it would be most unfortunate to write in law specific rules as to credit because credit condtions are fluid and laws are static.[28] It was argued by Frank Altschul, chairman of the committee on stock list, New York Stock Exchange, that no law provides rigidly that the Federal Reserve Banks should establish a certain discount rate and that that rate should be maintained.[29] The discount rate is changed from time to time in accordance with conditions. In the same way, it would seem to be quite reasonable to have a provision that margin requirements should not be made rigid but left capable of

22. Senate Hearings, Part 15, p. 7546.
23. Evidence of Dean Witter, Senate Hearings, Part 15, p. 6778.
24. Evidence of W. G. Paul, Sec. of the Los Angeles Stock Exchange, Senate Hearings, Part 15, p. 6778.
25. Samuel Untermyer, attorney, N.Y. C. Senate Hearings, Part 16, p. 7725.
26. Evidence of Richard Whitney, Senate Hearings, Part 15, p. 6634.
27. Ibid. 28. Ibid.
29. Senate Hearings, Part 15, p. 6703.

being adjusted from time to time in order to accommodate themselves to the day-to-day or month-to-month developments in the speculative market.

It was asserted by Richard Whitney, that it would not be humanly possible to adopt any law which would operate fairly in all possible circumstances for determining margins.[30] Many factory determine the amount of a sound margin. The nature of a security; the securityés activity in themarket; the degree to which it is held on margin or as a collateral for loans; and whether it is stable or volatile; all these are important criteria by which the safe and proper margin should be computed.[31] The determination of what constitutes a sound margin, then, involves questions of opinion as to the evolution of actual and potential values and therefore requires the exercising of experienced and trained judgement in the appraisal of conditions which change from day-to-day.[32] It was the opinion of Frank R. Hope, President of the Associated Stock Exchange Firms of New York City, that a legislative formula could not be used "as a subsitute for such a judgement and Appraisal."[33][34]

The problem of fixing the loan value of any particular security is a local one and must be dealt with by persons who are familiar with the local market conditions. The people who are best qualified to determine the loan values of securities are the people who are in constant daily touch with all the factors on which loan values depend. For these reasons stock exchange authorities were opposed to any plan whereby the loan values of of securities in margin trading would be fixed by statute.[34]

30. Senate Hearings, Part 15, p. 6627.
31. Ibid.
32. Ibid.
33. Senate Hearings, Part 15, p. 6907.
34. Published Statement of The New York Stock Exchange, Senate Hearings, Part 15, p. 6630.

## OBJECTIONS TO THE COMMISSION PLAN

It was held by the drafters of the bill that placing large powers of regulation over margins in the hands of a commission would not prove satisfactory. A government commission that was empowered to fix margins at any point that seemed to be desirable would be under terrific pressure all of the time to make these margins more liberal.[35] Senator Gore declared in this connection that

> "when there is a general movement (of the market) downward, Senators will find themselves under a good deal of pressure to try to exercise their influence with the commission to get them to liberalize margin requirements. This is politics."[36]

This condition would be avoided by adopting the statutory formula for determining margin requirements. The public policy, embodied in the bill, would be assured by "placing a bright red line" for the fixing of margins, beyond which "discretion could not go."[37] Furthermore, despite the assertions of the market authorities to the contrary, it was believed that the statutory margin requirements provided in the bill would prove workable.[38]

Another argument which might be advanced against the commission plan for determining margin requirements is that the commission might allow a speculative movement to get under way before deeming it necessary to increase margin requirements. After a speculative movement has gathered force, raising the margin requirements might prove ineffective as a brake on the further development of the movement. If statutory margin requirements are fixed, however, no great amount of credit would be allowed to enter the market and a speculative movement could not get under

35. Evidence of Senator Gore, Part 15, p. 6763. Senate Hearings
36. Ibid.
37. Evidence of Thomas G. Corcoran, Senate Hearings, Part 15, p. 6493.
38. Evidence of Eugene Black, Governor of the Federal Reserve Board, Senate Hearings, [illegible]

way. It was felt that since there would be but little credit in the securities market at the time of adoption of the margin requirements there would be little danger of disturbing the market.

It will be seen from the discussions concerning the two plans that both the statutory and the commission plan for determining margin requirements would be open to certain criticisms. The determination of margin requirements under the statutory plan would tend to be rigid and inflexible. On the other hand, if the power of determining margin requirements was to be granted to a commission unhampered by statutory limitations, margin requirements would be subject to change according to current needs. The commission would be subject to political pressure, however, and might be too slow to act. The plan which was incorporated in the Securities Exchange Act of 1934 may be considered as a compromise.

## THE PLAN ADOPTED FOR FIXING MARGINS

For the purpose of determining margin requirements a statutory formula was provided in the Securities Exchange Act of 1934. The Federal Reserve Board was granted the power to prescribe higher margin requirements and in certain circumstance to decrease margin requirements. The Act instructs the Board to use broad consideration of credit control as criteria for judgement in determining margin requirements. Under this arrangement the formula provided in the statute will have the effect of preventing a security speculative movement, based on credit, from getting under way. The power of the Board will make it possible to change margin requirements according to current needs. This power should serve to make the margin requirements less rigid and inflexible.

In prescribing margin requirements the Federal Reserve

Board adopted the formula stated in the Securities Exchange Act. It was ruled that, with certain exceptions, a member of a national securities exchange or a broker or a dealer subject to the regulation shall not make any initial extension of credit to any customer on any registered security (other than an exempted security) for the purpose of purchasing or carrying any security, in an amount which causes the total credit extended on such registered security to exceed which ever is the higher of:

(1) 55 per cent of the current market value of the security; or
(2) 100 per cent of the lowest market value of the security computed at the lowest price thereof during the period of 36 calendar months immediately prior to the first day of the current calendar month but not more than 75 per cent of the current market value.[39]

As a result of a general increase in security prices, by 1935, the Federal Reserve Board passed a regulation which had the effect of increasing the highest required margin from forty-five to fifty-five per cent of the current market price.[40] This was done because pyramiding in quite a number of securities had become possible due to an increase of over one hundred and eighty-two per cent in market price above the low. The increased margin requirement had the effect of preventing pyramiding up to a two hundred and twenty-two per cent rise above the lowest market price for the thirty-six months period.

39. Regulation T of the Federal Reserve Board.
40. Amendment to Regulation T of the Federal Reserve Board.

# CHAPTER V.

## THE LOCATION OF DISCRETIONARY CONTROL OF MARGINS

In the preceding chapter the statutory versus the discretionary control of margins was discussed. It was noted, in theis connection, that the granting of wide powers of margin control to a commission, unhampered by statutory requirements, would make it possible to change margin requirements to suit current conditions. This was the plan desired by the market authorities.

The representatives of the organized exchanges were opposed to federal control. If such control was inevitable, however, it would be to their advantage to prevent the enacting of a statute which would not allow market representatives to influence control. The fixing of margin requirements by law would remove the matter from the influence of market representatives.

It was the desire of the market authorities to have margins subject to the discretionary control of a commission. If this could be accomplished, it might then be possible to secure market representation on the commission or to influence the commission set up for regulating margins. This would greatly mitigate the objections of the market representatives to federal control of security credit. The importance, then, of the location of the discretionary powers of control over margins is evident.

The powers which should be placed in the hands of a commission was a controversial subject, as has been observed. We will now indicate the authority which was granted to the commission by the terms of the proposed bill. The summary of these powers will

be followed by a discussion of the stand taken by various groups concerning the selection of a commission to wield these powers.

## POWERS OF THE COMMISSION IN MARGIN CONTROL

In the bill as originally drafted, a statutory formula for determining margins was provided.[1] The power to raise margin requirements above the statutory requirement, but not to decrease them below it, was granted to a commission.[2] The section of the bill containing this authority reads in part:

> "The commission may by rules and regulations prescribe lower loan values as may be deemed appropriate in the public interest or for the protection of investors during any stated period or in respect to any specified class of securities."[3]

Additional power in regard to the calculating of values, the time of payments by security purchasers, the notice to be given, and the method to be followed in closing out accounts was placed in the hands of the commission.[4]

The power of the commission was increased in the enacted Securities Exchange Act by providing that the commission might prescribe margin requirements below the statutory margin requirements as well as to increase them above the statutory requirements.[5] It was recommended that the commission adopt the statutory formula for the initial determination of margin requirements but the commission was instructed "to use broad consideration of credit control as criteria for judgement as to margin requirements."[6] Thus, it will be seen, that a great amount of power is granted to the commission. This adds importance to the selection of the commission which is to wield that power.

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1. Fletcher-Rayburn bill, Section 6(b)
2. Ibid.
3. Ibid.
4. Ibid.
5. Securities Exchange Act of 1934, Section 7(c).
6. Ibid.

## THE SELECTION OF A COMMISSION FOR MARGIN REGULATION

There were many opinions in regard to the selection of a commission for controlling margin requirements. The intention of the drafters of the original bill was that this power should be allocated to the Federal Trade Commission. The market interests favored the creation of a special commission. This commission would be made up of the representatives of the government, the organized exchanges, and federal credit control bodies. There was much support for the location of discretionary control over margins in the hands of the Federal Reserve Board. This was approved by stock market authorities as a less desirable alternative to the special representative commission suggested by them. It would be, however, more desirable than the Federal Trade Commission. The Federal Reserve Board was favored in another prpposal but it was suggested that the Board be reconstructed by adding more members to administer the new duties.

There were various opinions concerning the desirable features to be considered in the establishing of a regulatory commission. It would be possible for a governmental body already in existence to assume the additional duties, or a special body for the express purpose of regulating margins could be established. The co-ordination of various interests might be brought about by a commission composed of ex-officio members. The discretionary power of regulating margins might be considered as additional powers of regulation of credit by the federal government or such power might be considered as police power for protective purposes. The headquarters of the commission was considered important i-

by some. The commission might, logically, be required to establish headquarters in New York City or in Washington. These questions will be kept in mind in the discussion of the various proposals for the selection of a commission to have discretionary control of margin requirements. The various commissions, for the regulation of margin requirements, which were suggested will now be discussed.

The Federal Trade Commission

The commission to be empowered with the discretionary control over margins is not explicitly designated in the original draft of the Fletcher-Rayburn bill. It was evident, however, that the drafters of the bill intended that this power would be granted to the Federal Trade Commission.[7] This commission has served as an administrative body for the enforcing of federal trade regulations. It appears that it was the intention that the power to regulate margins be considered as police power. This is indicated by the purpose and history of that organization. The Federal Trade Commission was first established to enforce fair trade practices. The additional power which would be given to the Federal Trade Commission in the regulation of margins might be considered as police power for protective purposes.

The selection of the Federal Trade Commission as the regulatory body in charge of determining and regulating margin requirements within the scope of the law met with almost universal criticism. One of the chief objections was that the proposed legislation would be in the nature of credit control and it was asserted that the Federal Trade Commission should not have anyting to do with credit control. It was contended by Frank R. Hope, President of the Associated Stock Exchange Firms of New York City, that this

7. Evidence of Thomas G. Corcoran, in office of counsel for the Reconstruction Finance Corporation, Senate Hearings, Part 15, p. 6479.

would be "without reference to other governmental departments and agencies having concurrent jurisdiction."[8] This would result in "confusion and conflict" in the policy and regulation of credit.[9] The "broad" powers over the entire "credit and financial system of the country" which are given by the provisions of the bill should be placed in the hands of a commission "familiar with the credit conditions throughout the country.[10]

Another objection to the selection of the Federal Trade Commission was that it has many other responsibilities. It was asserted that because of this the Commission would not be able to give "sufficient and immediate" attention to the regulation of margin requirements.[11] Senator Carey felt that this would be true because the Federal Trade Commission has been given various additional duties from time to time since it was created over twenty years ago. The many duties imposed by the Securities Act of 1933 are among these new duties. It was stated by Louis K. Comstock, President of the Merchant's Association of New York, that these duties would require

> "all of the time and ability which the members of the Federal Trade Commission possess without adding thereto the task of supervising and preparing regulations for the conduct of an extremely technical, delicately adjusted business with manifold ramifications into every part of the world."[12]

The Federal Trade Commission is not given the power of discretionary control over margins in the Securities Exchange Act of 1934 as finally enacted. Although it might act as a protective body, it could hardly be expected to act efficiently in the control

8. Senate Hearings, Part 15, p. 6904.
9. Ibid.
10. Evidence of Richard Whitney, President of the New York Stock Exchange, Senate Hearings, Part 15, p. 6627.
11. Senate Hearings, Part 15, p. 6984.
12. Senate Hearings, Part 15, p. 7051.

of credit. Likewise, the many other duties of the Federal Trade Commission would not permit it to give sufficient time to the new duties. As a result of these objections the Federal Trade Commission was not given much support as the margin regulatory body.

THE Commission Proposed by the New York Stock Exchange

We will now turn our attention to the proposals of the New York Stock Exchange representatives concerning the selection of a commission for regulating margin requirements. In this connection, Richard Whitney stated that:

> "The most important question in regard to any regulatory legislation is the determination of what body shall exercise the regulatory power."[13]

The reason for the tremendous importance which the representatives of the securities exchanges placed on the selection of a regulatory commission has been inferred in the early part of this chapter. The commission which they proposed would permit the exerting of considerable market influence in the determination of margins as will be seen by an examination of their proposals.

The desirable qualities which the regulatory commission for determining margins should have are described in the published statement of the New York Stock Exchange.[14] According to this statement the authority should include persons who are "familiar with credit conditions throughout the United States" and persons who are "fully conversant with the technical problems connected with the operations of the stock exchanges."[15] The commission should include, in addition, "outstanding individuals" who would "represent the public."[16] With these ideas in mind a special

13. Senate Hearings, Part 15, 6641.
14. Senate Hearings, Part 15, p. 6641.
15. Ibid.
16. Ibid.

co-ordinating authority was suggested.

The committee suggested in the published statement of the New York Stock Exchange and backed by other market interests would be composed of seven members.[17] The seven members in the commission would consist of two members appointed by the President; two cabinet officers, who might well be the Secretary of Treasury and the Secretary of Commerce; one person appointed by the Open-market Committee of the Federal Reserve System; and two persons representing stock exchanges, one to be designated by the New York Stock Exchange and the other to be elected by the members of those exchanges in the United States other than the New York Stock Exchange.[18]

It will be seen that the proposed commission would represent several interests. The public and the government would be represented by the presidential appointees and the two cabinet officers. The members appointed through the Federal Reserve System would serve as credit representatives. The securities exchanges would be represented by two members who would be competent to advise the commission in matters concerning the operation of the exchanges.

The commission described above was criticized by Senator Carey.[19] It was his opinion that it should be a full time rather than an ex-officio body. A full time body would be better because a commission made up of officers who have other duties usually does not meet very often or pay very much attention to its new duties. Senator Carey cited the Federal Power Commission as an example. This commission was at first an ex-officio commission but afterward it was found advisable to create a full time commission. Senator

17. Senate Hearings, Part 15, p. 6641.
18. Ibid.
19. Senate Hearings, Part 15, p. 6735.

Carey believed that a full time commission would be better because it would be in position to act immediately, whereas the suggested commission would be too slow to act.

The regulatory commission suggested above was approved by exchanges throughout the country. It failed to receive any great amount of consideration during the hearings, however. This was probably due to the fact that it was recognized as an attempt to make the federal regulation of margin trading ineffective. This would probably have taken place if the commission had been adopted because the governmental representatives on the commission would not possess any common unity. Therefore, the suggested commission was not adopted in the enacted Securities Exchange Act of 1934.

The Selection of the Federal Reserve Board

Considerable preponderance of opinion was expressed which favored the grant of the regulatory powers of a commission, under Section Six of the proposed bill, to the Federal Reserve Board.[20] It was felt that this would be justified since the Board is responsible for the federal control of credit and the regulation of margins as a special form of credit control should be placed in their hands.[21] The Federal Reserve Board, furthermore, would be in touch with market conditions and the general credit conditions throughout the United States. They would, also, provide a co-ordinated and unified control.

20. Evidence of the following:
Samuel Untermyer, Attorney at law, New York, Senate Hearings Part 16, p. 7546.
Trowbridge Callaway, chairman of an investment-house group of seventeen companies, Senate Hearings, Part 16, p. 7586.
Roland Redmand, Attorney for the New York Stock Exchange, Senate Hearings, Part 16, p. 7546.
Eugene Black, Governor of the Federal Reserve Board, Senate Hearings, Part 16, p. 7418.
Senator McAdoo, Senate Hearings, Part 16, p. 7547.

21. Ibid.

The question of placing margin control in the hands of the Federal Reserve Board was discussed by its Governor, Eugene Black. Speaking for the Board, he stated that "the power to regulate margins under the bill should be given to it because it is credit control."[22] He felt that the Board could "keep itself informed of current market prices" in order to fix margin requirements. in order to take care of this a seperate department in the Federal Reserve Board would be set up.[23]

In regard to the regulation of security speculation Eugene Black further stated that the Board "has great authority in restricting speculation" under the Banking Act of 1933 but the power granted under the proposed bill would be "additional authority."[24] Thus, we see that the Board felt capable and willing to undertake the new duties in connection with the regulation of margins under the terms of the bill.

Although the New York Stock Exchange authorities had proposed a special representative commission for the regulation of margins they did not dissapprove of the grant of this authority to the Federal Reserve Board. It is likely that they felt that control by the Board would be less objectionable than control by the Federal Trade Commission. An amendment was offered on the behalf of the New York Stock Exchange the purpose of which was to entirely do away with Section Six of the proposed bill.[25] This amendment which was substantially followed inthe Securities Exchange Act of 1934, placed the entire matter of the regulation of margin requirements in the hands of the Federal Reserve Board.

22. Evidence of Eugene Black, Senate Hearings, Part 16, pp.7417-9
23. Ibid.
24. Ibid.
25. Evidence of Roland Redmand, Senate Hearings, Part 16, p. 7554.

The question arose as to whether the power granted to the Board by the amendment proposed by the market authorities would be premissive or mandatory. Senator Adams contended that the provisions would be mandatory.[26] The intention of the market authorities was that if the Federal Reserve Board did not consider that there was an excessive use of credit they could allow the existing condition to go along, and after that, if the Board felt it was excessive, they would have the power to act.[27] In regard to the initiation of margin changes it was anticipated by the market authorities that the Board would express the idea that margins should be, raised, and the exchanges would voluntarily raise the margins thereby avoiding the necessity of the Board issuing a rule or regulation evenn though they would have the power to do so if they felt it necessary.[28] Senator Gore favored the initiation of margin rules by the securities exchanges because he felt that they could be held responsible for results rather than the Board or Congress.[29]

The making of any further connections between the securities exchanges and the Federal Reserve Board was decidedly opposed by Senator Carter Glass.[30] Inasmuch as Senator Glass had had much to do with the founding of the Federal Reserve System and is considered an authority on credit and banking, his opinion is of considerable interest. It was his decided opinion that the Board should not be mixed up in the regulation of the securities exchanges. Senator Glass stated that the "Federal Reserve law excluded the system from stock market transactions" and that in his judgment "there is not a

26. Evidence of Senator Adams, Part 16, Senate Hearings, p. 7554.
27. Evidence of Roland Redmand, Senate Hearings, Part 16, p. 7554.
28. Ibid.
29. Evidence of Senator Gore, Senate Hearings, Part 16, pl 7556.
30. Evidence of Senator Glass, Senate Hearings, Part 16, p. 7555.

single member of the present Board of eight members who knows anything about stock market transactions."[31] In his opinion the Board ought not to have control of credit and that they were not set up for that purpose. The Board was set up to respond to the requirements of credit. The conversation between Senator Glass and Richard Whitney in regard to this point is of interest and will be reproduced here.

Mr. Whitney: "We are very glad to leave ourselves in the hands of the Federal Reserve Board. We believe they can acquire that knowledge(of the stock market) because of their present connection with the conditions of credit."[32]

Senator Glass: "Do you mean, Mr. Whitney, or I guess you mean that you can tell the Federal Reserve people what to do, as you have been telling them what to do for a long time,and maybe you could not tell somebody else."[33]

It was suggested by Samuel Untermyer that the Federal Reserve Board be empowered to regulate margins, but he further suggested that the Board be reorganized in such a way as to make the adequate performance of its new duties possible.[34] He proposed that the President should appoint three new members to the Board for the purpose of the administration of regulation of margins. He stated that

> "while it might be true that the present Board are closely allied with high finance it would not be true of the new members appointed by the President."[35]

It may be noted here that the enacting of the Bank Act of 1935 has changed the Federal Reserve Board considerably by granting additional powers and by adding members. The name of the Federal Reserve Board was also changed to Board of Governors.

31. Evidence of Senator Glass, Senate Hearings, Part 16, p. 7555.
32. Senate Hearings, Part 16, p. 7556.
33. Senate Hearings, Part 16, p. 7556.
34. Senate Hearings, Part 16, p. 7731.
35. Ibid.

## LOCATION OF THE REGULATORY BODY

The location of the body in charge of regulating margins is important. It might well be argued that it should be located in New York City or that it should be located in Washington. The market interests would, of course, favor its location in New York City. Louis K. Comstock felt that the regulatory body should establish its headquarters in New York City because most security business is transacted in the financial capital of the United States.[3] He stated that this

> "would relieve business men of the expense and delay which would be inseparable from transacting business with a regulatory body located in Washington."[37]

The best interests of federal regulation would probably be served, however, by the location of the regulatory body in the nation's capital. This was favored by Samuel Untermyer who "feared that the regulatory commission might come under the domination of high finance in New York City."[38] This procedure has been followed.

The selection of the Federal Reserve Board as the commission for regulating margin trading may be considered as a compromise. The market interests who were opposed to regulation, had favored the selection of a commission on which they would have representation. The selection of the Federal Trade Commission as the commission would have put emphasis on protection of the investors, rather than on the control of credit. The selection of the Board is a compromise betwee those who favored rigid control for protective purposes and those who desired that the markets be less rigidly regulated. It may be expected that the Board will apply the same principles of credit regulation which they have applied to business.

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36. Senate Hearings, Part 15, p. 7052.
37. Senate Hearings, Part 15, p. 7054.
38. Senate Hearings, Part 16, p. 7746.

# CHAPTER VI.

## THE PROBLEM OF UNLISTED SECURITIES

The problem of the unlisted securities was brought about by the provisions of the Fletcher-Rayburn bill which would prohibit the use of unlisted securities as collateral for loans. The bill provided that in order to be eligible as collateral a security would have to be registered with a nationally registered securities exchange.

The registration requirements would result in many securities not being eligible as collateral for loans and because of their nature it could not be expected that they would be able to meet the listing requirements. The destruction of the collateral value of unlisted securities for loan purposes would greatly impair the value of these securities. Because of this, much criticism was directed toward the enactment of such provisions. These criticisms were substantiated by pointing out the harm that would be done and by indicating remedies which would make the proposed measures less objectionable. The provisions of the bill which require listing of securities for margin trading, the expected results of these provisions, and the remedies which were indicated, will be discussed in this chapter.

The Securities Exchange Act of 1934 did not initiate listing requirements for securities. It had been the practice for exchanges throughout the country to require the listing of certain information and conformation to a certain standard before securities would be admitted to trading on that particular exchange. There was little uniformity in the listing requirements of the

various exchanges, however. For example, the security listing requirements of the New York Stock Exchange had led to the creation of the New York Curb Exchange which was organized for the purpose of trading in securities which did not meet the more severe requirements.[1]

The general effect, then, of the provisions of the Fletcher-Rayburn bill which had to do with security listing requirements would be to locate control of these requirements with the federal government rather than with the exchanges. In addition, the federal listing provisions would institute uniform requirements for securities throughout the country.

In a previous chapter the federal provisions for the regulating of margin trading in securities has been detailed. The provisions of the bill requiring the listing of securities on a nationally registered exchange in order to make them eligible as collateral for margin trading are a practical necessity for the regulation of such trading. If the margin requirements are to be properly supervised the government must have a record of the various securities and exchanges to be supervised. The logical step, then, would seem to be to refuse margin trading privileges to those securities which are not listed in compliance with the bill. Such a restriction, with certain limitations, is made in the Securities Exchange Act of 1934.

The bill did not propose to make the listing of securities compulsory. The privilege of margin trading is an incentive for listing, however, and the prohibition of margin trading in unlisted securities penalizes such securities. It was contended, in this connection, that the Act creates a hardship on issuers and holders of many securities which cannot be listed because of their nature.

1. Norman Buck, Survey of Contemporary Economics, article by

There was considerable agitation, because of this, to have the listing provisions changed, or to have its provisions modified.

The problem, then, seemed to be to provide listing requirements which would protect the investor and make the administration of margin regulations effective. If some penality was not provided for the failure to register securities the Act would fail in its purpose. A flight of securities from listing on the nationally registered exchanges, in order to escape regulation, had to be prevented. With due consideration to these problems, the position of securities which could not be listed because of their nature required consideration.

## PROVISIONS OF THE BILL REQUIRING LISTING

The provisions of the Fletcher-Rayburn bill which had to do with listing requirements on nationally registered exchanges will now be considered. The use of interstate media of transportation and communication in connection with security transactions is denied to all security exchanges and brokers unless such exchanges are registered with the commission as national securities exchanges.[2] The members of a registered exchange or dealers and brokers operating through such an exchange are forbidden to effect a transaction in any security unless such security had been registered for that exchange with the commission in accordance with the regulations prescribed by it.[3] An application for registration of a security must contain information which by specification is substantially the same as that required in connection with the issue of a security under the Securities Act of 1933.[4]

2. Fletcher-Rayburn bill, Section 11(a).
3. Ibid, Section 11(b).
4. Ibid.

## OBJECTION TO LISTING REQUIREMENTS

It was asserted that because of the stringent listing requirements the securities of many corporations would not be listed.[5] The corpoarations which would undertake to comply with the listing requirements would, necessarily, be put to a considerable expense.[6] The officers and directors would, also, make themselves legally liable for any misstatement of facts unless they could show that the statement had been made in good faith.[7] Alfred L. Bernheim, director of the Twentieth Century Fund market survey, stated that

> "it should be borne in mind that many unlisted issues are for one reason or another unsuitable for listing on any exchange."[8]

For these reasons it might be presumed that many corporations would not take the necessary steps to secure listing under the terms of the Act.

It has been pointed out that it would be difficult to register certain securities in order to make them eligible as collateral. This would be true in cases in which the issuing corporation is small and the distribution of the issue is limited. The securities which would be most likely to be affected under the registration requirements would include many public utility bonds and common and preferred stocks, bank and insurance company stocks, guaranteed railroad stocks, industrial stocks and bonds, and State, county, and municipal bonds.[9]

It was asserted by Alfred L. Bernheim that the panalizing of these securities would be without regard to their value.[10] Many securities that could not be listed, he further asserted, are sounder and have a better record than many securities that could easily be listed. He cited the Newark Gas Company, first six per

5. Evidence of Frank R. Hope, Pres. of Assoc. Stock Exchange Firms, New York. Senate Hearings, Part 15, p. 6905.
6. Ibid. 7. Ibid. 8. Senate Hearings, Part 15, p. 6941.
9. John Legg, member of the New York, Baldimore, and Washington

cent bonds of 1944 "which enjoy the highest rating" yet they would not be eligible for a loan because they are not listed, while, on the other hand, "many bonds of railroads in receivership can be used as collateral because they are listed."[11]

The volume of securities which would not be listed cannot be accurately determined. It was believed however that it would be huge.[12] Richard Whitney, President of the New York Stock Exchange stated that

> "there are hundreds of thousands of corporations which do not have their securities listed on any exchange at present."[13]

Eighty-two per cent of the securities dealt in upon the New York Curb Exchange, which has a larger business than any exchange except the New York Stock Exchange, come under their "unlisted" c classification.[14] E. Burd Grubb, President of the New York Curb Exchange, asserted that the present bill, if enacted, "would throw the great majority of trading in these securities off the exchange and into the over-the-counter market."[15]

The difficulty or impossibility of listing the securities described above would have a detrimental effect upon certain individuals and institutions. The various small, local industries, the securities of which are not large in volume or widely distributed would be adversely affected.[16] The various local units and institutions of government borrow money by issuing bonds. Since these could not be listed they would not be used as collateral for loans.[17] The small securities exchanges would be vitally interes-

11. Senate Hearings, Part 15, p. 6940.
12. Ibid.
13. Senate Hearings, Part 15, p. 6626.
14. Evidence of E. Burd Grubb, Senate Hearings, Part 15, pp. 7099-7100. 15. Ibid.
16. Evidence of Eugene E. Thompson, Pres. of Assoc. Stock Exchang Firms, Washington. Senate Hearings, Part 16, p. 7576.
17. Evidence of George B. Gibbons, Municipal Bond Dealer, New York City, Senate Hearings, Part 16, p. 7443.

ted because they deal, largely, in securities which would not be listed.[18] Lastly, investors in the types of securities described above would be concerned, It was pointed out in this connection that these securities are largely held by public institutions, insurance companies, savings banks, and trust companies.[19] Thus, it will be seen, that because of the volume of securities and the institutions and individuals which would be affected by the listing requirements, the problem concerning unlisted securities was of considerable consequence.

## POSSIBLE RESULTS OF LISTING REQUIREMENTS

The various securities, the volume of these securities, and the institutions, which would be chiefly concerned with the provisions of the proposed Fletcher-Rayburn bill have been indicated. The detrimental effect, which the failure to list, would have upon security issuers and holders will now be discussed. Under the proposed bill unlisted securities would be ineligible as collateral for loans. It was asserted, by interested parties, that this would have the undesirable result of deflating the market value of such securities. This, in turn, might cause forced liquidation of security holdings. As a result of such unfair discrimination against unlisted securities business recovery would be retarded.

It was contended that the affect of making unregistered securities ineligible as collateral would greatly reduce the market value of such securities.[20] This would be brought about

18. Evidence of Frank Hope, Senate Hearings, Part 15, p. 6905.
19. Evidence of Alfred L. Bernheim, Senate Hearings, Part 15, p. 6941.
20. Evidence of Frank Hope, Senate Hearings, Part 15, p. 6906.

by the destruction of their collateral value which would tend to make such securities less desirable for investment purposes. To that extent, securities worth billions of dollars would suffer a decrease in price.[21] Samuel Untermyer, Attorney of New York City, took the extreme view that the marketability of these securities would be "wellnigh destroyed."[22]

Another criticism of the listing provisions that was advanced was that their effect would be extremely deflationary.[23] The higher margins which would be required if the Fletcher-Rayburn bill is enacted will necessitate more collateral or funds. In cases where margin accounts are backed partly by registered and partly by unregistered securities, additional funds or registered securities would have to be put up. In many cases this could not be done and this would result in forced liquidation of accounts.[24] The result of this would be to deflate security prices.

The retarding of business recovery was foreseen as another undesirable result of making unlisted securities ineligible as collateral for loans. In this connection, it was contended that the raising of capital, which business needs for prosperity, would be greatly impeded. There would be many corporations which would find it difficult to issue and distribute their securities in order to raise the necessary capital. In this connection George H. Huston, Vice-Pres. of the National Manufacturers Association, stated that:

> "It is in the public interest to not burden the securities issued by business for the procurement of such capital with such strigent regulations with respect to their use as

21. Evidence of Frank Hope, Senate Hearings, Part 15, p. 6906.
22. Senate Hearings, Part 16, p. 7720.
23. Senate Hearings, Evidence of Eugene Thompson, Part 15, p. 6983.
24. Ibid.

capital as to interfere with their free issuance, distribution, and retention."[25]

It was his opinion that the present method of fixing the collateral availiability of such securities through the Federal Reserve System appears to be entirely adequate for the protection of the public interests.[26]

## CHANGES IN LISTING PROVISIONS OF THE BILL

The detrimental results which, it was asserted, would result from the destruction of the collateral values of unlisted securities have been discussed. Certain suggestions were made, by those who would be affected by the registration provisions, which would mitigate the expected evils. As a result of these suggestions a number of changes were made in the bill. These changes provided that unlisted securities might be used as collateral for bank loans. The Act further specifically exempts certain securities and provides that the Securities and Exchange Commission and the Secretary of the Treasury may grant unlisted trading privileges to other securities at their discretion. Thus, it was hoped that the evils of the registration requirements would be eliminated without impairing the enforcement of margin regulations. The changes which were made in regard to the registration requirements were as follows.

The Fletcher-Rayburn bill, as originally drafted, was widely interpreted to prohibit the use of unlisted securities as collateral for bank loans.[27] It was asserted that this would still further disturb the credit mechanism of the country. The opinion

25. Senate Hearings, Part 15, p. 7344.
26. Ibid.
27. Evidence of the following; before Senate Hearings:
George B. Gibbons, Municipal Bond Dealer, New York, Part 16, p. 7556.
Eugene Thompson, Part 15, p. 6984.
Lyle Wilson, Secretary, Washington State Securities Dealers Association, Part 15, p. 6753.

was expressed that the bill should be more clearly defined or re-written so as to allow the making of bank loans on unlisted securities.[28]

Thomas G. Corcoran, counsel for the Reconstruction Finance Corporation, stated that the drafters of the bill did not intend that its provisions would prohibit bank loans on unlisted securities.[29] It was his opinion that it would be better to put such loans in the banks where they will be dealt with as a commercial proposition. Likewise, they will have the further check of the examination of bank examiners. Accordingly, bank loans, on unlisted securities, subject to the regulations of the Federal Reserve Board, are permited under the terms of the Securities Exchange Act of 1934.[30]

It was argued by George B. Gibbons, that bonds of States and the political subdivisions and agencies thereof should be eliminated from the registration provisions of the Fletcher-Rayburn bill.[31] He further argued that speculative abuses do not exist in such securities because of their more stable value. These securities "have no rightful place in the bill" and no useful purpose would be served by including them in the bill.[32]

Action Taken in the Securities Exchange Act in Regard to Unlisted Securities

The Securities Exchange Act of 1934 specifically exempts from its provisions all obligations of the United States Government, of any State or minicipal or other political subdivision.

28. Evidence of Eugene Thompson, Senate Hearings, Part 15, p. 6984.
29. Senate Hearings, Part 15, p. 6473.
30. Securities Exchange Act, Section 7, Sub-section c, part 1(d)
31. Senate Hearings, Part 15, p. 7445.
32. Ibid.

and of agencies or instrumentalities of a State or local government.[33] Obligations guarranteed as to principal or interest by the Federal or local governments are also exempted.[34] In addition, the Securities and Exchange Commission has authority to exempt other securities either unconditionally or upon specified conditions, and the Secretary of the Treasury to exempt such securities issued or guaranteed by corporations in which the United States has a direct or indirect interest as may be necessary or appropriate in thepublic interest.[35] Under thes authority the Secretary of the Treasury has designated as exempted securities, farm loan bonds issued by the Federal intermediate credit banks under the authority of the Federal Farm Loan Act.[36] Obligations of the Federal Farm Mortgage Corporation and of the Home Owners' Loan Corporation, being guaranteed by the United States Government, are also exempted.[37]

The Securities Exchange Act fixes certain margin requirements on listed securities for margin trading. Unlisted, non-exempted securities are forbidden the privilege of margin trading. The Act must do this in order to make margin regulations effective. Likewise, listed securities are given a frank premium for the purpose of brokers' loans, as an inducement to keep listed securities on the exchanges. It was recognized, however, that certain harmful results would occur. To a certain degree the harmful provisions are mitigated by exempting certain securities and by permitting loans by banks, subject to Federal Reserve regulations, on unlisted securities.

33. Securities Exchange Act, Section 3(a)
34. Ibid.
35. Ibid.
36. Federal Reserve Bulletin, October 1934, pp. 630-631.
37. Ibid.

# CHAPTER VIII.

## EXPERIENCE IN GOVERNMENT REGULATION OF MARGIN REQUIREMENTS

The problem confronting legislative control of security speculation by regulation of margin trading simmers down to two questions. These are the discouraging of speculative trading that verges on gambling and preventing such trading from disrupting the credit which should flow to industry. It is not merely a problem of making bank loans on securities safer. It is more the need of preventing bank deposit funds from feeding a speculative orgy on the market.

Low margin requirements draw into the speculative market people with little money. These people can not afford to lose. They become the victims of stock market manipulation more than others because of their inability to provide additional margins when a slight disturbance in prices wipes out their equities. When a large volume of stock is held on margin, a decline in prices brings forced selling, thus causing prices to sink still lower. This frequently brings about important financial disturbances. The aim then of the margin requirements fixed by the Securities Exchange Act of 1934 is to protect the business and credit structure and to protect the small investor from the evil effects of excessive security speculation.

It will be the purpose of this chapter to discuss the effectiveness of the margin requirements of the Securities Exchange Act in protecting the public against the harmful effects of excessive security speculation. The Act has not been in force long

enough to enable the making of definite assertions regarding its success or failure. It will be possible, however, to point out certain results. These observations will be based on current expert opinion and statistics

## CONTROVERSIAL QUESTIONS OF HIGH MARGINS

Many opinions have been advanced concerning the probable success of the Securities Exchange Act in preventing excessive security speculation. The sponsors of the bill predicted that it would do away with harmful security speculation. The market authorities predicted that it would do away with speculation entirely. They forsaw certain evils as a result of this. They predicted that the act would greatly decrease the volume of trading, deflate security prices, cause a flight of securities from listing on organized exchanges, and make corporate financing difficult. Current statistics give some indication as to the extent to which these predictions of the market authorities have proved to be accurate.

The proposals for public regulation of security speculation were discussed in Chapter Two. The decision was made to control security credit by federal regulation of margin requirements. The proposal to entirely eliminate margin trading was not adopted. Under the terms of the Act margin trading is still permitted. The drafters of the bill were of the opinion that the prohibiting of margin trading might eventually be a good thing but that this condition should be brought about gradually.

In Chapter Four the question was raised as to whether margins should be fixed by statute or left to discretion of a regulatory body. The Act places discretionary control over margins in the

hands of the Federal Reserve Board. The history of the control of margin requirements by that body may be used to judge the wisdom of placing such control in their hands rather than in statutory form.

Finally, the trading in unlisted securities should be considered. This problem was discussed in Chapter Six. There are no available statistics concerning the effect of prohibiting margin trading on such securities. The Securities and Exchange Commission have made studies of the over-the-counter trading in unlisted securities and they have made regulations governing them.

## SUCCESS OF HIGH MARGINS IN PREVENTING SPECULATION

The Securities Exchange Act has been in force for too short a period to permit passing positive judgment concerning the effectiveness of high margins as a device for preventing excessive security speculation. In order to properly test the measure, a period of general speculative activity is needed. Furthermore, since there has been no rapid decline in security prices during the time the Act has been in force the effect of high margins in such a contingency can only be predicted. The opinions concerning the probable effectiveness of the margin provisions of the Act will now be discussed.

### Effect on Stable Securities

The provisions of the Securities Exchange Act which provides for a higher loan value on less volatile stocks was particularly criticized by John T. Flynn.[1] He felt that the effect of this provision will be to make stable stocks more volatile. This will

1. John T. Flynn, Security Speculation, Its Economic Effects, Harcourt, Brace, and Company, New York, 1934, pp. 291-297.

true because at any time speculative activity may develop in a security which was previously stable. As the year progresses first one and then another issue becomes the subject of speculative activity. When this happens the previous stability of the stock will operate to accentuate the speculative fluctuations under the stable lending rule. It was further asserted by Mr. Flynn that because of this the automatic provisions for margin requirements will be unsuccessful in preventing excessive security speculation.

Regulation of the Use of Credit in Preventing Security Speculation

The regulation of the use of credit by speculators is discussed by Wilford J. Eiteman.[2] He pointed out that there was a general suspician that borrowed funds were responsible for inflation of stock prices in 1929. This led to agitation to regulate brokers' loans by prohibiting loans to brokers by corporations and by limiting lending by banks. It was the opinion of Mr. Eiteman that because this scheme of regulation erroneously assumes that the total of brokers' loans indicates the total amount of credit being used by marginal operators, it will fail in its purpose. Since this theory of the relation of brokers' loans to Security speculation has a bearing on the probable success or failure of the security credit control feature of the Securities Exchange Act, it will be summarized here.

According to Mr. Eiteman, the published totals of brokers' loans reveals only a portion of the borrowings that permit traders to operate on margin. The other portion of brokers' loans is composed of customers' credit balances. The total of these is unknown even to brokers. These balances come about when speculators sell

2. Wilford J. Eiteman, "The Regulation of Brokers' Loans", American Economic Review, September 1933, pp. 456-465.

securities and leave the proceeds with the brokers at interest. Such funds may be loaned by the broker to other traders until such a time as they may be used by their owner. Shrewd speculators use such funds to take a long or short position in the market according to inside, technical information. This information might consist of knowledge of dividends to be reduced or passed. In such a case the speculator would sell his holdings in the security and leave the proceeds with his broker. After the security had had a price decreas he could use the funds to buy back in again. It was the opinion of Mr. Eiteman that the total of such customers' free credit balances must have constituted a very large sumein 1929. This is an important fact to the success or failure of any scheme to limit the use of bank credit by brokers.

A limitation upon the total of brokers' loans will not prevent excessive marginal speculation nor inflation in stock prices in the opinion of Mr. Eiteman. This is true because speculative trading in a bull market is essentially buying and selling upon open account. Banks supply the funds needed to permit the occasional retirement of speculators with credit balances. Hence, a law that limits brokers' loans does not limit the credit that supports prices. It only limits the extent to which banks may underwrite that credit. Such a mode of regulation tends to check the speculative fever after the real damage has been accomplished.

Mr. Eiteman stated a proposal for the regulation of brokers' loans. The regulation of brokers' loans should include loans from customers as well as loans from banks so that brokers will be able at any moment to convert credits in customers' accounts into cash by borrowing from banks. If regulation is to stop short of

loans from customers, then the stock exchange should at least publish a semi-monthly report of the total of customers' credit balances so that traders may be warned when the danger zone is approached.

High Margins During Decreasing Prices

The effect of the emplpyment of high margin requirements on securities markets during a period of decreasing security prices must be considered. The comparatively short time during which such requirements have been in force may not have revealed, as yet, the full effects of such margin requirements on securities markets. This is true because the current margin requirements have not been called upon to bear the test of a falling market. In the opinion of A. Tate Smith, New York Stock Exchange Economist, much may be learned when "registered securities are subject to a falling as well as a rising market."[3]

The effect of high margin requirements during periods of falling security prices in the past may be taken, however, as an indication of the effect of the current margin requirements in a similiar situation. During the securities 'boom' which terminated in 1929, margins on the New York Stock Exchange were very high. When security prices begun to decline it was necessary for margin traders to put up more funds. In many cases this could not be done and the trader's securities had to be sold. This resulted in still further depressing the market and causing still more sales. The result of rigid margin requirements at that time was to accentuate the speed and the extent of the deflation of security prices. In order to prevent this and to support the market, many brokers waived margin requirements during this period.[4] It

3. A. Tate Smith, letter in answer to inquiry.
4. Irving Fisher, The Stock Market Crash and After, MacMillian Co.

may be observed that during a period of decreasing security prices the granting of more liberal margin requirements will have the effect of stabilizing the securities markets. This procedure can not be followed by brokers at present due to the margin provisions of the Securities Exchange Act.

## HISTORY OF HIGH MARGINS IN PREVENTING SPECULATION

Various opinions regarding the effectiveness of the high margin requirements under the Securities Exchange Act have been quoted. It has been noted that because of the short period of time during which the Act has been in force a definite statement concerning its effectiveness is difficult to make at this time. Certain developments have occurred, however, which give some basis for judgment of the effectiveness of the margin provisions of the Act in preventing security speculation. These developments will now be considered.

The effect of the present high margins upon the technical position in the market may now be considered. The important question is whether, because of the present high margins, future 'bull' markets will be built on a sounder basis than previous outbursts of speculative enthusiasm. In this connection, George T. Hughes, market observer, points out that in addition to providing a measure of protection i n an active market the present high margins will be dangerous.[5] This will be true because the market is so strongly margined that it will tend to be obstinate. This will be true because security holders, at the peak of the 'boom' will hold on doggedly long after they know that they are wrong in their judgment.

5. Detroit News, Feb. 5, 1936.

The fact that the margin rules provided in the Securities Exchange Act are so difficult to understand tends to defeat their purpose. In the opinion of Elmer Walser, market observer, the small trader, puzzled by high margin rules, merely asks the broker how much stock he can obtain for a certain amount of money.[6] If the answer is favorable he will place an order. It is his further opinion that the small traders will do the same thing under higher margins.

A disturbing effect of the margin regulations has been the reckless buying of low priced stocks of doubtful merit and value.[7] This has occurred because a minimum of capital is necessary. Large blocks of issues selling from one to five dollars have been purchased by uninformed outsiders. These purchasers reason that since other issues once as low priced have risen these will also. This has led to speculation that might be called gambling by small investors. It is one of the objectives of the Securities Exchange Act to prevent such speculation.

It is doubted that the raising of margin requirements in 1936 by the Board of Governors will halt the present increased activity in the stock markets. Instead of depressing market prices and curtailing trading, it is asserted that the effect of the raise has been 'bullish'.[8] This was true because purchasers saw the Board's action as an admission of its belief for a more active market. The result of such advertising was to attract more customers to the markets.

6. Detroit News, Feb. 5, 1936.
7. George T. Hughes, Detroit News, Feb. 19, 1936.
8. Elmer Walzer, Detroit News, Feb. 26, 1936.

EFFECT OF HIGH MARGIN REQUIREMENTS ON THE MARKET

During the course of the Pecora Hearings it was predicted that the margin requirements provided for by the proposed Fletcher-Rayburn bill would have an undesirable effect on the securities markets. It was asserted that the organized markets would be destroyed. This would come about because security speculation would be entirely eliminated. Unless there is speculation in the market the volume of trading will be too small to enable the market to function properly. As a result securities would lose their liquidity and the price would be greatly deflated. Trade in securities, under these conditions would be carried on better on the over-the-counter markets. This would cause a flight of securities from listing on the organized exchanges. Furthermore, as a result of the disruption of the organized markets, the securing of new corporate funds by floating new issues would be made difficult.

The drafters of the Act took an opposit view. They felt that the markets would be disturbed but little by the margin provisions of the Act. Instead of being entirely eliminated, only excessive security speculation would be done away with. As a result there would be a wider gap between the bid and the asked price and the volume of trading would be decreased. This would result in fewer commissions for brokers but security prices would not be greatly deflated. It was predicted that the regulation of the over-the-counter market by the Securities and Exchange Commission would prevent a flight of securities from the organized exchanges.

The effect of the margin provisions of the Securities Exchange Act on the organized markets may now be considered. Certain observations can be made. These observations willlbe based on statistics of the New York Stock Exchange concerning the volume

of trading in securities, the trend of security prices, the price of exchange seats, and the raising of new corporate capital by the flotation of new issues on the New York Stock Exchange.

Volume of Trading on the New York Stock Exchange

The stock exchange authorities predicted that the margin provisions of the Securities Exchange Act would decrease greatly the volume of trading in securities on organized exchanges. This prediction may now be examined. In the diagram of Chart VIII the solid line represents year by year the turnover of shares on the New York Stock Exchange.[9] The rate of turnover has been determined by dividing monthly reported sales of stock by the number of shares listed. An average of the volume of trading for the 1925-25 period is taken to equal one hundred.

It will be noticed that during June 1934, when the Securities Exchange Act became effective, the volume of trading decreased considerably. There was little increase in the volume of trading until the middle of 1935. This decline in volume of trading might be attributed to the effect of the Act. Other factors should be considered, however. During the year 1933 a minor 'boom' occurred in the New York Stock Exchange. When the Securities Exchange Act became effective security prices and the volume of trading were already declining. After the Act had been in force for some time the volume of trading began, in 1935, to increase considerably.

An examination of theaverage monthly volume of trading during 1934 reveals more accurately the effect of the Act on the volume of trading in the New York Stock Exchange. The Securities Exchange

9. New York Stock Exchange Bulletin, "New Capital and Market Activity", November, 1936. Chart included at end of chapter.

Act became effective June 1, 1934. The New York Stock Exchange monthly averages show a decline in trading during June of 1934 followed by a rise in July. In September, when the margin provisions of the Act became effective, the volume of trading reached a low for the year. The volume of trading began to increase in October and in December was a little less than half of the volume of trading of the preceding January. The volume of trading continued to increase during the early part of 1935. During the latter part of 1935 the volume of trading fell off but it began to increase again in 1936.

It may be concluded from the statistics available that the margin provisions of the Securities Exchange Act will not permanently reduce the volume of security trading greatly. The reduction which occurred may be accounted for, in part, by the psychological factor and by the need of traders to familiarize themselves with the new regulations.

The Price of Securities

The effect of the margin provisions of the Act on the prices of securities listed on the New York Stock Exchange may now be considered. Chart IX shows the total market values of shares listed on the New York Stock Exchange from 1927 to 1936.[10] The dotted line showing the total market values of listed shares in the chart moves in harmony with the solid line in Chart VIII which shows the volume of trading. Likewise, the average monthly price of securities during 1934 shows a similiar variation to the average monthly volume of trading during 1934. In June of 1934 the average price of stocks dropped two dollars a share and in August a drop of two dollars and eighty-four cents occurred for a new 1934 low. It may

10. N. Y. S. E. Bulletin, Listed Stocks-Total Shares and Total [illegible] at end of chapter.

be inferred that the sag in security prices at the time the Securities Exchange Act became effective was caused by forces simular to those which caused a decline in the volume of trading on the New York Stock Exchange during the same time.

Margin Requirements and the Flight of Securities

Statistics do not show that the inauguration of the Securities Exchange Act has resulted in a flight of securities from listing on the New York Stock Exchange as was predicted by market authorities. Chart IX, at the end of the chapter, shows a slight decline in listing during 1933. In 1936, however, the number of shares listed increased to reach a new high.

Margin Requirements and New Corporate Capital

The effect of the Securities Exchange Act on the securing of new corporate capital is difficult to predict because of the short time during which the Act has been in force. The New York Stock Exchange have statistics indicating the amount of new corporate capital raised by listing of new issues on the Exchange. The broken line in Chart VIII represents corporate capital flotations, excluding those of investment trusts and those for refunding purposes Beginning in 1929 and continuing until 1931 stock market activity decreased more regularly and presistently than capital flotations. Since 1931 and until quite recently capital flotations have been relatively smaller than market activity. Capital flotations began to increase in 1935, however, and during 1936 they were a little less than forty per cent of what they were in the 1923-25 period. This may indicate that the Securities Exchange Act will not impede new capital flotations,

Price of New York Stock Exchange Memberships

It may be assumed that if the Securities Exchange Act has had the evil effects predicted it would result in decreasing greatly the value of exchange memberships. This decrease would be due to the inability of brokers to make a profit. Statistics taken from the New York Stock Exchange indicate the relationship of the Securities Exchange Act to the price of memberships. Chart XII, at the end of the chapter, reveals the high and low prices for such memberships from 1927 to 1936, inclusive. The trend in the price of memberships moves in sympathy with the volume of trading and the average price of securities listed on the Exchange. The highest price paid for a membership was $625,000 in 1929. In 1932, after the market collapse, the highest price paid for a membership was $185,000. During the minor 'boom' in 1933 the highest membership price rose to $250,000. This was followed by a drop in 1934 to $190,000 and in 1935 to $140,000. In 1936, the highest membership price rose to $174,000.

The decrease in exchange membership prices in 1934 and 1935 may be partly accounted for by the fact that the volume of trading in the New York Stock Exchange was declining following the collapse of the minor 'boom' in 1933. With all due allowance to other causes, the drop in 1934 and 1935 suggests that the Securities Exchange Act may have resulted in fewer commissions for brokers and consequently less profit for brokers. This would make a membership in the New York Stock Exchange worth less to a broker.

## DISCRETIONARY CONTROL OF MARGIN REQUIREMENTS BY THE BOARD OF GOVERNORS

The question as to whether margin requirements whould be controlled by statute or through the discretionary control of a commission was settled in favor of the latter. In the original bill a statutory formula was provided for determining margin requirements. The power to raise margin requirements but not to decrease them was granted to a commission. In the enacted legislation discretionary control was given to the commission by providing that they might determine margin requirements. The granting of such power was at first opposed on the grounds that the discretionary commission would be susceptiable to political influence. It was also contended that the commission might postpone margin requirement increases until the increase would be too late to be effective.

The success of the operation of the discretionary control of margins may be judged by the history of such control by the Board of Governors. Up to the present time it does not seem possible that the adoption of the statutory plan first suggested would have made any difference in margin requirements. This has been true because the Board of Governors followed the statutory formula for margin regulation. Since the adoption of the formula margin requirements have been raised only. Thus, the discretionary power to decrease margins has not been put into use.

The question has been raised above in regard to the effect of high margins during a period of decreasing security prices. It is in such a period that the power of the Board to decrease margin requirements will be important. If margin requirements are reduced, at such a time, the relatively high marging which have been in force will serve to stabilize the market.

The question as to where the discretionary control of margins should be located was decided by placing such control in the hands of the Federal Reserve Board. This was done, primarily, because it was felt that the emphasis should be placed on credit control. There were some who felt that the Federal Trade Commission should have control of margin requirements. This control would be in the nature of ppolice power for the protection of the business structure and the investors.

The feature of the use of margin requirements for the control of credit and their use for protective purposes is realized through the co-operation of the Board of Governors and the Securities and Exchange Commission. The actual prescription of margin requirements lies with the Board of Governors but the administration of these requirements is in the hands of the Securities and Exchange Commission The Securities and Exchange Commission determine whether or not margin requirements are being observed. They also determine where such requirements are weak and where they prove inequitable. Thus, it would seem that adiquate protection is provided.

History of Margin Control

The Board of Governors, acting in accordance with the requirements of the Securities Exchange Act, on September 27, 1934, issued a regulation (Regulation T) with respect to the extension and maintenance of credit on securities. This regulation prescribes rules regarding the amount of credit on securities that may be initially extended and subsequently maintained for customers by brokers and dealers in securities. In prescribing margin requirements the Board adopted the basis stated in the Act and ruled that, with certain exceptions, a member of a national securities exchange or a broker

or a dealer subject to the regulation shall not make any initial extension of credit to any customer on any registered security (other than an exempted security) for the purpose of purchasing or carrying any security, in an amount which causes the total credit extension on such registered security to exceed the amount provided for in the statutory formula.

On January 24, 1936 the Board of Governors, acting under the powers granted it by the Securities Exchange Act, announced an increase, effective February 1, 1936, in margin requirements on loans made by brokers and dealers in securities. Under the new rule, the minimum required margin on a loan collateraled by a security that has advanced in price by less than thirty-three per cent above its lowest price since July 1, 1933, will continue to be twenty-five per cent of current market price, while the margin on loans on securities that have had the largest increases in price will be fifty-five per cent, rather than forty-five per cent as heretofore. Margins required on other securities will vary between twenty-five per cent and fifty-five per cent of current market price, depending upon the degree of their price advance. This change in margin requirements was brought about by an amendment to Regulation T described above. In this amendment the Board prescribed the following maximum loan values of registered securities(other than exempt securities):

(A) Forty-five per cent of current market value of the security; or
(B) One hundred per cent of the lowest market value of the security computed at the lowest market price thereof during the period of 36 calendar months immediately prior to the first day of the current month, but not more than seventy-five per cent of the current market value.

The new rule of the Board for the purpose of raising margin requirements was made necessary by the increasing activity in the

market and by the advancing prices of securities. This price increase began in March 1935. In eight months the average price of common stocks, as measured by the Standard Statistics Company for more than four hundred stocks, increased by about fifty per cent. The movement continued until in January 1936 the average price of common stocks had reached a new high level. The advance in price was accompanied by an increased volume of trading on the New York Stock Exchange and other security exchanges.

By the latter part of 1935 most stocks had advanced in price to a point at which, by reason of the mechanical effects of the price advance on margin requirements, withdrawals of profits or their use as margins for further commitments was again possible. There was evidence of increased borrowing by brokers customers for for the purpose of purchasing and carrying securities. In order to prevent an excessive growth in the use of credit for these purposes, the Board increased the margin requirements on the stock that had risen most in price.

The action of the Board in raising from forty-five to fifty-five per cent of the market price, the margin required for securities that had risen most in price had the effect of raising from one hundred and eighty-two to two hundred and twenty-two per cent of the low price, the level to which the price must have advanced before pyramiding of profits again became possible. This was true because not until the price rises above two hundred and twenty-two per cent is forty-five per cent of the market price more than one hundred per cent of the low price.

The regulation described above places no restrictions on loans for industrial, agricultural, or commercial purposes, nor do they apply to loans by banks. Restrictions to be imposed under the

Securities Exchange Act on security loans by banks were the subject of further study by the Board. The rise in stock prices which has been described above and the use of bank credit for security purchases indicated a need for restriction of bank loans on securities. Regulation U restricting bank loans on securities was put into effect by the Board May 1, 1936.

Regulation U provides that the maximum loan value of any stock, whether or not registered on a national securities exchange, shall be forty-five per cent of its current market value, as determined by any reasonable method. It makes further provisions in regard to loans to brokers and dealers. Notwithstanding the foregoing, a stock, if registered on a national securities exchange, shall have a special maximum loan value of sixty per cent of its current market value, as determined by any reasonably method, in the case of a loan to a broker or dealer from whom the bank accepts in good faith a signed statement to the effect (1) that he is subject to the provisions of Regulation T (or that he does not extend or maintain credit to or for customers except in accordance therewith as if he were subject thereto), and (2) that the securities hypothecated to secure the loan are securities carried for the account of his customers other than his partners.

## ELIMINATION OF MARGIN TRADING

The Securities Exchange Act works a compromise between those who were against any federal regulation of margin requirements and those who favored the complete elimination of such trading. This stand was taken because it was felt that it would be better to attempt to control margin trading rather than to completely eliminate such trading. It was predicted that the federal

margin requirements would result in an increased ratio of bank loans to customers over brokers' loans to customers for financing security trading. It is not possible to determine the extent to which this has taken place. It is our opinion that the Board can, at any time, encourage security traders to gotto banks for credit by requiring less margins on such loans than on loans by brokers to security traders. It is evident, however, that they have not desired to do this. This has been indicated by the fact that the Board's Regulation T prescribing margin requirments on loans by brokers and Regulation U prescribing margin requirements on loans by banks are nearly alike in their more important provisions. This was done in order to put borrowing from banks and brokers on the same basis.[11]

## UNLISTED SECURITIES

The provisions of the Securities Exchange Act denying non-exempt, unlisted securities the right of margin trading was necessary for the proper administration of margin regulations. The result of this provision is to throw such securities into the over-the-counter markets.. The regulation of trading in the over-the-counter markets is entrusted to the Securities and Exchange Commission by the Securities Exchange Act.

The extent of trading in the over-the-counter markets causes its regulation to assume considerable importance. A total of 6,584 over-the-counter brokers registered with the Securities and Exchange Commission. There are no reliable statistics with respect

11. Carl E. Parry, Chief, Division of Security Loans, Board of Governors of the Federal Reserve System, Address at Annual Convention of Associated Stock Exchanges, Cleveland, Ohio, May 18, 1936.

to the volume of trading in the over-the-counter markets. There is reason to believe, however, that both the value of the issues dealt in and the volume of transactions in such issues are "enormous greatly in excess of that on registered exchanges."[12]

An important relationship exists between the organized exchanges and the over-the-counter markets. If, for example, restrictions of an undue kind are placed upon the Exchange market and the over-the-counter market remains free from these restrictions, there will be a tendency for transactions to move off the exchanges. The fact that there has not been a flight of securities from the organized exchanges into the over-the-counter markets suggests that the Securities and Exchange Commission have been successful in regulating trading in the over-the-counter markets.

## SUMMARY

A most important question to be considered in determining the effectiveness of the Securities Exchange Act of 1934 in accomplishing its purpose is whether or not it will prevent excessive security speculation. In regard to this question, the situation, with regard to the market, seems to indicate that the margin requirements of the Securities Exchange Act may not be successful in preventing the development of a speculative 'boom' in securities. Public attention was called to the danger of such a 'boom' by the recent warning of the President against speculation in the securities exchanges. He stated that he was not "technically informed" as to whether an increase in margin requirements would "put a damper on security speculation."[13] Officials of the Re-

12. Detroit News, March 14, 1936.
13. Detroit News, March 24, 1936.

serveBoard said that they were making a careful, continuing study of the extent of stock market speculation.[14] The Board recently ordered brokers and banks to submit more detailed reports on credit advanced for stock dealings.

The officials of the Board of Governors are in position to lift margin requirements to one hundred per cent, immediately, if it appears that speculative credit is being used to create an artificial 'boom'. In this connection, the authorities of the Securities and Exchange Commission have reported that they are keeping a check on speculation. Any signs which indicate a dangerous security upturn will be discussed with the Reserve Board.

During a period of rapidly decreasing security prices, it will be possible for the Board to decrease margin requirements. In such an event, the previous high margins will be a factor for market stability. This will be due to the fact that security holders have a large equity in their securities. Thus, if margins are decreased by the Board during such a period, it will be possible for security holders to avoid forced liquidation until their margins have sunk to the new level of requirements fixed by the Board. The burden, then, will be placed upon the judgment of the Board of Governors.

14. Detroit News, April 24, 1936.

CHART VIII. NEW CAPITAL AND MARKET ACTIVITY

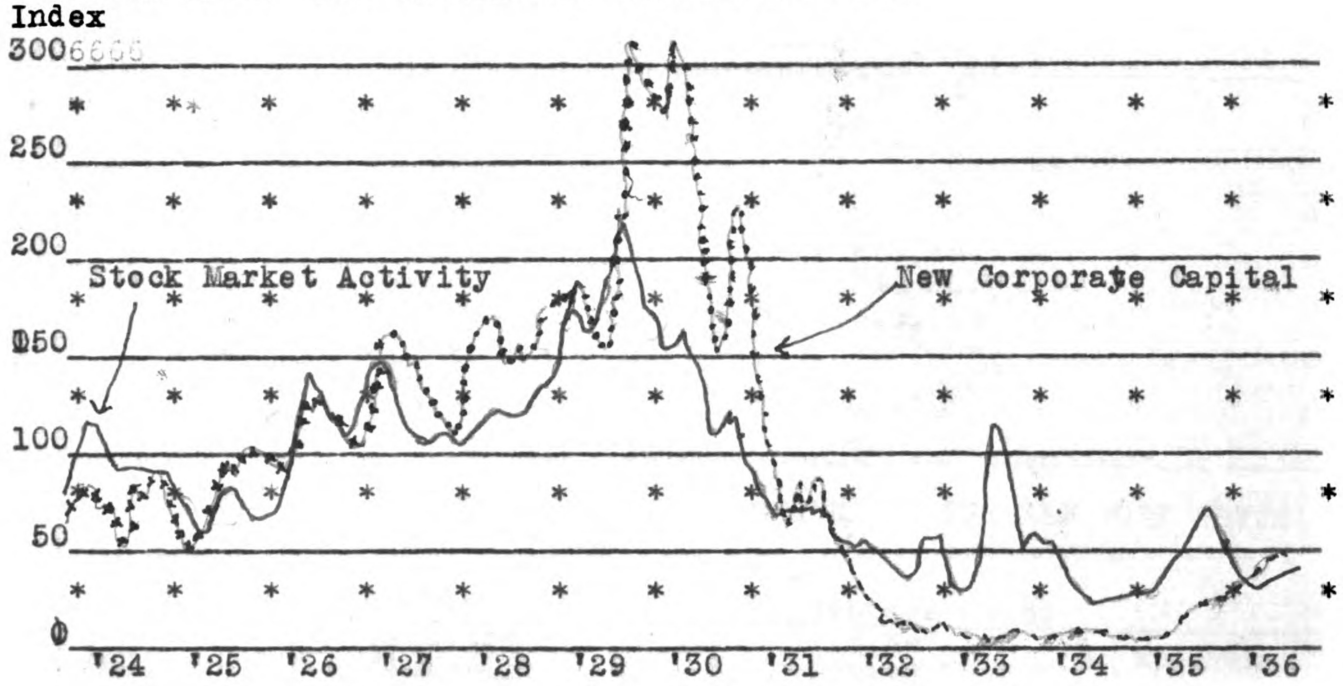


CHART IX. LISTED STOCKS-TOTAL SHARES AND TOTAL MARKET VALUES

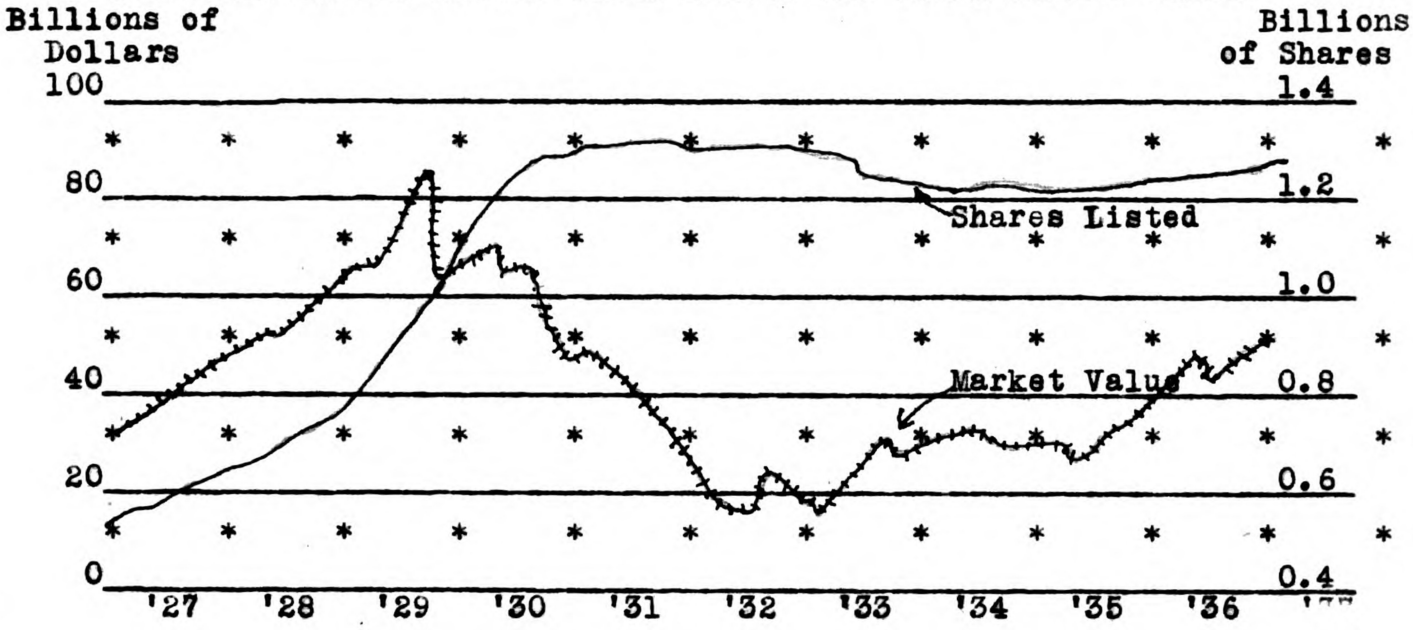

CHART X. AVERAGE MONTHLY VOLUME OF TRADING ON THE NEW YORK STOCK EXCHANGE DURING 1934.

| Month | Transactions |
|---|---|
| January | 2,098,667 |
| February | 2,583,180 |
| March | 1,150,581 |
| April | 1,193,811 |
| May | 1,974,449 |
| June | 646,160 |
| July | 844,523 |
| August | 618,184 |
| September | 505,435 |
| October | 602,305 |
| November | 907,429 |
| December | 943,544 |

CHART XI. AVERAGE MONTHLY PRICE OF SHARES ON THE NEW YORK STOCK EXCHANGE DURING 1934.

| Month | Average Price |
|---|---|
| January | $25.59 |
| February | $28.90 |
| March | $28.34 |
| April | $28.37 |
| May | $28.13 |
| June | $26.13 |
| July | $26.60 |
| August | $23.76 |
| September | $24.90 |
| October | $24.61 |
| November | $24.22 |
| December | $25.97 |

CHART XII. MEMBERSHIP PRICES OF NEW YORK STOCK EXCHANGE SEATS

| Year | High | Low |
|---|---|---|
| 1927 | $305,000 | $170,000 |
| 1928 | $595,000- | $290,000 |
| 1929 | $625,000 | $550,000 |
| 1930 | $480,000 | $205,000 |
| 1931 | $322,000 | $125,000 |
| 1932 | $185,000 | $66,000 |
| 1933 | $250,000 | $90,000 |
| 1934 | $190,000 | $70,000 |
| 1935 | $140,000 | $65,000 |
| 1936 | $174,000 | $89,000 |

APPENDIX

## SUMMARY OF IMPORTANT SECTIONS OF TITLE I OF THE SECURITIES EXCHANGE ACT OF 1934[1]

I. Necessity for Regulation:

The reasons for public interest in the regulation of securities exchanges are given as being: (1) that the mails and other channels of interstate commerce and communication are used in exchange transactions; (2) that general prices and the volume of federal and state taxes are affected; (3) that fluctuations in prices of securities affect credit, taxes, and the national banking system; and (4) that the precipitation of national emergencies as a result of security transactions places a burden upon national credit.

II. The Securities and Exchange Commission:

The Act sets up the Securities and Exchange Commission of five members appointed by the President with the consent of the Senate for terms of five years at $10,000 a year, the term of one member to expire in each year. Not more than three shall belong to any political party and no member shall have any other employment or participate in any way in stock market operations regulated by the commission.

III. Registrations of Securities Exchanges:

The use of interstate media of transport and communication in connection with security transactions is denied to all securities exchanges and brokers unless such exchanges are registered as national securities exchanges with the commission or are exempted by the commission because of limited volume of transactions.

IV. Registration Requirements:

In order to register with the commission an exchange must place on file; an agreement to comply with the Securities Exchange Act; data as to the organization, rules, and membership of the exchange; copies of its rules; and an agreement to furnish copies of amendments of provisions of exchange rules. An exchange must also give evidence of provision for enforcing its rules by disciplining it members. Registration is effected when the Commission is satisfied that organization and rules are proper and adequate for the purpose of the Act.

V. Margin Requirements:

The Federal Reserve Board is granted power to determine the margin requirements for different classes of stock and types of transaction in connection with securities listed on a registered exchange. The Federal Reserve Board is instructed to use broad considerations of credit control as criteria for judgment as to margin requirements.

1. Norman S. Buck, Survey of Contemporary Economics, Nelson and Sons, 1934. pp. 718-722.

VI. Restrictions upon Borrowing:

1. The Act forbids any member of an exchange, or any broker or dealer operating through an exchange to borrow funds on any security covered by the operation of the Act from any person or agency other than the following: (a) any non-member bank filing an agreement with the Federal Reserve Board undertaking to live up to the terms of the Act, the Federal Reserve Act(as amended), and the Banking Act of 1933; (b) any other bank operating under rules and regulations prescribed by the Federal Reserve Board: (c) one another, except as prescribed by the Federal Reserve Board.

2. The commission, furthermore, is empowered to limit, with certain restrictions, the aggregate indebtedness of any broker; and to regulate or prohibit the hypothecation or commingling of customers' securities.

3. The Act specifically forbids the lending by a broker of a customer's securities without the written consent of the customer.

VII. Prohibitions against Manipulation of Security Prices:

1. The following manipulative practices are unconditionally forbidden: fictitious transactions or wash sales; transactions to raise or depress prices to induce purchase or sale by others; circulation by the seller or purchaser of information as to a possible change in price resulting from market manipulation or activity; the making of statements to influence purchase or sale when having reasonable ground to believe such statements to be false or misleading with respect to any material fact.

2. The commission is empowered to regulate or prohibit the following practices; pegging, fixing, or stabilizing prices; puts, calls, straddles, or options.

3. Violation of these prohibitions or regulations of manipulative practices shall make the violator liable to suit for the recovery of damages to purchaser or selling resulting from such violation. Suit must be brought within one year after the discovery of the violation and within three years after the violation took place. The court may require bond for costs.

VIII. Short Sales and Stop-Loss Orders:

The commission is empowered to regulate or prohibit the practice of selling short and the use of stop-loss orders, and to prohibit any manipulative or deceptive practice.

IX. Registration Requirements for Securities:

Members of a registered exchange or dealers and brokers operating through such an exchange are forbidden to effect a transaction in any non-exempt security unless such security has been registered for that exchange with the commission in accordance with the regulations prescribed by it. Application for registration of a security must contain information which by specification is substantially the same as that required in connection with the issue of a security under the Securities Act. The commission may establish regulations for unlisted trading.

X. Reports and Records Required:

1. The commission has power to require: (a) the filing of information by issuers needed to keep information in applications for registration reasonably current, (b) the filing of annual and quarterly reports by issues in such form as may be prescribed, and (c) the keeping for examination by the commission of such accounts and records, by exchanges, members, brokers, and dealers as may be prescribed by the commission.

2. The Federal Reserve Board has power to require the filing of such reports as it may prescribe by any person extending credit under regulations of the Board pursuant to this Act.

XI. Segregation of Functions:

Power to segregate and limit the functions of members, brokers, and dealers is granted to the commission. Important among the objects of such regulation are limitation of floor trading by members, and segregation of the functions of specialists and odd-lot dealers.

XII. General Powers with Respect to Exchange and Securities:

The commission has partially restricted power, if necessary, to (1) suspend or withdraw the registration of an exchange; (2) suspend or withdraw the registration of a security; (3) suspend or expel a security for a limited period; and (5) alter or supplement rules and practices of exchanges.

XIII. Requirements with Respect to Directors, Officers, and Principal Stockholders:

1. Every person beneficially owning more than 10 per cent of a registered equity, security (stock or security with any right of conversion into stock), or who is a director or officer of the issuer of such security, shall file monthly reports of his ownership of all equity securities of such issuer.

2. To prevent unfair use of "inside" information by such a person, any profit realized by him within any period of 6 months from any purchase and sale, or sale and purchase, of a non-exempt equity security of such issuer shall inure to and be recoverable at law by the issuer, unless such security was acquired in good faith in connection with a debt previously contracted. Suit must be brought within two years after the profit was realized.

3. No such person shall sell short, or sell without delivery within twenty days, any equity security of such issuer.

XIV. Proxies; Over-the-Counter Markets:

1. Full powers are granted to the commission to regulate or prohibit the solicitation of proxies or the use by brokers of the proxies of customers' securities.

2. Power is also granted to regulate over-the-counter markets for securities.

XV. Liability for Misleading Statements:

Any person making a false or misleading statement in any connection with the administration of the Act is liable for damages to any person who, in reliance upon such statement, suffered as a result (unless the defendant can prove that he did not know the statement to be false or misleading). The court may require bond for costs, and suit must be brought within one year of discovery and three years of occurrence of the offense.

XVI. Court Review of Commission Orders:

Any person aggrieved by an order of the commission may appeal to a Circuit Court of Appeals of the United States. The findings of the commission as to the facts shall be conclusive. The Court may institute a stay of the disputed order of the commission during proceedings before it.

XVII. Penalties:

Anyone who wilfully violates any provision of the Act or any regulation of the commission, or any person who knowingly makes a false or misleading statement of fact shall be liable to a fine of not more than $10,000, imprisonment for not more than two years, or both. If such person is an exchange, a fine not exceeding $500,000 may be imposed. However, no person shall be liable to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

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