STOCK EXCHANGE PRACTICES

FRIDAY, MARCH 23, 1934

UNITED STATES SENATE,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C.

The committee met at 10:30 a.m., pursuant to call of the chairman following adjournment on Friday, March 16, 1934, in room 301 of the Senate Office Building, Senator Duncan U. Fletcher presiding.

Present: Senators Fletcher (chairman), Bulkley, Gore, Costigan, McAdoo, Adams, Goldsborough, Townsend, Carey, Couzens, Steiwer, and Kean.

Present also: Senator King, of Utah.

Present also: Ferdinand Pecora, counsel to the committee; Julius Silver and David Saperstein, associate counsel to the committee; Frank J. Meehan, statistician to the committee; Roland L. Redmond, counsel to the New York Stock Exchange.

The CHAIRMAN. The committee will come to order, please.

Senator MCADOO. Mr. Chairman, before you start the hearing may I present some telegrams received from California in regard to the bill now under consideration, and ask that they may be made a part of the record and returned to me?

The CHAIRMAN. The committee reporter will make them a part of the record and return the original telegrams to you for your purposes.

(The telegrams are as follows:)

LOS ANGELES, *March 22, 1934.*

WILLIAM GIBBS MCADOO,
Senate Office Building, Washington, D C ·

Amended Fletcher-Rayburn bill is improvement over the original Still think it ambiguously worded and little thought given to margin provisions which ahe inflexible and unworkable and places all stocks in same category regardless of earnings, dividends record, and market history. Present bill continues to vest potential power in Federal Trade Commission to control and dominate industry and business which is fundamentally un-American. Sections relating to odd-lot dealers, specialists, and segregating functions of broker and dealer poorly worded, and present wording would destroy functions of stock exchanges and hinder marketability of odd lots of stock held by small investors, who comprise the majority of investors. Bill so technical only you in Washington can comprehend Public continues to be misled in the belief that only excessive speculation and brokers affected. You must know this is not the case; on the contrary, think bill in present form would be extremely deflationary

FREDERICK A SPEIK,
810 Roosevelt Building,
Los Angeles, Calif.

SAN FRANCISCO, CALIF., *March 22, 1934*

HON. WILLIAM GIBBS MCADOO,
United States Senate, Washington, D C

I am a stockbroker and taxpayer in San Francisco. I ask nothing for myself, but I have 102 loyal employees here to whom I am attached by ties of friendship Many of them have been with me for 15 years If the Fletcher-Rayburn bill becomes a law in anything like its present form, no recourse is open to me and to all other stockbrokers but to discharge 80 percent of these excellent men and women. On their account I appeal to you to defeat this measure or at least to secure its modification.

W. C. VAN ANTWERP.

LOS ANGELES, CALIF, *March 22, 1934*

WILLIAM GIBBS MCADOO,
Senate Office Building, Washington, D C

Ask that you reconsider redrafted Fletcher-Rayburn bill and urge revision to bill such as that introduced by Congressman Bulwinkle along lines suggested by Dickinson report Also urge clarification of language and that Federal Reserve Board be given more discretionary power in establishing marginal requirements Believe amended bill may have unforseeable effects and consequences and this will certainly be true unless language simplified and clarified Urge your reconsideration

HARRY C. ALLEN,
450 N Rosmore,
Los Angeles, Calif.

LOS ANGELES, *March 22, 1934*

WILLIAM GIBBS MCADOO,
Senate Office Building, Washington, D C

May I be permitted to earnestly say in past depressions the investment of private capital in industries has always helped to pull us out The stock exchange bill appears to me and to others to whom I have talked to seriously threaten accesses of industries to capital markets. Cutting such industries' accesses could not increase the protection to either the investor or to national recovery

C. L BUNDY,
2153 Lamesa Drive,
Santa Monica, Calif

LOS ANGELES, CALIF., *March 22, 1934*

WILLIAM GIBBS MCADOO,
Senate Office Building, Washington, D C.:

Hear tremendous amount of criticism of revised Fletcher-Rayburn bill. First, excessive authority is granted Federal Trade Commission and fear is that commission will use its authority for regimentation of industry and for purposes foreign to intent of bill. This could be cured by a section stating rules and regulations of commission shall be reasonable and limited to provisions of bill as stated in section 2 Second, it imposes rigid regulation instead of supervision They have provided margin provisions which are arbitrary, unreasonable, inflexible, and unworkable instead of giving Federal Reserve Board large authority Also alters greatly present machinery of stock exchanges developed over many years and substituting something which may or may not work Earnestly urge your reconsideration which is introduced by Bulwinkle along ideas suggested by Dickinson's committee.

LESLIE LUMLEY,
2563 Saluson Avenue,
Huntington Park, Calif

Senator GOLDSBOROUGH. Mr. Chairman, I have a telegram that I also should like to have made a part of the record.

The CHAIRMAN. The committee reporter will make it a part of the record and return the original to you for your purposes.

(The telegram is as follows:)

BALTIMORE, MD., *March 21, 1934.*

HON PHILLIPS LEE GOLDSBOROUGH,
United States Senate:

This bank representing thousands of depositors and stockholders earnestly requests your cooperation in opposing paragraph A, section 7, of the National Securities Exchange Act of 1934 This unfair and un-American discrimination against State banks is viewed with a deep concern by a large portion of the citizens of Maryland.

Respectfully,

MERCANTILE TRUST CO. OF BALTIMORE,
A. H S. POST, *President.*

The CHAIRMAN. I understand that Mr. Cotton, of California, is here this morning and has only a word to say. Mr. Cotton, you may come forward. [A pause, without response.]

Senator MCADOO. Is Mr. H. H. Cotton here? [A pause, without response.]

The CHAIRMAN. Very well; we will go on with our hearings. Is Mr. Whitney here?

Mr. REDMOND. Mr. Chairman, Mr. Whitney will be here in a few minutes. He was informed that he would be wanted later on in the morning.

Senator COUZENS. Mr. Chairman, why can't we go on now and hear Governor Black?

Senator MCADOO. Oh, Mr. Chairman, Mr. Cotton has now returned to the committee room. Will you hear him for just a moment?

The CHAIRMAN. Yes. Mr. Cotton, do you wish to make a statement to the committee in regard to municipal securities?

Mr. COTTON. Yes, Mr. Chairman.

The CHAIRMAN. All right. If it is to be very brief you may stand right there. Please state your name, residence, and whom you represent.

Mr. COTTON. My name is H. H. Cotton, of Los Angeles, Calif. I represent the Investment Bank, of Los Angeles.

The CHAIRMAN. You may proceed with your statement.

STATEMENT OF H. H. COTTON, LOS ANGELES, CALIF., REPRESENTING THE INVESTMENT BANK OF LOS ANGELES

Mr. COTTON. Mr. Chairman and gentlemen of the committee: I should just like to say that the bill as now drawn does not seem to protect securities of municipal and political subdivisions as exempted securities, the objection offered, as I understand it, being that some are now in default. It seems to us that this would unduly and without valid reason penalize the great majority of such securities which are now not in default, and that even as to those now in default they have a well-recognized market and collateral value. We respectfully submit that they ought to be kept in the bill as originally drawn as exempted securities.

Senator TOWNSEND. Have you any suggestions to make to the committee as to how we might remedy that situation and also improve the bill as drawn?

Mr. COTTON. I have only that one statement that I care to make in regard to the bill.

The CHAIRMAN. But you wanted exempted State, city, and municipal securities?

Mr. COTTON. I should like to have State, city, municipal, and political subdivisions exempted.

Mr. PECORA. Without regard as to whether any issues are in default or not?

Mr. COTTON. Yes; because if in default at this time they still have a recognized market and collateral value, for we all feel that they will be all right again, just as soon as the tax situation straightens up a little.

Senator ADAMS. When do you anticipate that will occur?

Mr. COTTON. Do you mean the tax situation?

Senator ADAMS. Yes.

Mr. COTTON. Well, we hope it will straighten out very shortly. No time limit is set by the proponents.

Senator MCADOO. And you do not think you will have to wait for the millennium in that regard, do you?

Mr. COTTON. No.

Senator ADAMS. Well, California seems to be getting about all of the Government money that we have.

Mr. COTTON. Well, we have left that for Senator McAdoo to look after, as he has been rather the chief performer in it. That is, as a money-getter he has been very nice to us.

Senator MCADOO. What about Senator Johnson?

Mr. COTTON. Oh, yes; he has done his part too.

Senator TOWNSEND. I think we will have to agree with you that Senator McAdoo has been pretty satisfactory to his constituents in the matter of getting money for them.

Senator MCADOO. I should like to have put in the record that Senator Johnson is entitled to much credit in that matter.

Senator ADAMS. You want to share the blame with him, do you?

Senator MCADOO. I referred to credit and not to blame.

Senator ADAMS. Well, that depends upon the point of view.

Mr. COTTON. I might suggest that California has more good things to offer than most States.

Senator CAREY. Is the climate still good out there?

Mr. COTTON. The climate out there is a little better than it is in Washington this morning, I can assure you.

Senator COUZENS. How about Florida? I am sure the chairman could tell you something about that.

Mr. COTTON. Well, we are willing to share the good things with the chairman.

The CHAIRMAN. All right, Mr. Cotton, we will consider your suggestion.

Mr. COTTON. And I wish to thank you gentlemen for hearing me.

(Thereupon Mr. Cotton left the committee table.)

The CHAIRMAN. Governor Black, we have asked you to come down here this morning. The committee would like to have your views regarding this measure, particularly S. 2693 and H.R. 8720, which is a modification of S. 2693.

STATEMENT OF HON. EUGENE R. BLACK, GOVERNOR OF THE FEDERAL RESERVE BOARD, WASHINGTON, D.C.

Mr. BLACK. Mr. Chairman and gentlemen of the committee, I have prepared a rather short statement, and, with your permission, will be glad to read same.

The CHAIRMAN. The committee will be glad to have the benefit of any views you are prepared to submit.

Mr. BLACK. The staff of the Federal Reserve Board conferred for a week with representatives of the Treasury and with Mr. Pecora, Mr. Corcoran, and Mr. Cohan, attorneys, in reference to the provision of the National Securities Exchange Act of 1934. Governor Black participated in some of these conferences, was in close touch with all of them, and kept the members of the Board fully advised. During these conferences the attitude of the Board was requested, and the following expression of this attitude was given:

The Board is in thorough accord with the following purposes of the bill:

1. To regulate national securities exchanges to the end that they may operate under fair practices only.

2 That speculation be properly curbed and dishonest speculation be eliminated

3. That exchange credit be properly restrained and the undue use of credit in speculation be prevented

4 That necessary penalties be enacted to guarantee the accomplishment of these purposes

The Board is not primarily concerned with the features of the bill with regard to the policing or regulating of the exchange, but feels that these features should be fair and in accord with established American business principles.

If it is desired the Board will be glad to undertake the responsibilities of the bill regarding the fixation of marginal requirements upon loans based upon exchange equities, whether the loans are made by brokers or banks, provided power is vested in the Board to handle this subject in the public interest and to the protection of the investor. This function would usefully supplement the considerable powers vested in the Board under the Banking Act of 1933 to prevent the undue use of credit for speculative purposes and would in the judgment of the Board furnish effective protection against the economic evils of speculation

During these conferences very many changes in the original bill were recommended by the Federal Reserve staff. These recommendations were followed in substance and changes were made in the bill, and the bill was greatly improved in order to properly effectuate its purpose.

The bill known as H.R. 8720, introduced in the House by Mr. Rayburn, embraces these recommended changes. It is the feeling of the Reserve Board that the revised bill H.R. 8720 is workable, is right in principle, and will accomplish the purpose of regulating national securities exchanges under fair practices and that undue and excessive speculation will be properly curbed, and that exchange credit will be properly restrained and the undue use of credit in speculation be prevented. The Board is therefore prepared to approve the bill as revised.

The Board requests the privilege of making such further constructive suggestions as to the bill as may appear necessary or desirable as the result of the further study of the bill, and this request applies especially to questions affecting technical operations of the exchanges covered by the bill.

Now, Mr. Chairman, I will go into the matter at length if you desire me to do so, or I will answer any questions the members of the committee may desire to ask me. I have stated the position of the Federal Reserve Board.

The CHAIRMAN. Governor Black, there was one provision in the original bill, section 7, paragraph (a) about which there has been some controversy, or some objection raised. I believe there is a modification in the amendment that has been offered. I wanted to ask you about section 7, which provides that it shall be unlawful for any member of a national securities exchange or person who transacts a business in securities through the medium of such member, directly or indirectly:

(a) To borrow on any security registered on a national securities exchange from any person other than a member bank of the Federal Reserve System

Now, we have modified that provision. Do you think the modification meets the objection that has been made to it? It was pointed out, for instance, that a number of industrial organizations, particularly the larger ones, had large sums out on call loans as much as $20,000,000,000 in 1929, and that their loans were not made through a bank at all, but made to brokers. So the requirement in the original bill that all such loans must be made through a member of the Federal Reserve System met with some criticism and objection. Now that we have modified that provision I think perhaps it would meet the objection. Is that modification satisfactory to you?

Mr. BLACK. Do you mean that there has been a further modification than is shown in H.R. 8720?

The CHAIRMAN. No. That is the modification I now refer to.

Mr. BLACK. The modification shown here is satisfactory to us.

The CHAIRMAN. That permits loans other than through a member bank of the Federal Reserve System under certain circumstances and conditions.

Mr. BLACK. That is correct, but it must be in accordance with the rules and regulations of the Federal Reserve Board.

Senator GOLDSBOROUGH. Mr. Chairman, I should like to ask Governor Black a question or two.

The CHAIRMAN. Proceed, Senator Goldsborough.

Senator GOLDSBOROUGH. Governor Black, wouldn't section 6, paragraph (d)——

Senator MCADOO (interposing). What page is that, Senator Goldsborough?

Senator GOLDSBOROUGH. Page 13. Wouldn't that section necessitate the Federal Reserve Board figuring out prices each day and publishing them in order that the margins throughout the country could be understood?

Mr. BLACK. Well, would you mind referring me to the page of the bill, Senator?

Senator GOLDSBOROUGH. It is on page 13.

The CHAIRMAN Do you mean of the bill H.R. 8720?

Senator GOLDSBOROUGH. No. I mean of the bill S. 2693. It is section 6, paragraph (d), which begins on page 13.

Mr. BLACK I don't see it.

Senator GOLDSBOROUGH. It is section 6, paragraph (d), II.

Mr. BLACK. There doesn't seem to be a section 6, paragraph 2, II.

Senator ADAMS. I think what Senator Goldsborough refers to begins on line 2 of page 15.

Senator GOLDSBOROUGH It is subdivision (c).

Senator STEIWER. Which bill is it?

Senator GOLDSBOROUGH. Oh; I am now referring to H.R. 8720. It is section 6, paragraph (c), and then another paragraph (ii).

Mr. BLACK. Yes; I see here on page 15 of H.R. 8720, section 6.

Senator GOLDSBOROUGH. And you will find paragraph (c) and then a subparagraph (ii), found on page 15, being line 13 of the House bill. Wouldn't these sections require the Federal Reserve Board to figure out prices each day and publish them in order that margins throughout the country could be followed properly?

Mr. BLACK. The sentence that I have before me, on page 14, reads:

If such security has been traded in for a period of not less than 36 months—

Is that the one you are now referring to?

Senator GOLDSBOROUGH. And also the one on page 15, line 13, which says:

If such security has been traded in for a period of not less than 36 months—

and so forth

Mr. BLACK. Well, I think prices of securities are shown every day on the exchanges. I see no reason why the Federal Reserve Board every day would have to figure current market prices of securities.

Senator GOLDSBOROUGH. Then you do not think there is anything in that provision requiring the Federal Reserve Board to publish daily securities prices in order that the margins throughout the country could be properly followed?

Mr. BLACK. I do not think so. I think these would be accepted as current market prices.

Senator TOWNSEND. Governor Black, there has been a great deal of discussion about the margin provisions of the bill. Do you consider the margin provisions, as now written in the bill, workable?

Mr. BLACK. Yes, Senator Townsend; I think they are workable.

Senator TOWNSEND. You do not think the margin requirement is excessive?

Mr. BLACK. I think Congress has the right to express its opinion by way of enactment of law as to what are proper marginal requirements, and as I understand the situation that is what this bill will do; giving then to the Federal Reserve Board the power, under certain exigent circumstances, to meet the situations as they may arise.

Senator TOWNSEND. Do you feel that the provision as now written would restrict credit?

Mr. BLACK. I think it would restrict speculation.

Senator TOWNSEND. But would not restrict credit?

Mr. BLACK. I do not see why the provisions of the bill should restrict credit. I think they will restrict credit in speculation, and I understand that that is the purpose of the bill.

Senator MCADOO. As to this portion of the provision:

If such security has been traded in for a period less than 36 months, such amount, but not more than 75 per centum of the current market price, as the Federal Reserve Board may by its rules and regulations prescribe as appropriate or necessary in the public interest or for the protection of investor

Do you think as expressed there the Federal Reserve Board could properly see to the administration of the matter?

Senator GOLDSBOROUGH. Is that found on page 15 of the bill?

Senator MCADOO. No. That is on page 14 of H.R. 8720, beginning with line 6 and winding up with line 12.

Mr. BLACK. I think the Federal Reserve Board could fix rules and regulations. I think the law would attend to proper observance of the rules and regulations, because the law fixes a very severe penalty for violation.

Senator MCADOO. I mean, is it practicable, so far as current market prices are concerned, for the Federal Reserve Board to follow these things and police them, see that the requirements are complied with? I am now asking for information and not attempting to express an opinion, as to how you will administer such a provision.

Mr. BLACK. I think the Federal Reserve Board can do that as well as any other control agency. I see no reason why the Federal Reserve Board could not keep itself informed of current market prices in fixing the margin requirements.

Senator MCADOO. Would you have to do anything additional, in particular?

Mr. BLACK. I think we would have to set up a separate department in the Federal Reserve Board to take care of it.

Senator MCADOO. You would have to police it?

Mr. BLACK. Yes; so far as margin requirements are concerned.

Senator MCADOO. Do you think it is practicable to do that? I am merely looking at it from the administrative viewpoint, as to whether or not it could be actually done without a very large organization and a very expensive one, being set up.

Mr. BLACK. I think it can be done. But it is going to entail some work.

Senator MCADOO. It will require a very large organization, will it not?

Mr. BLACK. Well, it is very difficult to answer that question. It would require a sufficient organization I will say. How large it would have to be I do not know at this time.

Senator MCADOO. You understand, Governor Black, that this will apply to the Nation——

Mr. BLACK (interposing). Yes.

Senator MCADOO (continuing). Not to the New York Stock Exchange alone, but to all stock exchanges of the country; that they must be policed.

Mr. BLACK. Well, I think the matter of policing is up to the Federal Trade Commission; not up to the Federal Reserve Board.

Senator MCADOO. Well, whatever the agency may be, it is going to require a very large organization to police it, isn't it?

Mr. BLACK. I think so.

Senator MCADOO. There was running through my mind the matter of the practicability of the scheme of trying to see that all transactions on the many exchanges of the Nation are properly policed, or policed to the necessary extent to compel observance of this statute.

Mr. BLACK Well, I would hope that the exchanges would obey the law in very large part.

Senator MCADOO Well, we hope for that in the case of all laws, but whether or not we entertain such hopes, we have to set up police

and courts and prosecuting attorneys and all the necessary machinery for the administration of justice in order to enforce them.

Senator GORE. Oh, yes; that was true about prohibition.

Senator ADAMS. We have had laws against false pretenses on the statute books for years, and, of course, they have to be taken care of.

Senator COUZENS. The Interstate Commerce Commission has been able to enforce the Interstate Commerce Act without undue trouble.

Senator MCADOO. I concede that, but I think the matter of transportation and rates are very much simpler than the multifarious transactions that occur on all stock exchanges of the country.

Senator KEAN. Not only that occur on the stock exchanges of the country, but the transactions of individuals.

Senator MCADOO. Yes.

The CHAIRMAN. Well, I take it as being hardly fair to assume that the stock exchanges will have to be watched to see that they do not violate the regulations laid down by the Federal Trade Commission and the Federal Reserve Board; or, at least, that they will cooperate in a proper spirit in this matter, and that it won't be necessary to watch every transaction taking place on the exchanges. I should think we may assume that the stock exchanges will be willing to cooperate with the authorities in carrying out the law once it is enacted.

Senator KEAN. But there are many people all over the United States who will be involved in this thing if this provision is included.

The CHAIRMAN. Precisely.

Senator KEAN. And just the same you can assume, even with the enormous forces of every State and every city, as well as those of the United States, in the way of protective matters, and policemen, the laws are violated every day.

The CHAIRMAN. Precisely. But we won't argue that matter now. The question is, what do you wish to ask Governor Black?

Senator GOLDSBOROUGH. One other question: Governor Black, did I understand in the statement you submitted, that the Federal Reserve Board approves all provisions of this bill as now written?

Mr. BLACK. Yes, sir; with the request that we may make further suggestions, especially as to details of the technical operations of exchanges as may appear necessary from a further study of these technical operations.

Senator GOLDSBOROUGH. And that you are not now prepared to submit to us.

Mr. BLACK. No.

Senator ADAMS. But you are making a further study of the bill?

Mr. BLACK. We have been continually studying the bill since first requested to do so a week ago.

Senator KEAN. Were you requested to study the entire bill or only certain sections of it.

Mr. BLACK. I understood that we were requested to study the entire bill, sir.

Senator KEAN. And you have studied the entire bill?

Mr. BLACK. I have studied every word of it, Senator Kean, 6 days and 6 nights.

Senator STEIWER. Governor Black, does the Federal Reserve Board desire the function of fixing the regulations as to margin requirements?

Mr. BLACK. The Federal Reserve Board never requested that power. It was, perhaps in the second review of this bill, brought to my attention and the Federal Reserve Board does feel that that power should be given to it because it is credit control. The Federal Reserve Board, together with its other credit control, should have charge of this credit control, and no other department of the Government should have charge of credit control.

Senator STEIWER. And if this bill is enacted into law the Federal Reserve Board would expect then to function in its capacity of control of credit?

Mr. BLACK. Absolutely.

Senator STEIWER. Through the medium of margin requirements?

Mr. BLACK. As one of the mediums of credit control; yes, sir. There are a great many.

Senator STEIWER. Perhaps I misunderstood you a while ago. I thought you said the margin requirements would restrict speculation, but would not restrict credit. I now understand you to say that it is the purpose of the Federal Reserve Board under certain circumstances and conditions to restrict credit through this medium if the power is given to the Board.

Mr. BLACK. If I have said something that was misunderstood, I regret it. Of course, in restricting speculation you have to do it through restriction of credit under the provisions of this bill—I mean, so far as the marginal requirements are concerned

Senator STEIWER. Well, to what extent would you feel justified in restricting credit in order to restrict speculation?

Mr. BLACK. Wherever there is excessive speculation or undue use of credit in speculation.

Senator STEIWER. Has the Federal Reserve Board set up any standard to which it would adhere in the determination of matters of that kind?

Mr. BLACK. It had not had the time to do that, and could not properly attempt to do it until the occasion for doing it was approaching.

Senator STEIWER. I assumed that that would be your answer. However, the net result is that if the Federal Reserve Board is clothed with power to restrict speculation through the medium of restriction of credit, the extent to which it would do it would be a matter for further judgment.

Mr. BLACK. Precisely.

Senator STEIWER. And from time to time.

Mr. BLACK. Yes.

Senator STEIWER. And Congress could have no way of knowing now, while considering proposed legislation, the extent to which you might see fit to restrict credit to business of this country.

Mr. BLACK. Well, I would prefer to use the expression: "Restrict credit in prevention of undue or unwise or excessive speculation." I would rather leave out, "of the business of the country" I do not think that is comprehended in this bill. Further answering your question, Senator Steiwer, of course the Congress, if it gives the

Federal Reserve Board the power to exercise its judgment in this matter, could not be at this time advised as to what that judgment may be at sometime in the future.

Senator STEIWER. That is necessarily the fact, but I was wondering what your viewpoint was.

Senator TOWNSEND. You do not feel that you have sufficient authority, then, under the Glass-Steagall Bank Act, to do this thing proposed here?

Mr. BLACK. Well, we have very great authority in restricting speculation under the Glass-Steagall bill. We have the right, for instance, to regulate reserves, to increase reserves; we have the right to tell a bank that it cannot make any further security loans. We have the right to fix the amount of security loans that a bank can take. We have the right to take other steps for the prevention of undue speculation in accordance with the wishes of the Secretary of the Treasury. But I think this is another provision.

Senator TOWNSEND. Then this is giving additional power?

Mr. BLACK. Yes, sir.

Senator GORE. In that connection let me ask you if you have reached any conclusion on this point. In 1927 a good many people felt that the rediscount rate was made too low; that it encouraged an over-use of credit, accelerated a misuse of credit, and paved the way for the crisis in 1929 and the depression which followed. Other people felt that the Federal Reserve Board could have raised its rediscount rate in 1928 and 1929 even more than it did, could have then put on the brakes I rather doubt the latter, but think there is a good deal of truth in the former charge.

Now, Governor Black, what is your conclusion about it, if you have given it any critical thought?

Mr. BLACK. Senator Gore, you are now taking me back to 1927, 1928, and 1929, I believe?

Senator GORE. Yes. When the rediscount rate was very low, in September of 1927, some people alleged that in that action, to get gold, it was not for our own purpose——

Mr. BLACK (interposing). Of course, I was not on the Federal Reserve Board at that time, although I am not saying that by way of excuse, and I think they were really doing it to try to spur business in America. And I think in 1928 and 1929 we did everything on earth we could to stop, as far as we could, the drunken debauchery in speculation. But I do not believe any board on earth could have stopped it at that time.

Senator GORE. I doubt it, too. But do you think it is possible to devise any sort of mechanism that can stop the runaway passion for gambling, like that was?

Mr. BLACK. I do not believe at that time it could have been stopped. I think marginal requirements, with stocks going up every day, would not have been effective. They might have been a deterrent. I think the discount rate, when men were making 20 or 30 or 40 percent a day on stocks in gambling would not have stopped it. It might have been a deterrent. But I think we are now coming into saner times, and——

Senator GORE (interposing). Well, that is what we always think.

Mr. BLACK. Well, I hope so at least.

Senator McAdoo. Temporarily, anyway.

Mr. Black. I hope so.

Senator Gore. But it takes time for such a gambling passion to accumulate, and yet it does accumulate every time such a situation arises.

Mr. Black. I think that is true. I want to say that I went through the gambling in Florida, and that I was there before the stock exchange situation started. So that perhaps I am rather an expert on gambling.

Senator Gore. But you did not sell short down there.

Mr. Black. I sold it both ways, and lost at each end. [Laughter.]

Senator Gore. Then you qualify as an expert on it.

Mr. Black. Yes, sir.

Senator McAdoo. I should like to ask two questions: First, in this proposed legislation we establish by statute 40 percent as a marginal requirement. Now, I should like to ask you if you think——

Senator Gore (interposing). It is 60 percent here.

Senator McAdoo. Well, 60 percent, or whatever it is. I want to ask you, Governor Black, if you think it wiser to establish an inflexible margin like that in a statute, or to leave it to an administrative board, like the Federal Reserve Board, to regulate that matter from time to time to meet the conditions as they may develop?

Mr. Black. Senator McAdoo, my own opinion about that in the beginning was that there should be perfect flexibility in the matter of margin requirements, and that it should be left to the regulatory body. Now, since that time, I have thought about it a great deal. I think the whole purport of this bill is to restrict speculation, to prevent undue speculation, to guarantee fair practices in speculation, and to get undue credit out of the excesses of speculation. And so far as I am concerned as Governor of the Federal Reserve Board, I am perfectly willing for Congress to give expression, and that is what this is meant to be, to what they think the marginal requirements should be. Now, then, there is a further provision in this bill, in the same section, that the Federal Reserve Board under certain circumstances can change the margin requirements. Personally, I would rather that were more flexible. But——

Senator Kean (interposing). In other words, do you mean to say that you would prefer, because this margin business figures out into absurd figures in some cases, to have it left entirely to the Federal Reserve Board?

Mr. Black. I would be perfectly willing for the Federal Reserve Board to take the responsibility for that.

Senator Gore. Do you think it could resist the pressure when the flood tide comes? Don't you think the dam would break? This is imperfect, of course, and we appreciate it, but I remember in 1929 when the race was running high, any suggestion by way of raising the rediscount rate provoked a storm of protest, and I do not think any human beings would have been able to withstand it, or at least not any in politics.

Senator McAdoo. The rediscount rates attempted to control it, but they did not have either the teeth or the capacity to control it or to properly influence it. I think as Governor Black says a provision for increased reserve requirements would be very much more

effective. But, Governor Black, I should like to get you back, if I may, to the other question, as to whether or not I am correct in my understanding that you prefer to have minimum marginal requirements established in this bill rather than to have a determination of those marginal requirements established through regulation from time to time by the Federal Reserve Board.

Mr. BLACK. Senator McAdoo, I think the wisest course would be for Congress to express its opinion in the bill. And then widen the provision as to flexibility, leaving variations from the expressed opinion of Congress, to the judgment of the Federal Reserve Board.

Senator MCADOO. Well, that would cover the point. That gives it some flexibility. Are the provisions of the bill such that you do have that flexibility?

Mr. BLACK. The provisions of the bill do not give us that degree of flexibility.

Senator MCADOO. You think it would be wise to insert it after the expression of opinion of the Congress in the bill?

Mr. BLACK. If the Congress is in accord with me, with my view about that; yes.

Senator MCADOO. Well, now, one other question: You heard the brief statement made by Mr. Cotton a moment ago about municipal bonds, State bonds, and bonds of political subdivisions. What is your idea about exempting them?

Mr. BLACK. My recollection about that is that they are not listed as exempted securities, but that the power is vested in the Federal Trade Commission to exempt them.

The CHAIRMAN. That is right.

Senator TOWNSEND. Should that power be vested in the Federal Trade Commission or in the Federal Reserve Board?

Mr. BLACK. In the Federal Trade Commission.

Senator KEAN. That will only leave them subject to every little school district, every little town in the country, having to apply to a bureau of the United States for permission?

Mr. BLACK. So far as I am concerned I would not object to making municipal, county, and State bonds as exempt securities, if that is what you are asking me.

Senator MCADOO. Yes; that is what you are being asked.

Senator GORE. It has been suggested that if the margin dropped down to 59 percent a customer would be sold out arbitrarily. Is that your understanding?

Mr. BLACK. That is as to new loans. As to old loans, they are protected.

Senator GORE. That is, current accounts are exempted?

Mr. BLACK. Yes, sir.

Mr. PECORA. The revised bill modifies that section of the original bill.

Senator GORE. And that was in the original bill?

Mr. PECORA. Yes.

Senator GORE. That was too arbitrary, in my judgment.

Mr. PECORA. That has been considerably modified in the revised version of the bill.

Senator GOLDSBOROUGH. To what extent has it been modified?

Mr. PECORA. To the extent that the revision allows for a sag of 20 percent in the market price before——

Senator GORE (interposing). Well, then, that covers that objection now?

Mr. PECORA. Yes.

The CHAIRMAN. Have you anything further, Governor Black?

Mr. BLACK. Mr. Chairman, these gentlemen seem to be especially interested in this matter of the marginal requirements. I have some intensive data on that which is very interesting to me, and if the committee would like to have it——

Senator GORE. Yes; let us have it.

The CHAIRMAN. You may go ahead and give it to us.

Mr. BLACK. The principal differences between the margin provisions of the revised bill and those of the first draft are as follows:

1. Loans are permitted up to 100 percent of the lowest value for the preceding 3 years (except as stated in the next paragraph) instead of 80 percent of such value—but a maximum limitation of 75 percent of current market value is established in the revised bill. In both bills loans may be in any case at least as much as 40 percent of the current market price.

2. The new bill provides that until July 1, 1936, the lowest price since July 1, 1933, is taken in lieu of the lowest price for the preceding 3 years. The effect of this is to eliminate the extremely low prices of 1932 and early 1933 as limiting factors upon loan values.

3. Provision is made in the new bill for maintenance of credits up to certain points after accounts have become undermargined. For instance, an initial loan of 75 percent need not be closed out in an adverse market as long as it does not exceed 85 percent of the current market price, and an initial loan of 40 percent need not be closed out as long as it does not exceed 60 percent of the current market price.

4. Under the new bill loans outstanding at the time of the enactment of the act are permitted to be continued, with certain restrictions as to substitutions and withdrawals, until January 1, 1939.

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

6. Under the new bill, as contrasted with the old 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.

7. Under the original bill administration of margin requirements was vested in the Federal Trade Commission, which could increase but not lower margin requirements. Under the new bill, control over margin requirements is placed under the Federal Reserve Board, which may increase margin requirements and, in certain extraordinary circumstances, may also decrease such requirements.

8. The new bill directs the Federal Reserve Board in cooperation with the Federal Trade Commission to study the feasibility of fixing maximum loan values on the basis of earnings, and on other bases, and to submit its recommendations to Congress on or before January 3, 1935.

NOTE: Regulation of short selling is vested in the Federal Trade Commission in both bills. This appears to carry with it the control of margin requirements on short sales.

Summary of margin provisions, original and revised stock exchange bills

	Original bill	Revised bill
1 Maximum loans, when based on lowest prices		
(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 prices		
(a) Initial loan (percentage of market)	40	40
(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

Now, Mr. Chairman, here is a little memorandum of the operation of the margin provisions of the bill:

Application of the margin requirements of the stock-exchange bill to a selected list of leading stocks traded in on the New York Stock Exchange indicates that on the basis of current market prices the maximum of 75 percent could be borrowed on a large number of important securities; on many other securities between 60 and 70 percent could be borrowed; and the limit of 40 percent would apply to few stocks.

On a number of the securities on which 75 percent could now be borrowed, the loan could be further increased with a rise in price, that is, the maximum loan now permitted does not equal 100 percent of the lowest price reached since July 1, 1933.

In general, it appears that the margin provisions would operate as follows:

1. Securities with relatively stable prices would carry the higher-loan percentages.

2. Securities that have been declining in price would carry the higher-loan percentages.

3 Lower loan percentages would apply to securities that have risen more than 33 percent from their lowest prices.

4 The lowest loan percentage—that is, 40 percent—would apply to securities that have risen more than 150 percent from their lowest prices.

Now, as compared with present margin prices as established by the rules of the New York Stock Exchange, let me give you something on that:

The rules of the New York Stock Exchange prescribe margins of at least 30 percent of the debit balance for accounts as large as $5,000, and at least 50 percent of the debit balance for smaller accounts. Translating these requirements into the terms used by the bill, they provide in effect for loan values up to 76.9 percent for the larger accounts and 66.7 percent for the smaller accounts.

It should be noted, however, that these are the requirements below which the broker must not permit the customer to go. In practice the broker would presumably be exacting higher margins; that is, lower loan values. The 76.9 and the 66.7, therefore, are probably more comparable with the 60–85 range within which margins must

be maintained under the revised bill than with the range 40–75 prescribed for the initial extension of credit to customers.

However, it is not known exactly what margins are being maintained by customers in practice.

The CHAIRMAN. One criticism, I think, has been urged that the Federal Reserve Board might not be able to act promptly and quickly in case of change of prices, and so forth; that their authority to vary the margin might be covered in a general way, and that they might lay down general regulations, but could they act quickly enough, for instance, during the day when prices are going up or down. What have you to say about that?

Mr. BLACK. They could act only in compliance with this law, in which you allow them to execute higher margins whenever they want to, but lower margins only under very exigent circumstances. The Federal Reserve Board, in order to have credit control, if this Congress wants them to have it, is perfectly willing to go ahead with this bill. My personal opinion is that the margin requirements in order to be scientific should be more flexible.

The CHAIRMAN. I think Mr. Potter testified before the committee, referring to the powers of the Federal Reserve Board to prevent any such occurrences as October of 1929, that if they had acted quickly enough they could have checked that situation.

Mr. BLACK. Well, Mr. Chairman, a great many of these people who criticize the Federal Reserve Board could be criticized themselves in the management of their own institutions. If they had been a little less liberal themselves they wouldn't have had complaint of the Federal Reserve Board. Mr. Chairman, when anybody attacks the Federal Reserve Board, I try to come right back at them.

The CHAIRMAN. Well, I did not understand that Mr. Potter was attacking the Federal Reserve Board but was merely expressing his opinion of that situation.

Mr. BLACK. I have a very great respect for Mr. Potter, and a warm personal feeling for him, and I was not referring to his institution, but that is my opinion of a great many institutions.

Senator MCADOO. One further question: The purpose of this bill is to restrain speculation, and it proceeds upon the theory that all speculation is bad and ought to be suppressed. Now, if you are going to be thoroughly effective in that, I should like to know if you would think it wise to require that all transactions on exchanges be on a cash basis, that a purchaser must buy his stock and pay for it, and if he has to have any additional money that he will go to a bank and borrow it, that he will there get the credit he needs if he can. Would that, in your opinion, be a wise thing? That is, to go the whole hog at once and be done with it? I am not expressing any opinion myself, but am asking you for an expression of opinion on the matter.

Mr. BLACK. I think it would be too drastic a step to take at once. But my best recollection is that that is the process in England.

Senator BULKLEY. Will you answer that question without regard to the time element; that is, as to how long you might give to put it into effect; would it be a good system ultimately, regardless of the embarrassment of the time it might take to put it into effect?

Senator MCADOO. Senator Bulkley, I was just going to ask Governor Black that very question.

Mr. BLACK. Senator Bulkley, there are two very strong views about that. One of them is that it would be a good thing to do.

Senator BULKLEY. What is you view of it?

Mr. BLACK. I think ultimately it might be a good thing to do.

Senator MCADOO. How much time do you think would be necessary for a reasonable transition period?

Mr. BLACK. I think it would be such a drastic step to take with the markets of America that it should not be done within any less period than you have here about your long-time loans, and I think it should not be done without a very exhaustive study, to see what effect it will have. I should like to answer your question directly, but it is a very hard question to answer.

Senator BULKLEY. What would be the nature of the exhaustive study you suggest?

Mr. BLACK. I think I should like to know exactly how it operates in England, what are the factors relative to it in England, what are the practices in England, if I am correctly advised that that is the practice in England, and I think I am correct about it

Senator KEAN. That is the practice in London.

Mr. BLACK. I think so.

Senator KEAN. This country is a good deal bigger than England.

Mr. BLACK. I said I wish I could answer your general question directly on that, but I cannot do it.

Senator GORE. In this connection I want to ask a question. Senator McAdoo asked you and you stated a while ago that the purpose of this bill was to stop speculation. In your mind don't you make a substantial and real distinction between "speculation" and "gambling"?

Mr. BLACK. I sort of prefer gambling. You are there and know what you are doing.

Senator KEAN. You prefer puts and calls?

Mr. BLACK. I prefer poker, Senator.

Senator GORE. I might agree with you there, but, to make it literal, do you think that all speculation ought to be prohibited?

Mr. BLACK. No, sir. I do not. I think it is absolutely necessary in America to have stock exchanges in order to have a free market for equity securities in America.

Senator GORE. And legitimate speculation, if you want to call gambling illegitimate speculation and the other category legitimate speculation, that might represent the point I have in mind, and the point to which I want to get your reaction. I think if you stop all legitimate speculation, that is, people who, after investigating all the facts, reach the conclusion that the stock will go up and there will be improvement in business and an increase in its earnings and it is bought for a rise—I do not think that is any crime. It ought not to be in law and in morals. It is not in morals.

Mr. BLACK. I do not either, Senator, and I would like to be distictly understood as favoring the maintenance of national securities exchanges in order that there may be a perfectly free market in America for securities.

Senator GORE. A market place where people who want to buy securities can buy, and where people who want to sell can sell.

What I have in mind by gambling is this: We had it here in 1929. People—janitors and judges, as well as waitresses and heiresses—

bought stock today because they thought they could sell it for more tomorrow, without any regard to the physical properties in the business, the management, the earnings, prospects, or anything else. That is what I characterize as gambling. That is what we want to stop.

Senator COUZENS. That is what the governor says he is driving at.

Senator GORE. Yes; I want to get that on the record, because just to say stop speculation in this country is not quite accurate.

The CHAIRMAN. No one has contended that we should not check that kind of thing.

Senator ADAMS. Senator McAdoo said that the purpose of the bill was to stop "all speculation."

Senator COUZENS. Well, he assumed a premise that I think is not in the bill.

Senator MCADOO. No; I said on the presumption, as I recall it, that that was the intention. I did not say that it was. I agree with Senator Gore and with Governor Black that we ought to stop the evils of speculation.

Senator ADAMS. I think what we are trying to do is to stop using loaded dice.

Senator MCADOO. I think we ought to preserve the markets as a place for legitimate buying and selling. The point is to get rid of wild speculation on these exchanges, because they do render a useful service and create a liquid market.

Mr. BLACK. Unquestionably.

Senator MCADOO. A market which is there for special business transaction. I do not like to be misunderstood or misconstrued in questions that I ask you, because I merely want to bring out the argument without having it indicated at all that the questions I asked represent any contentions or views of my own

The CHAIRMAN. Governor, I would like to ask you this question: Some telegrams and letters have come to me expressing apprehension that the business of the country would be greatly and adversely disturbed by this kind of legislation. Do you see anything in this bill that would cause that sort of reasonable apprehension? Do you think business will be harmfully affected if we pass this bill?

Mr. BLACK. I haven't any apprehension about that. I think we have gone through a great many radical changes in the past year trying to better conditions in America: I have heard the same prophecy and I have not seen the result.

Senator CAREY. Governor Black, I would like to ask you if you think it is better to have the margin fixed in the law or to leave it to the discretion of the Federal Reserve to fix it?

Senator COUZENS. The Governor answered that question before you came in, Senator.

Senator CAREY. I was not here.

Mr. BLACK. I will be glad to answer it again. I would be perfectly willing for the margins to be named as they are in the bill for the purpose of indicating the expression of the views of Congress relative to them. I would be willing even to operate under the bill with the power given to the Federal Reserve Board relative to margins. I think that as a matter of scientific operation of credit there should be more flexibility vested in the Federal Reserve Board relative to margin requirements.

Senator KEAN. And Governor Black has already said that he thought the Federal Reserve could regulate these margins, as they were charged with regulating credit.

Senator GOLDSBOROUGH. Governor Black, referring to margin requirements, which you outlined so definitely a moment ago, is not the understanding current among the bankers and brokers and customers throughout the country that they have always figured their margins on loans on the debit basis?

Mr. BLACK. I think that is correct.

Senator GOLDSBOROUGH. If that is correct, sir, do I understand that 60 percent of the current market price would be 150 percent of the debit?

Mr. BLACK. The way they figure it; yes.

Senator GOLDSBOROUGH. And 40 percent would be 66⅔ percent?

Mr. BLACK. Figured on a debit balance, yes, on their present practice. There is not any question about these margin requirements requiring more cash paid on stock, Senator. That is the purpose of it.

Senator GOLDSBOROUGH. I think that is very evident by the requirements.

Mr. BLACK. That is the purpose.

Senator COUZENS. Is not the provision of this bill more liberal than the present rules and regulations of the stock exchange?

Mr. BLACK. Senator, I cannot answer that question.

Senator COUZENS. I thought you in part answered it when you gave us those figures awhile ago.

Mr. BLACK. Well, I would not say they are more liberal. You mean as to marginal requirements?

Senator COUZENS. Yes.

Mr. BLACK. I would not say they are more liberal.

Senator COUZENS. Is there any great difference between the rules and regulations of the stock exchange on margins and as provided in the bill?

Mr. BLACK Only as I read from that memorandum.

Senator COUZENS. That is what I thought. As I interpreted the memorandum that you read, the bill is somewhat more liberal than the present rules and regulations of the stock exchange.

Mr. BLACK. I do not think that is correct

Senator MCADOO. I understood him to say that this revised bill was more liberal than the previous bill but not more liberal than the stock exchange.

Senator COUZENS. Yes; but I think there is a margin of 30 percent.

Mr. BLACK. They are not more liberal than the stock exchange

Senator MCADOO. They are less liberal, as a matter of fact——

Senator KEAN. Governor Black, we had before us Mr Potter, of the Guaranty Co., and Mr. Johnston, of the Chemical Bank. Mr. Johnston said he agreed with Mr. Potter He had read the statement made by Mr. Potter, so he agreed with that statement. In that statement Mr. Potter said that if these rules for margins were put into effect at once, why, it would mean a decrease or a liquidation of loans in his bank to a very large amount, and also the Chemical Bank.

Mr. BLACK. If I understand the provisions of the bill, that protection is granted for 5 years on existing loans

Senator KEAN. If they carry a loan, but nobody is going to carry a loan—at least I never have—for 5 years

Mr. BLACK. Then they have 5 years in which to work it out.

Senator KEAN. No; because your customers buy and sell and you have got to make substitutions, and as soon as you make substitutions you come under the new rule.

Mr. PECORA. Senator Kean, Mr. Potter's observations were based upon the provisions of the original bill.

Senator KEAN. Surely.

Mr. PECORA. The revised bill contains the provision that Governor Black has alluded to, which allows virtually a 5-year period for the liquidation of existing margin accounts unless they are brought up to the standards fixed by this bill.

Senator KEAN. Unless you make substitutions.

Mr. PECORA. Substitutions have to be made, of course, in accordance with the bill.

Senator KEAN. And that changes your whole loan

Mr. PECORA. No; it does not change the whole loan, in my opinion. It prevents a utilization of existing margin accounts for the purpose of evading the provisions of this bill. It maintains margin accounts now existing in their present status It preserves their status, but will not permit of the utilization of those accounts as a means of evasion of the bill. The fear expressed by Mr. Potter and by other opponents of the original bill, as I interpret their opposition here, was that under the original bill a forced liquidation would be compelled by the time the bill went into effect, which was October 1 next. Now, that period has been extended to January 1939.

Senator KEAN. Mr. Chairman, most of these brokers' loans are made day-to-day loans. They are callable any time from 11 in the morning till 1 in the afternoon; and I assert, and I think I am correct, that there is no broker that has a loan that has run for 5 years or 3 years or 2 years All loans are paid off long, long before that, unless it is a special loan made on special terms with the institution.

Therefore, all brokers' loans would come within a year under this clause.

Senator COUZENS. Yes; but you referred awhile ago to the bankers' objections, and that has been overcome.

Senator KEAN. No; I do not think it has, because these loans would not run that time. They are brokers' loans.

Mr. PECORA. Senator Kean, may I call your attention to the provisions of the revised bill appearing on page 18 of the House draft, subsection (f):

> The provisions of this section shall not apply on or before January 31, 1939 to any loan, renewal or extension thereof, made on any security or securities prior to the enactment of this act, or on any exempted securities and/or securities registered in a national securities exchange substituted therefor

So that that provision is certainly broad enough to take care of the situation that you have in mind, sir.

Senator KEAN. Mr. Chairman, I cannot agree with the counsel for the committee that that broadens the question that I have in mind, because a client comes in today and buys a hundred shares of stock and we borrow the money for him, and within 2 weeks or 3 weeks he comes in and sells that stock and buys another share of stock or something or other. Those loans do not run for the periods

that I am telling you are in the bill, and they cannot possibly run. We have got to make substitutions for new customers. We have got to make substitutions under the loans. And therefore the loan becomes a new loan or it is called.

The banks do not carry these loans. The banks vary every day. One day they are debited a million dollars at the clearing house. The next day they are credited with a million dollars at the clearing house They send that money down to the exchange to be loaned for their account. That money is loaned for their account, and they call 1 day for the loans or a part of their loans. The next day they loan so much money. So that the loans are swinging back and forth between different institutions all around the street.

Mr. PECORA. If it were your purpose to preserve existing margin accounts in the fashion that you indicate, you would be announcing right now to the world that any margin accounts established prior to the enactment of this act on any margin basis lower than the provisions called for by this act with respect to new margin accounts could be utilized for all time to come.

Senator KEAN. No.

Mr. PECORA. As the credit basis for the operation of that account; and you would take all existing margin accounts and constitute them wide-open doors to evade the provisions of this act.

Senator KEAN. No. What I am saying is——

Mr. PECORA (interposing). You might just as well not enact the act, because anybody could establish a margin account between now and the date of the act going into effect, unless this bill were properly drawn to prevent such an evasion, and thoroughly escape the consequences of this act so far as margin provisions are concerned.

Senator KEAN. Not at all, Mr. Chairman. That is not what I am driving at at all. Counsel is trying to put words in my mouth which I did not say, which I do not mean. What I say is that these loans will all be paid off and changed within a year, so that this 5-year plan does not mean anything.

The CHAIRMAN. We get the point, Senator.

Senator GOLDSBOROUGH. May I ask Governor Black just one more question? Governor, may I direct your attention to section 6 (a), on page 13? Does this section still leave unprovided for all unregistered securities?

Mr. BLACK. May I read it, Senator?

Senator GOLDSBOROUGH. Certainly.

Mr. BLACK (after perusing section). It appears to do so.

Senator GOLDSBOROUGH. It does. That is all.

Senator TOWNSEND. Governor Black, does the Federal Reserve bank, or banks, often find it necessary in order to stabilize Government obligations to buy and sell Government securities?

Mr. BLACK. Senator, you mean do we buy and sell Governments for the purpose of making a market?

Senator TOWNSEND. In order to stabilize the market.

Mr. BLACK. I do not think we do that, sir.

Senator MCADOO. The Treasury does that, doesn't it, Governor?

Mr. BLACK. Well, if it is done, the Treasury does it. Let me put it that way, Senator.

Senator GORE. It would not be a proper function of the Federal Reserve bank?

Mr. BLACK. No, sir; the Federal Reserve bank.

Senator TOWNSEND. If it is done by the Treasury Department would not subsection 8 of section 8 (a), page 23, prohibit that—

To engage in any series of transactions for the purchase and sale of any security registered on a national securities exchange or any security not so registered, which has the purpose of pegging, fixing, or stabilizing the price of such security—

And so forth?

Mr. BLACK. I think governments are exempt from the operation of it.

Mr. PECORA. There is a general clause here, Senator Townsend, which exempts Government securities from the provision of this act.

Senator TOWNSEND. Then the pegging of a Government security would stand in a separate category from pegging other securities; is that the idea?

Mr. PECORA. Government securities are exempt from the provisions of this act.

Senator MCADOO. The Government may do what the individual cannot do.

Mr. PECORA. What the Government does is done for the public good. What individuals do is presumed to be done for their individual good.

Senator TOWNSEND. That may be true and it may not be true.

Senator ADAMS. Mr. Pecora, were you saying that it exempted the Government or it exempted dealers in Government securities?

Mr. PECORA. It exempts Government securities from the provisions of this act.

Senator ADAMS. There is no provision prohibiting a banker or a broker from buying and selling Government securities for the purpose of stabilizing or affecting the market?

Mr. PECORA. I think that is correct, sir.

The CHAIRMAN. There is no evidence that that practice prevails.

Senator MCADOO. Governor, I would like to ask just one more question, and I would like to revert to the administrative feature that we discussed a bit ago, the difficulty of administering these margin requirements and all.

Would it in your opinion simplify that machinery and add to the effectiveness of the policing if on each stock exchange in the country there were a Government representative, in other words, a Government agent or a Government director or Government governor, who had no responsibility for the operation of the exchange but who was there to represent the public interest to see that the exchanges complied with the law?

Mr. BLACK. Senator, I personally would dislike to see that done very much.

Senator MCADOO. We do that with the banks, because we have a Federal Reserve agent and a chairman of the board, and he has three Government directors on this board.

Mr. BLACK. Senator, I believe the exchange is going to comply with your rules.

Senator MCADOO. I think they will.

Mr. BLACK. I would hate to think of the necessity of a man having to see it done.

Senator McAdoo. Well, we thought the Federal Reserve directors would comply with the rules too, but in order to make sure of it we appointed three Government directors on each one of these boards.

Mr. Black. Well, I have just answered your question as best I can. Personally, I would not like that at all.

Senator Gore. The Federal Reserve Board is a quasi-Government institution.

Senator Townsend. This language says in section 8 (a):

To engage in any series of transactions for the purchase and sale of any security

Mr. Black. "Registered on a national exchange"—well, that is correct. But there is another provisions in this bill that this act does not apply at all to exempted securities, and governments are exempted securities. If I am wrong about that I would like to be corrected.

Senator Kean. Governor Black, as I said before, Mr. Percy Johnston and Mr. Potter were down here. They testified that if this bill—and that was the old bill but it was practically this bill—if this bill went into effect it would mean a large liquidation of the loans in their banks, and they figured that out. Now, wouldn't you think that was probably so if they had figured it out?

Mr. Black. If those gentlemen have figured it out and state it, I would put a great deal of reliance on the statement of those two men. I think they are both perfectly straight and perfectly honorable and perfectly capable. But that may be one of the things that is desired in connection with this bill, Senator—I don't know.

Senator Kean. What study did the Department make of this bill? I am talking now from the stock-exchange standpoint. What study did they make about the practices, and so forth, of the stock exchange?

Mr. Black. You mean the Federal Reserve Board?

Senator Kean. Yes.

Mr. Black. And the Treasury Department?

Senator Kean. Yes.

Mr. Black. And the representatives of the committee?

Senator Kean. Yes.

Mr. Black. Well, we consulted with some experts. We are not experts on this question, Senator. And if you will note in my statement, I have put a provision in that I would like to make such suggestions relative to the technical parts of the operation of this bill as may seem necessary.

Senator Kean. And in regard to these call loans, why, you think that this provision of 5 years would really not be effective from the causes that I have named?

Mr. Black. I think probably it would affect them very considerably, relative to brokers' loans in banks.

Senator Kean. In other words, all loans would be changed in the course of a few weeks?

Mr. Black. I think that is correct, Senator.

The Chairman. Any other questions of Governor Black? If not——

Mr. Black. Mr. Chairman, may I bring up one other matter that the Board has asked me to submit to the committee?

The Chairman. Very good, sir.

Mr. BLACK. We have made recommendations a number of times that reserve requirements of member banks be changed, and be based upon velocity of turn-over rather than to be fixed. It has been studied very exhaustively. During the consideration of the Glass bill we sent up a proposed bill to that end.

By basing reserves upon velocity of turn-over we would automatically correct a great many of these abuses. I would like very much to leave a report of our committee on that with your committee and have your committee give study to that, either in connection with this bill or independent of this bill.

Senator MCADOO. What is that, the velocity of what?

Mr. BLACK. The velocity of turn-over of a bank, instead of having fixed reserve requirements.

Senator GORE. Now, Governor, on that point, don't you think it would be a good idea to allow the Federal Reserve Board to have the power to enforce either requirement? I have understood that the velocity of circulation might be prejudicial to the small banks of the country, whereas it would be applicable to the big banks in the big cities.

Mr. BLACK. I think it would be prejudicial to the big banks, if you want to use the word " prejudicial."

Senator GORE. Yes.

Mr. BLACK. I think it would be more restrictive of the big banks and a great deal less restrictive of the small banks.

Senator GORE. The point has been made that the velocity of circulation taken as a basis of the bank would not be equally applicable, but if the board had the power to apply one standard in one particular set of banks and another in another, it would meet the varying circumstances of the the two categories. Don't you think that would be better than tying our hands and limiting it to either one and excluding it from the other.

Mr. BLACK. Senator, I think this is a scientific way to do it for all banks.

Senator ADAMS. Governor Black, what do you mean there by " velocity of turn-over "?

Mr. BLACK. Well, suppose, like times are now, banks are doing very little, very little business going on, very little speculation going on. You will find a small turn-over for most banks. The drawing on accounts by customers is very small.

Senator ADAMS. You mean the total amount of business in relation to the total resources of the banks?

Mr. BLACK. To the total deposits of the banks.

Senator ADAMS. Total deposits

Mr. BLACK. In times of excessive speculation that turn-over is very rapid; and, gaged by the turn-over, if the reserve requirements automatically followed the turn-over as it went up or went down, you would have a very good check on the use of credit in speculation.

Senator ADAMS. Then you would increase the reserve requirements as the turn-over increased in velocity?

Mr. BLACK. That is correct, sir. I would like very much to be allowed to leave that memorandum with the committee and ask that they give study to it, because the Board is very strongly committed to the view that it aids very largely in the solution of the problem we have before us.

Senator GORE. Do you have copies of it, Governor?

Mr. BLACK. Senator Gore, I will be glad to send you copies.

Senator KEAN. Will you send one to me, too?

Mr. BLACK. I will, Senator. I am not suggesting that so much in connection with this bill, because I would hate very much to be put in the position of thinking that I have thrown some other factor in this bill, but I would like very much for the committee and counsel for the committee to study this problem, because it can be done just as well independent of this bill as in connection with the bill.

The CHAIRMAN. I doubt if it is relevant to this particular matter, but the committee as a whole will receive it and it may be in the record so as to preserve it.

Senator ADAMS. It would have the effect of operating as a deterrent to excessive speculation?

Mr. BLACK. Automatically.

I am asking you now, please, not to be misunderstood; to consider that this is suggested in connection not with this bill necessarily but simply that the committee will study it, because we believe that it is an automatic check on this kind of speculation.

(The matter submitted by Mr. Black at this point will be found in the record at the end of Governor Black's testimony.)

Senator TOWNSEND. What treatment is given to savings banks under this bill; the same as the Federal Reserve banks?

Mr. BLACK. The same as any other bank.

Senator TOWNSEND. The same as any other bank?

Mr. BLACK. In reference to brokers' loans or loans on equities.

The CHAIRMAN. Governor, our plan is to close the hearings entirely on this bill and the proposed amendment to the bill tomorrow. You suggest in your statement that you may have something further to submit as a result of further study. Could you let us have that early next week?

Mr. BLACK. Yes; I will.

The CHAIRMAN. Is there anything else?

Senator MCADOO. Just one question I would like to ask the Governor. It is not altogether germane to this bill but relating to the question of reserves and the liquidity of banks, which is always a troublesome problem. I again wish to say that I am not expressing an opinion in this question; I am merely asking for information

Would you think, Governor, that there was any virtue in the idea that all reserves for banks be dispensed with, and in lieu thereof that they should be required to keep liquid by making loans to the extent of their deposits only on eligible paper, the definition of which might be expanded or enlarged, and they be permitted to invest their capital and surplus in other forms of securities?

Mr. BLACK I think they should keep their reserves, Senator.

Senator MCADOO. I mean if they were required to make their loans only on a liquid basis.

Mr. BLACK. I think they should keep their reserves.

Senator MCADOO. Suppose they keep their reserves as they are required and are permitted to make loans to the extent of their deposits on eligible paper only, the definition of which might be enlarged?

Mr. BLACK. I do not think you could restrict a bank's operations that way, Senator. You and I are not in business. Of course, this

is, as far as I am concerned, rather a far-flown thought, but I might be perfectly good for a thousand dollars.

Senator McADOO. Well, you have the capital and surplus at the bank to be employed in such loans

Mr. BLACK. But I do not think they would take care of what I would term personal loans.

Senator McADOO There are not any of those any more, are there?

Mr. BLACK. Senator, you are discouraging me in my thoughts.

Senator ADAMS. In the small outside banks the personal loans are a very substantial percent, and the smaller percent is eligible paper?

Mr. BLACK. That is true. You could not do that, because you cannot obtain eligible paper.

Senator McADOO. You would have to enlarge the definition, of course.

Senator KEAN. I am going to ask Governor Black a disagreeable question.

Mr. BLACK. I have had so many since I got to Washington it does not make any difference.

Senator KEAN. The law says that you shall discount, rediscount or discount, eligible paper and buy eligible paper. It specifies that it shall be commercial paper given for a transaction. Now, then, how much paper of that kind is there?

Mr. BLACK. Very little, sir.

Senator KEAN. In other words, you are discounting paper every day which is not in strict compliance with the law?

Mr. BLACK. Senator, I am not going to confess here about it. [Laughter.]

Senator KEAN. I told you it was a disagreeable question. It was brought out by another Senator.

Senator McADOO. I recognize the necessity in any such idea as this of enlarging the definition of "eligible paper."

The CHAIRMAN. This does not apply to this bill. Let us discuss that later. Let us go on with this hearing. Any other questions? That is all very interesting, but we have other witnesses here to hear on this subject. If there are no other questions, Governor, we are very much obliged to you.

FEDERAL RESERVE BOARD,
Washington, March 24, 1934

HON DUNCAN U FLETCHER,
Chairman Senate Committee on Banking and Currency,
United States Senate, Washington, D.C.

DEAR SENATOR FLETCHER: At the hearing before the Banking and Currency Committee of the Senate yesterday on the so-called "stock-exchange bill", Governor Black of the Federal Reserve Board referred to a report on Member Bank Reserves submitted by the Committee on Bank Reserves of the Federal Reserve System and approved by the Federal Reserve Board He also read to the Committee a memorandum containing a brief review of the proposal to change reserve requirements as recommended by the Committee on Bank Reserves

With the thought that each member of the Banking and Currency Committee would desire copies of the material above referred to, Governor Black has requested me to send you a copy of the committee report and a copy of the statement which he read before your committee While there is included in the report of the Committee on Bank Reserves a proposed amendment to Section 19 of the Federal Reserve Act which would give effect to the committee's recommendations, it has been necessary to revise the amendment by reason of changes made in the law since the committee report was submitted, and, therefore, a

revised draft of amendment to Section 19 of the Federal Reserve Act in accordance with the committee's recommendations is also inclosed

Very truly yours,

CHESTER MORRILL, *Secretary*

MEMORANDUM REGARDING PROPOSED REVISION OF RESERVE REQUIREMENTS AS TO MEMBER BANKS

As an amendment to the bill regulating security exchanges, the Federal Reserve Board wishes to reiterate its recommendation made two years ago for basing member bank reserve requirements not solely on the volume of deposits but also on the rapidity of their turnover, in other words, on the extent to which the deposits are utilized

Member bank reserve balances are high-power money On the basis of one billion dollars of excess reserves, member banks can extend credit amounting to between ten and fifteen billion dollars without having to resort to borrowing at the Federal Reserve banks The volume of excess reserves at the present time is one and one-half billion dollars, and these excess reserves furthermore may increase greatly when a period of credit expansion sets in. Under existing law national banks can issue an additional seven hundred million dollars of bank notes, which when deposited with the Federal Reserve banks add to the reserves of member banks There is also still a billion or a billion and one-half of currency that has not returned from hoarding but is likely to be utilized and thus flow back into the banks when an expansion sets in. In these circumstances if an expansion of credit should get under way, the member banks will have a large volume of reserves without recourse to the Federal Reserve banks These banks therefore would be out of touch with the market and thus not in a position to exert a restraining influence through discount policy

The Board's proposal carries out to its logical conclusion the existing distinction between time deposits, which require a 3 percent reserve, and demand deposits, which require a 7, 10, or 13 percent reserve, depending upon the location of the bank The proposal would result in an automatic increase of reserve requirements when boom conditions arise and an automatic decrease of reserve requirements in times of depression The proposal furthermore has the advantage of making the increase in reserves applicable not to all banks in all localities alike, but rather to those banks in those communities only where excessive speculative activity is manifesting itself If this proposal were adopted, its operation, together with the authority existing under the Thomas Amendment to raise reserve requirements with the consent of the President when an emergency arises from excessive credit expansion, would make it possible for the Federal Reserve Board to combat the recurrence of speculative excesses The proposal, therefore, presents a logical complement to the bill for the regulation of security exchanges

The proposal would counteract two abuses that have developed under existing law and have created serious obstacles to credit control One is the evasion of reserve requirements by classifying as time deposits many deposits that to all intents and purposes are demand deposits, a practice that has developed since the classification of deposits in one or the other category has determined the volume of reserves that a bank must carry. And the other, the reduction of actual reserves carried through diminishing the volume of till money which under existing law does not count as reserve The proposal would permit banks within certain limitations to count their vault cash as reserves and would therefore close the door to the practice of greatly reducing actual reserves by diminishing cash holdings to a nominal amount

In times of great speculative activity, such as 1928 and 1929, the banks under a law like the one proposed would have had to carry three or four hundred millions of additional reserves and would, therefore, have had to increase their borrowings at the Reserve banks by that amount This would have greatly increased the power of the System to exercise a restraining influence at an early date On the other hand in times of depression when deposits are inactive member bank reserve requirements would diminish and there would be a decrease in the volume of idle funds that the banks would be required to carry as reserves In effect, the plan would supplement open-market operations by the Reserve banks, by withdrawing funds from the market under boom conditions and furnishing additional funds at times of depression

The plan would also work for a more equitable distribution of reserves as between city banks and country banks City banks, owing to their proximity to the Reserve banks, have been able to reduce their vault cash to a very small proportion of their deposits, while at country banks a much more considerable proportion has been necessary As a consequence the actual distribution of effective reserves differs from that contemplated by the law and is much more favorable to banks in financial centers. The Board's proposal would do away with this disparity

Most important of all, however, the proposed plan would result in an increase of reserve requirements not only at the time when such an increase will be in the interests of sound banking conditions but also at the spot where speculative excesses get under way, and at the banks where enhanced activity of deposits will be caused by a rising tide of speculation Big nation-wide booms develop at financial centers, and this proposal by imposing restraints on speculation in these centers without increasing the burden of idle reserves for banks in those communities to which the boom has not penetrated, will not only be more equitable but will serve the purpose of applying restraining influences automatically at the right time, in the right places, and to the right institutions

With the heavy responsibilities imposed upon the Federal Reserve System in connection with the possibilities of speculative expansion, the adoption of this plan would place into their hands an instrument that would be of great assistance in serving the interests of trade and industry by restraining the use of credit for speculative purposes.

Concretely under the proposal, member banks would be required to carry 5 percent reserves against their net deposits plus 50 percent of the amount of the bank's average daily debits to deposit accounts In order to avoid too heavy burdens in extreme cases, the proposal provides that in no case shall agggregate reserves required of a bank exceed 15 percent of its gross deposits

In computing their reserves, the member banks would be permitted to count as reserves a certain proportion of their vault cash At banks in cities near the Federal Reserve banks or branches, the banks would be required to carry four-fifths of their total reserves as deposits with the Federal Reserve banks, while at other banks they would only be required to carry two-fifths of their reserves as balances with the Reserve banks.

As an exhibit in connection with this statement I should like to submit the report of a committee of the Federal Reserve System on bank reserves presented to the Federal Reserve Board in 1931 Your attention is particularly called to the chart on page 10 of this report which shows that demand deposits and consequently reserve balances of member banks showed practically no increase during the period of the greatest credit expansion in 1928 and 1929, while bank debits during that period increased at a very rapid rate Another chart on page 19 of the report shows how under the proposed plan reserve requirements would have risen rapidly during the expansion and would have declined much more rapidly than actual reserves after the depression set in.

A BILL TO amend Section 19 of the Federal Reserve Act as amended

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That Section 19 of the Federal Reserve Act, as amended, is further amended and reenacted to read as follows:

"RESERVES OF MEMBER BANKS

"SEC 19. (a) Each member bank shall establish and maintain reserves equal to five per centum (5%) of the amount of its net deposits, plus fifty per centum (50%) of the amount of its average daily debits to deposit accounts: *Provided,* That any member bank, at its option, for any period not less than 90 days, may omit any specific deposit account or accounts from such computation of its reserve requirements if such account or accounts are reported separately to the Federal reserve bank and if a reserve of 50% is maintained against such account or accounts: *Provided, however,* That, in no event, shall the aggregate reserves required to be maintained by any member bank exceed fifteen per centum (15%) of its gross deposits.

"(b) Each member bank located in the vicinity of a Federal reserve bank or branch thereof shall maintain not less than four-fifths of its total required

reserves in the form of a reserve balance on deposit with the Federal reserve bank, and every other member bank shall maintain not less than two-fifths of its total required reserves in the form of a reserve balance on deposit with the Federal reserve bank The remainder of the total required reserves of each member bank, over and above the amount required to be maintained in the form of a reserve balance on deposit with the Federal reserve bank, may, at the option of such member bank, consist of a reserve balance on deposit with the Federal reserve bank, or of cash owned by such member bank either in its actual possession or in transit between such member bank and the Federal reserve bank *Provided*, That when, in its judgment the public interest so requires, the Federal Reserve Board may limit to an amount less than that permitted hereunder the amount of cash which any member bank or banks may count as reserve *Provided, however*, That, in prescribing such limitations, the Federal Reserve Board shall be guided by the general principle that member banks should be permitted to count as reserve, within the limitations of this section, as much cash as they reasonably need in view of the character of their business and their degree of accessibility to the currency facilities of the Federal reserve banks

"(c) The term 'gross deposits', within the meaning of this section, shall include all deposit liabilities of any member bank whether or not immediately available for withdrawal by the depositor, all liabilities for certified checks, cashiers', treasurers', and other officers' checks, cash, letters of credit, travelers' checks, and all other similar liabilities, as further defined and specified by the Federal Reserve Board: *Provided, however*, That, in computing the amount of 'gross deposits', (1) amounts shown on the books of any member bank as liabilities of such bank payable to a branch of such bank located in a foreign country or in a dependency or possession of the United States, and (2) liabilities payable only at such a branch, shall be treated as though said liabilities were due to or payable at a nonmember bank

"(d) The term 'net deposits', as used in this section, shall mean the amount of the gross deposits of any member bank, as above defined and as further defined by the Federal Reserve Board, minus the sum of (1) all balances due to such member bank from other member banks and their branches in the United States and (2) checks and other cash items in process of collection which are payable immediately upon presentation in the United States, within the meaning of these terms as further defined by the Federal Reserve Board

"(e) The term 'average daily debits to deposits accounts,' as used in this section, shall mean the average daily amount of checks, drafts, and other items debited or charged by any member bank to any and all accounts included in gross deposits as above defined and as further defined by the Federal Reserve Board, except charges resulting from the payment of certified checks and cashiers', treasurers', and other officers' checks

"(f) The term 'cash' within the meaning of this section, shall include all kinds of currency and coin issued or coined under authority of the laws of the United States

"(g) The term 'reserve balances', as used in this section, shall mean a member bank's actual net balance on the books of the Federal reserve bank representing funds available for reserve purposes under regulations prescribed by the Federal Reserve Board

"(h) The term 'vicinity of a Federal reserve bank or branch thereof,' as used in this section, shall mean the city in which a Federal reserve bank or branch thereof is located, until such term is otherwise defined by the Federal Reserve Board: *Provided*, That with respect to each Federal reserve bank and each branch thereof, the Federal Reserve Board, from time to time, in its discretion, may either (1) define a specific geographic area as comprising the vicinity of such Federal reserve bank or branch thereof, within the meaning of this section, or (2) compile a list of member banks which shall be deemed to be located in the vicinity of such Federal reserve bank or branch thereof, within the meaning of this section, and add banks to, or remove banks from, such list, from time to time: *Provided, however*, That, in defining such areas and compiling such lists, the Federal Reserve Board shall be guided by the general principle indicated in subsection (b) hereof.

"(i) With respect to each member bank, the term 'Federal reserve bank', as used in this section, shall mean the Federal reserve bank of the district in which such member bank is located

"(j) The Federal Reserve Board is authorized and empowered to prescribe regulations defining further the various terms used in this Act, fixing periods over which reserve requirements and actual reserves may be averaged, determining the methods by which reserve requirements and actual reserves shall be computed, and prescribing penalties for deficiencies in reserves Such regulations and all other regulations of the Federal Reserve Board shall have the force and effect of law and the courts shall take judicial notice of them.

"(k) Subject to such regulations and penalties as may be prescribed by the Federal Reserve Board, any member bank may draw against or otherwise utilize its reserves for the purpose of meeting existing liabilities: *Provided, however*, That, whenever the reserves of any member bank have been continuously deficient for fourteen consecutive calendar days, the Federal Reserve Agent or Assistant Federal Reserve Agent of the district in which such member bank is located shall send to each director of such bank, by registered mail, a letter advising him of such deficiency and calling attention to the provisions of this subsection, and each director of such bank who after receipt of such a letter, assents to or acquiesces in the making of additional loans or investments by such bank before the reserves of such bank shall have been restored to the amount required by this section, shall be held liable in his personal or individual capacity for any and all losses sustained by such bank on any such loans or investments

"(l) All penalties for deficiencies in reserves incurred under regulations prescribed by the Federal Reserve Board pursuant to the provisions of this Act shall be paid to the Federal reserve bank by the member bank against which they are assessed.

"(m) No member bank shall keep on deposit with any State bank or trust company which is not a member bank a sum in excess of ten per centum of its own paid-up capital and surplus No member bank shall act as the medium or agent of a nonmember bank in applying for or receiving discounts from a Federal reserve bank under the provisions of this Act, except by permission of the Federal Reserve Board

"(n) National banks or banks organized under local laws, located in Alaska or in a dependency or insular possession or any part of the United States outside the continental United States, may remain nonmember banks, and shall in that event maintain reserves and comply with all the conditions now provided by law regulating them or said banks may, with the consent of the Federal Reserve Board, become member banks of any one of the Federal reserve districts, and shall in that event take stock, maintain reserves, and be subject to all the other provisions of this Act

"(o) Notwithstanding the foregoing provisions of this section, the Federal Reserve Board, upon the affirmative vote of not less than five of its members and with the approval of the President, may declare that an emergency exists by reason of credit expansion, and may by regulation during such emergency increase or decrease from time to time, in its discretion, the reserve balances required to be maintained

"(p) No member bank shall act as the medium or agent of any nonbanking corporation, partnership, association, business trust, or individual in making loans on the security of stocks, bonds, and other investment securities to brokers or dealers in stocks, bonds, and other investment securities. Every violation of this provision by any member bank shall be punishable by a fine of not more than $100 per day during the continuance of such violation, and such fine may be collected, by suit or otherwise, by the Federal reserve bank of the district in which such member bank is located

"(q) No member bank shall, directly or indirectly by any device whatsoever, pay any interest on any deposit which is payable on demand: *Provided*, That nothing herein contained shall be construed as prohibiting the payment of interest in accordance with the terms of any certificate of deposit or other contract heretofore entered into in good faith which is in force on the date of the enactment of this paragraph, but no such certificate of deposit or other contract shall be renewed or extended unless it shall be modified to conform to this paragraph, and every member bank shall take such action as may be necessary to conform to this paragraph as soon as possible consistently with its contractual obligations: *Provided, however*, That this paragraph shall not apply to any deposit of such bank which is payable only at an office thereof located in a foreign country, and shall not apply to any deposit made by a mutual savings bank, nor to any deposit of public funds made by or on behalf

of any State, county, school district, or other subdivision or municipality, with respect to which payment of interest is required under State law.

"The Federal Reserve Board shall from time to time limit by regulation the rate of interest which may be paid by member banks on time deposits, and may prescribe different rates for such payment on time and savings deposits having different maturities or subject to different conditions respecting withdrawal or repayment or subject to different conditions by reason of different locations No member bank shall pay any time deposit before its maturity, or waive any requirement of notice before payment of any savings deposit except as to all savings deposits having the same requirement For the purposes of this subsection, the Federal Reserve Board is authorized to define the terms 'time deposits' and 'savings deposits'

"(r) All acts or parts of acts in conflict with this section are hereby repealed only in so far as they are in conflict with the provisions of this section"

There are hereby repealed the provisions of Section 7 of the First Liberty Bond Act, approved April 24, 1917, Section 8 of the Second Liberty Bond Act, approved September 24, 1917, and Section 8 of the Third Liberty Bond Act, approved April 4, 1918 (U S Code, Title 31, Section 771) which read as follows:

"That the provisions of section fifty-one hundred and ninety-one of the Revised Statutes, as amended by the Federal Reserve Act, and the amendments thereof, with reference to the reserves required to be kept by national banking associations and other member banks of the Federal Reserve System, shall not apply to deposits of public moneys by the United States in designated depositaries"

This section shall become effective on the first day of the seventh calendar month following the enactment of this Act

Senator ADAMS. Senator Fletcher, may I ask a question? You made a statement a while ago about closing the hearings. Has that been the definite action of the committee?

The CHAIRMAN. Yes.

Senator TOWNSEND. There has nothing been taken definite before the committee?

The CHAIRMAN It was taken up yesterday before the committee and that was the understanding.

Senator TOWNSEND. I was not here.

Senator ADAMS. I was not here.

Senator TOWNSEND. Personally, I feel we ought not to foreclose somebody who wants to be heard myself.

The CHAIRMAN. Mr. Roosevelt and Mr. Gibbons are here, I believe. They wish to be heard this morning on the subject of municipals. Are they present? Mr. Roosevelt, we will hear from you now, and Mr. Gibbons.

STATEMENTS OF ARCHIBALD B. ROOSEVELT, PRESIDENT OF ROOSEVELT & WEIFOLD, INC., DEALERS IN MUNICIPAL SECURITIES, NEW YORK, N.Y., AND GEORGE B. GIBBONS, PRESIDENT GEORGE B. GIBBONS & CO., INC., MUNICIPAL BOND DEALERS, NEW YORK, N.Y.—Resumed

The CHAIRMAN. Mr. Roosevelt, have you seen the proposed amendment to the bill?

Mr. ROOSEVELT. I have seen the new bill, but I have not seen any proposed amendment. That is H.R. 8720.

The CHAIRMAN. Yes; they were introduced before this committee.

Mr. ROOSEVELT There is no change since then?

Mr. Chairman and gentlemen of the committee, since I was last here I have made a little effort to find out some other aspects as to

how the bill affects not only us but other people. Obviously, I being merely a municipal bond dealer, I only know well the immediate effect it has on me and on my colleague, Mr. Gibbons here. But I took the opportunity in the last week to discuss the bill and talk over the bill with a couple of my friends who are in municipal and State government positions. They had no conception in two cases that the present bill had anything to do with anything except regulating the stock exchange, and did not realize that municipals were contemplated in any way.

I think it was Chief Justice Marshall who said that the "power to tax is the power to destroy." Well, I think you can go further than that and say that the power to restrict credit is also the power to destroy. And I feel very strongly that to turn over to seven appointees of the Federal Government the power to regulate to a certain extent at least—and it looks as though quite a lot—the credit of sovereign States and their subdivisions, is not intended by the legislators and has not been contemplated, but under the present bill this would be the case.

Now, as I am not an expert in that end of the thing, I would strongly suggest that before making any decision on the municipal or State credit as it is affected by this bill the committee get before them as witnesses State and city officials to discuss how the bill affects their credit and affects the credit of the political localities.

Mr. Gibbons has touched some aspects of this and has a statement more or less prepared on this subject, and some comments on it, and he and I both want you to know we are not experts on the problems of the municipalities themselves, but are simply putting up something for you gentlemen to consider from that point of view, as well as certain things which we do know about in our own business, and I will ask Mr. Gibbons to go on with the testimony here.

The CHAIRMAN. Proceed, Mr. Gibbons.

Mr. PECORA. May I ask a question of Mr. Roosevelt? I presume you are familiar with the observations that Mr. Gibbons is going to make. Might I ask if those observations would be necessary in the event that this bill were intended so as to put all State and municipal bonds in the exempt class of securities?

Mr. ROOSEVELT. No. If they were exempted from the bill entirely I do not see—again, I am not a lawyer, Mr. Pecora, and you might be able to dig up things that did show it in the bill. Section 16 might. I am not sure about that.

Mr. PECORA. The provision that not only Government securities but securities issued by a State or any political subdivision of a State be exempted, as Government securities now are, would probably meet all the criticisms you are about to give expression to?

Mr. ROOSEVELT. I think so, sir.

Senator GORE. Would not to include municipalities go too far? Wouldn't it include some that ought to be excluded?

The CHAIRMAN. That is a question for the committee, but what is your view about that?

Mr. ROOSEVELT. What was that? I did not get that, Senator Gore.

Senator GORE. The inclusion of municipalities just in general towns, wouldn't that include some that ought to be excluded, in

view of the fact that there are some 17,300 cities and towns that are delinquent?

Mr. ROOSEVELT. I don't think so. We have that taken up very carefully in this statement that we prepared.

Senator MCADOO. Even the delinquent bonds have some value, and you would only deal with their market rate?

Mr. ROOSEVELT. That is quite right. And, Senator, we have a point on that in here if you would let us come to it.

Senator GORE. There is a bill that has already passed the House and is now on the Senate calendar permitting cities at least to go under the bankruptcy laws. Do you think now that municipalities ought to be listed and dealt in by innocent persons when perhaps bankruptcy is pending or actually started?

Senator GOLDSBOROUGH. Let him give his statement. He says he is going to cover that.

Mr. ROOSEVELT. We will cover that. If you will talk, Mr. Gibbons, now, on this.

Mr. GIBBONS. Senator Fletcher and gentlemen of this committee, in going over this bill as amended and finding that State and municipal bonds are not specifically exempted, we have tried to summarize the reasons why in our opinion we think they should be exempted.

This bill apparently is designed to correct speculative abuses, particularly speculative abuses as they are believed to exist in trading on the stock exchanges; but it is also applicable to abuses in connection with securities issued by States and their subdivisions and agencies. They issue a class of securities regarding which the abuses which this bill is aimed to eliminate do not occur.

There is practically no speculation or market operations in municipal bonds. They are usually sold at public advertised sales, either to bond dealers or banks or local individuals. It is very difficult to speculate in them if you should wish to do so. Once a new issue is sold it is not again available for the purpose of speculation.

The purchasers of municipal bonds are quite different from those that buy stocks in many cases, and where they are the same purchasers they buy municipal bonds for a different purpose, and they are largely held by public institutions, insurance companies, savings banks and trust companies, and by corporations for their surplus account, against the time that they may need to sell them, and they are held by individuals for investment purposes. The ultimate purchaser of a municipal bond, excluding the dealer that buys them, very seldom buys them on margin, except possibly for a short period when he first purchases them, until he gets other funds in to complete payment.

It is almost impossible to effect wash sales of municipal bonds, and there would not be any object gained if you did effect a wash sale.

It is also practically impossible to sell municipal bonds short, except in the case of Government bonds, because there are not enough of them of any one particular interest rate and date of maturity and purpose. In other words, once you had sold a bond it would be very difficult to buy it back, so you could not sell it short.

So far as buying bonds and speculating in them with their customer's money, it practically does not exist in municipal bonds. The dealers use their own money. They have no customers' money on deposit. Those depositors are not made with a municipal bond dealer. If he is a member of an exchange he may have, but not otherwise. The only money most municipal bond dealers would ever have on deposit from a customer would be an advance payment for bonds.

Any bill which injures the marketability of municipal bonds or damages their availability as collateral likewise hurts the ability of the public to borrow for public purposes, such as unemployment relief, health, education, water, sewer, schools. This bill vests in the Federal Trade Commission, a board of 7 men appointed by the President for 7 years, the power to either exempt or to refuse to exempt the bonds of every State or municipal subdivision or agency within each State from the provisions of this act. The refusal to exempt a municipal bond of any State, city, or subdivision, would have a disastrous effect on its value and on the prices received for any new bonds offered for sale by the municipalities themselves and would have a disastrous effect on the sale and the prices of the bonds already outstanding.

I have permission to read a telegram to you from a man who is the custodian of a fund of about $180,000,000 of municipal bonds—that is, the Comptroller of the State of New York—and it is as follows [reading]:

ALBANY, N Y., *March 22, 1934.*

GEORGE B GIBBONS,
New Willard Hotel, Washington, D C .

You are authorized to use this telegram before any governmental committee and file it as a matter of record I firmly believe that the listing of municipal bonds on any stock exchange would be injurious to the credit of our municipalities——

Senator GORE (interposing). Read that again, please.

Mr. GIBBONS. Certainly. [Reading:]

You are authorized to use this telegram before any governmental committee and file it as a matter of record I firmly believe that the listening of municipal bonds on any stock exchange would be injurious to the credit of our municipalities, and serious harm would come from such listing for the reason that manipulation of prices on an exchange for this type of security is far more likely than if they were traded in over the counter Printed prices for small issues of securities, such as some of them are, could be used as a basis of soliciting orders above a natural market

In other words, by selling the bond at one selling price and quoting it on the exchange, you might get a similar price for a bond not as good.

Depressing prices could also be done through public quotations At the present time there are 15 issues of New York City bonds listed on the New York Stock Exchange but trades in these issues—

By that he means transactions—

are very seldom recorded The State of New York has more than a hundred and eighty million dollars of its investment funds in over 600 municipalities of this State The State annually invests upwards of $15,000,000 in municipal securities of this State and I believe as the State's chief fiscal officer that it would not be helpful to the great majority of these municipalities—

And there are some nearly 9,000 in the State of New York subdivisions—

to have their securities listed on any exchange at the present time A banker doing service for these municipalities is ready and willing to support the market for the securities that he has sold to his customers I can see no gain from listing these securities and this is demonstrated by the active trading in New York City bonds in over-the-counter market as compared to the exchange where they are listed Several banks took their securities off the New York Stock Exchange because of the possibility of manipulation and the consequent effect on credit of banks I believe this same rule might be a serious menace to the holders of municipal securities if listed on the exchange Therefore I strongly recommend as far as the State of New York is concerned that they neither be listed nor come under the supervision of the Federal Trade Commission It is the business of New York State to manage its own municipalities and their finances

Respectfully submitted.

MORRIS S TREMAINE,
State Comptroller

Senator GORE. One thing I want to ask. He says that 15,000,000 of bonds of cities of New York are listed on the New York Stock Exchange, and he says he does not think any ought to be; is that the point?

Mr. GIBBONS. That is the point. No good object is achieved by having them listed, and there are particularly no sales there. But if they all had to be listed, of course, the sales would be there.

The CHAIRMAN. What is the reason now that they did that?

Mr. GIBBONS. I really don't know, Senator, why they did it. There are bonds listed in Baltimore and in San Francisco and Cleveland. They are listed on all exchanges, certain issues are. Just why, I don't know.

Senator GORE. Is the real reason stated there why bank stocks are taken off the exchange?

Mr. GIBBONS. That I could not guarantee, sir. I don't know.

It is our belief that the bonds of States—reading again from my own memorandum—and the political subdivisions and agencies thereof should be eliminated from the National Securities Act of 1934. This bill is aimed to correct speculative abuses which do not exist in the sales and distribution of municipal bonds. State and municipal securities have no rightful place in the bill and no useful purpose is served by including them in the bill. The inclusion of State and municipal bonds in the bill does not confer any benefit on the holders of municipal bonds nor on the municipalities issuing them. On the contrary, it imposes a very distinct hardship on both the municipalities and the purchasers of their bonds and will seriously affect their value as an investment. The exemption of a municipal bond would not add to its present value, and refusing exemption would seriously impair its value.

If being exempted from this bill is helpful to United States Government bonds, certainly States and municipalities need that help also. If not being exempted would be harmful to Government bonds, certainly States and municipalities should not suffer that harm. They all belong to the same family, and the parent Government, having the strongest credit of all of them, needs the advantage of exemption from the bill less than any single one of the 200,000 or more municipal subdivisions in the country.

If I may go over the bill by paragraphs, this is a very short matter, section 3, subdivision (a) (7), seems to us to be slightly ambiguous, and the only reason we care about that is that it might affect the ability of banks to lend the money on municipals.

And it should be made perfectly clear that the term "dealer" and the term "broker" does not include a bank. We have an amendment for that which probably clarifies it somewhat. It now reads:

The term "broker" or "dealer" shall not include a bank or any person—

And so on.

We would change it this way:

The term "broker" or "dealer" shall not include a bank—comma—nor shall it include any person insofar as he buys or sells a security or securities for his own account and not as a part of a regular business.

In other words, many banks act as dealers for themselves and banks for you, because they lend you money on your municipal bonds, and if they acted as dealers they might come under a provision of the dealer part of the act and not be able to lend you the money, and it should be clarified.

Section (a) (13): State bonds and the bonds of their political subdivisions and agencies are not exempted by the provisions of this act, and they are under the power of the Federal Trade Commission. That gives them, if they so care to use it, a very dangerous power over the financial affairs of all the States, cities, counties, and political subdivisions and agencies in them, and it might be exercised to their great disadvantage.

The credit of a State, or a municipality or agency within it, and its ability to finance its many needs for roads, schools, preservation of health, and so on, would be seriously crippled by the refusal of the Federal Trade Commission to exempt its bonds or by the imposing of unreasonable conditions for granting such exemption, and cause irreparable damage and loss to both the State or municipality and to the holders of their outstanding bonds by the withdrawal of exemption in cases where it had once been granted.

The fact that such power exists would greatly depress bond prices, for it would be a constant threat, and one can never tell when a municipal bond now exempted might be withdrawn from exemption, so everybody would buy a bond in the constant fear that that might happen, and the price would accordingly be lower. It would have a continual depressing effect on bond prices.

Now, municipal securities are held to the extent of billions by insurance companies, fraternal orders, savings banks, Postal Savings funds, pension funds, banks, and other corporations, as well as by individuals, as well as your own governmental agencies, who would loan the money, and by corporations and individuals; so that anything that affects their value is vital.

Senator GOLDSBOROUGH. Trust estates.

Mr. GIBBONS. Yes; including trust estates, of course.

Now, in section 7, subdivision (a): This subsection affects a dealer or broker in municipal securities in cases where he is a member of an exchange. In New York City and throughout the country many dealers in municipal bonds are also members of exchanges and do a combined stock and municipal bond business. In such cases he

must make loans on all listed securities only through a member of the Federal Reserve System or in accordance with regulations of the Federal Reserve Board. It applies to municipal securities that are listed on an exchange, and they would either all have to be listed or exempted, and many municipal securities are now listed on the various exchanges throughout the country, usually their local exchange. It would be necessary to ascertain, when borrowing upon a municipal bond, whether that particular municipal bond was listed on some exchange, and it would be next to impossible to do this. Some exchanges might list thousands of them, and it would cause a great delay and embarrassment and practically retard the prompt sale and purchase of municipal bonds, which is a desirable thing if the market is to be kept free and open.

The subsection (b) of section 7 prevents a dealer from assuming liabilities exceeding 10 times of his net capital unless such securities are exempted. In other words, it would prevent a dealer even bidding at any one time for bonds in the aggregate of more than 10 times his capital, after deducting such bonds as he is already carrying. As only a small percentage of the bids made by dealers are successful in buying the bonds bid for, this would limit the amount of bonds bid for at a time, and would therefore greatly reduce the amount of competition that now exists in the public sale of State and municipal securities Many a man will take a chance in bidding for a large lot of bonds more than 10 times his capital. In this way it would be illegal for him to do so.

Senator GORE. Figuring he would get some and not all?

Mr GIBBONS. Correct, Senator. If he did get them, he could sell them before he would have to carry them or sell part of them. And, of course, a municipality does not care how much capital the dealer has, provided he has enough money and can finance his purchase when the bonds are delivered.

Senator GOLDSBOROUGH. He generally has to put up a certified check when he bids.

Mr. GIBBONS. Exactly; and how much money he has back of that they do not care, because if he does not comply with the terms of the bid he forfeits his check.

Senator GORE. Yes; because he is collecting interest, not paying it.

Mr. GIBBONS. And furthermore, if a dealer can buy a million of bonds and borrow $950,000, why shouldn't he? It is a good thing for the municipality, and it helps to keep the price maintained. They do not care how much capital he has, providing he pays for bonds he has bought.

Some dealers join together to bid for an issue of bonds which is too large an amount for any one of them to bid for alone. These accounts are often made on the basis of being undivided as to liability. For instance, if 10 dealers join together to buy 10 millions of bonds and they are successful in making the purchase, each dealer would have an interest of a million dollars. If one of those dealers should fail, the liability of the other nine dealers would each be increased by his share of that failed dealers liability. If a dealer bought two millions of bonds with one other dealer on an undivided liability account and one dealer failed, the remaining dealer would

be liable for the entire $2,000,000, whereas he only anticipated being liable for a million.

In other words, it would be very difficult for a dealer in municipal bonds, if he were limited as to the amount of bonds he could buy in proportion to his capital, to go ahead on one of these accounts and bid for a large block of bonds.

Senator GORE. He would not get the bonds, anyway, unless he paid for them?

Mr. GIBBONS. No. And if he did get them, he might be liable for more than he bought.

As an ordinary business chance he is willing to run that risk, but he is not willing to run the risk of going to jail and paying a $25,000 fine, and the answer is he would not bid on the bonds, and the municipality would not get the competition. Competition means a lot there. There were only two bids for 30 millions Pennsylvania State bonds. Forty-five houses joined on one bid and were successful, and many houses were in the other bid, and they were unsuccessful. Any one dealer on the successful bid might have been liable for that entire amount.

Senator GORE. You mean the combination got the bonds that was successful, or the other?

Mr. GIBBONS. There were two combinations, and one combination, Senator, got them, and they assumed the liability. If they had not had a great many smaller houses in that account, the bonds would have been sold to a few large banks, and they would not have paid the high price that they did pay, that is, a premium for a bond bearing interest at 3¼ percent, because they would not have had the assistance of the small dealers in selling the bonds for them.

Senator GOLDSBOROUGH. In other words, the limitation of capital put a burden on them and restricted their purchasing power?

Mr. GIBBONS. Absolutely; and it would have eliminated competition at the sale.

Senator GORE. What loss or damage does this provision safeguard the investor against?

Mr. GIBBONS. To have municipals in it?

Senator GORE. Yes.

Mr. GIBBONS. Senator, I cannot see that it does one atom of good to a holder of municipal bonds, or to a municipality or State, not one atom, and it is possible that it may do irreparable harm.

The CHAIRMAN. If municipal bonds are exempted from the bill that cures all those sections you mentioned?

Mr. GIBBONS. Then this would not apply. These are some of our reasons why, in our opinion, municipal bonds and State bonds, bonds of their agencies, should be exempted absolutely and irrevocably.

The CHAIRMAN. Does that include district bonds and other subdivisions?

Mr. GIBBONS. It should, because many States have many districts. For instance, the most important subdivision in New York State is that of the district, outside of the big cities, that is, the school districts.

The CHAIRMAN. Do you think they ought to be exempted?

Mr. GIBBONS. The school districts? They are undoubtedly the safest bonds we have in our State and in many other States.

Senator GORE. Do you know, Mr. Gibbons, how many Government units or subdivisions there are in the United States that have authority to issue bonds?

Mr. GIBBONS. Something between 175,000 and 200,000, Senator. New York State——

Senator GORE. There are 6,353 in Oklahoma alone.

Mr. GIBBONS. How many?

Senator GORE. Six thousand is all.

The CHAIRMAN. New York State has how many, you say?

Mr. GIBBONS. About 8,000; between eight and ten thousand.

Senator GOLDSBOROUGH. It is stated in that telegram, I think.

Mr. GIBBONS. No. He said that he had 180 million dollars of bonds of 600 different municipal subdivisions in New York, but there are nearly a thousand towns in New York State, some 57 cities, 60 counties and over 500 villages. Every town is subdivided into a school district, an average of about 8 to a town. The school districts are formed in their boundaries for the convenience of getting pupils to their schools. Their credit is of the utmost importance to them. Whether they sell a 6-percent bond or a 4½-percent bond is a vital matter to them; and for their credit. The cheaper they borrow their money the lower their taxes are.

The CHAIRMAN. Are any of those districts in default?

Mr GIBBONS. In New York State?

The CHAIRMAN. Yes.

Mr. GIBBONS. Not a one, to the best of my belief.

Senator GORE. Is there any way the public could be safeguarded by amending this bill or otherwise, against the sale or against the purchase of these municipal bonds that are not delinquent now or where delinquency is imminent?

Mr. GIBBONS. Senator, it is very difficult to tell when you buy a bond what the future will bring for that bond. The present administration sells a bond which under their proposed bill would entitle it to exemption, and that would justify a dealer in paying a high price for that bond. A subsequent administration might bring about a different situation, a worse one.

Senator GOLDSBOROUGH. Isn't it a fact that the delinquency on many of these bonds has occurred through the noncollection of taxes and that when the taxes are collected those bonds will come back?

Mr. GIBBONS. That is correct in many places, and in some places of course they sold too many bonds based on exceedingly high appraisal of property. But that is not general by any manner of means. As a matter of fact, in this country it is estimated as closely as may be that 1 percent of all, numerically, of the municipalities, are in default.

Senator GOLDSBOROUGH. That covers the entire country?

Mr. GIBBONS Yes. That would mean in Senator Gore's State, with 6,000 subdivisions, that 60 of them would be in default. In New York State there are practically none. I know of none in actual default. Many of them have been late. It is very difficult to tell what a default is. What would a default be? A week's delay in paying interest or a week's delay in paying principal, or 6 months'

delay? They might have a default of a month on one note and pay it and be restored, and in another month have another default on another note and pay that in 6 weeks. It is very difficult to decide what is a default and what is not. In New York State there are none in default that I know of.

Senator GORE. Isn't it a fact that about $35 of taxes or carrying charges per $1,000 worth of property is the danger line or rather the dead line?

Mr. GIBBONS. In actual value that is fairly high, Senator; not necessarily of assessed value.

Senator GORE. In my State I think it is $278, and the town just moves off the townsite and the obligations both.

Mr. GIBBONS. Well, if you did not exempt a defaulted bond how would that help either the municipality or the bondholder?

Senator GORE. Is there any way that you could vest this administrative agency with the power to forewarn prospective purchasers that the bond of a certain town is a bad investment? Is there any red light at all? One of the objects of this bill is to protect the fool against his follies. I do not know whether they can do it or not, but I do not see any difference between the man that loses his money by buying municipal bonds that are no good, I do not see that he is any better off than if he put it in a railroad bond or a chewing-gum factory bond or something of that sort. He lost his money. Is there any form of protection or warning that can be afforded?

The CHAIRMAN. Having reference to the investors particularly?

Senator GORE. Yes; from his point of view.

Mr. GIBBONS. It is very difficult for this reason, that the great money that has been lost in municipal bonds has not been lost by the ignorant man going in and buying a bond which was bad at the time he bought it and buying that bond at par or thereabouts. The money has been lost by the investor—when I speak of investor I include insurance companies—with every means to investigate, and savings banks with every means to investigate. The money has been lost by their buying a bond which, after their investigation, they decided was a good bond for them to buy, and they paid the price for a good bond. And later things went bad in that city or State—take Arkansas for instance; millions of bonds were sold to insurance companies and savings banks at par, when they thought the bonds were worth that or they would not have bought them. Since then they have declined in value.

Senator GOLDSBOROUGH. Those insurance corporations had statistical departments, didn't they?

Mr. GIBBONS. Certainly; and spent thousands of dollars keeping them up and keeping themselves posted to the last degree.

Now, how could you save the purchasers of those bonds from losing money if, after investigating, they decided the bond was good to buy and 5 years afterward it declined in value?

Senator GORE. Now, that brings me to the point: Suppose that happened, they would decline, and yet Tom, Dick, and Harry knows nothing about all these facts. He goes ahead and somebody wants to sell him a bond, and he buys it. Is there any sort of warning that this agency can give of what you describe as having happened?

Notwithstanding the foresight in this case of this insurance company, it actually has happened, and the people who know it has; it can be verified by the fact that it has happened.

Mr. GIBBONS. Senator, it is very difficult, as near as I can see, to guard against losses, and I will tell you an example. I bought New York City bonds last year when I thought they were a good purchase, and they went down 30 points, and I am a dealer in bonds, and I am every day there on the job, and I lost $60,000 on the New York City bonds. If there is any way that you could pass a law to prevent my doing that, it would be invaluable not only to me but to everybody. I have thought for years of some way whereby I could avoid losing money on municipal bonds, but I have never struck a way yet.

Senator GORE. And between those you have lost. There is no way in which you could provide a warning or no basis on which you could base any sort of law or regulation?

Mr. GIBBONS. I have never found one yet, Senator.

Senator GORE. I guess that is the fool with his folly. That is not personal at all.

Mr. GIBBONS. Section 10, subdivision (a): This provision seems to apply to the segregation of broker and dealer functions only to members of an exchange. However, many municipal-bond dealers are members. This is true throughout the country. There is not enough business, certainly in municipal bonds, either as a dealer or a broker, in most cases, for a man to subsist on. The customer does not care whether you own the bond or buy it for him. Municipal-bond dealers act in both capacities, and to prevent them acting as a broker or as a dealer would eliminate competition in the buying of municipal bonds.

And I will illustrate that: If, in bidding for the 30,000,000 Pennsylvania State bonds which were sold recently, the unsuccessful house or the unsuccessful bidding syndicate was prevented from acting as brokers, then the syndicate which bought the bonds would know in advance that if they bought them they would have no outside help in marketing those bonds.

Now, what actually happens is this: On 30,000,000 of State of Pennsylvania bonds—and the same applies to other places in lesser amounts—when they were offered for sale and various groups of dealers and banks join hands, the group I am in bids and the group you are in bids. The group that puts in the highest bid gets the bonds, and each group knows in advance—and there may be 10 groups—that if their group gets the bonds then the other groups who have been cultivating their customers in advance and getting orders for those bonds will have to come to them and buy them. Well, they are willing to bid higher, accordingly, because they would not have to sell them all themselves. If they make 1 percent profit on the bonds and allow a quarter of 1 percent to brokers, they know that a lot of those bonds are going to be taken right off their hands by their competitors.

Senator GORE. They would have a sort of a ready-made market?

Mr. GIBBONS. Correct. In other words, all the dealers, maybe 60 or 90, will join hands to bid. All have a certain amount of orders. Now, they go ahead, the dealers. If they do buy the bonds as dealers, they sell the bonds as dealers. But the unsuccessful groups

would have to go and sell the bonds as brokers To prevent them from doing that would mean that the competition of those bonds would not be so great, and that would be a very costly thing to the State of Pennsylvania in selling those bonds, or any others.

Senator GORE. You know, this distinction between dealers and brokers is hocus-pocus—now you see it and now you don't. It looks to me like running Hyde and Jekyll or changing colors when you get good and ready.

Mr. GIBBONS. That would not apply to a municipal bond, but if it did apply it would be to the disadvantage of the municipality and also to the bond dealer, as well as the State subdivisions.

Senator GORE. State that again. I didn't get the first part of it.

Mr. GIBBONS. If there is segregation of broker and dealer and it were made to apply to bonds, to the municipal bond dealer, it would not only be costly to them, because, unless they had bought the Pennsylvania bonds they could not sell them to their customers and make a commission. But knowning in advance that they could not do that, they would not bid for the bonds as high a price as they did.

Senator GORE. It is your idea that municipal bonds ought to be deleted from this bill altogether?

Mr. GIBBONS. State and municipal bonds and their political subdivisions and agencies should be absolutely out of this bill.

Senator GORE. Just forget them?

Mr. GIBBONS. Absolutely out of it from start to finish.

The CHAIRMAN. They should be included in the exemption?

Mr. GIBBONS. Half the municipalities in this country, even the cities who have their own conference of mayors, are not aware yet that they are in this bill. When Comptroller Tremaine, of New York State, heard about it he was not exactly amazed, because he had heard about it before, but he was pretty well wrought up. He could not imagine such a thing and he sat right down and sent me this telegram, which I read to you and have placed on file.

In times of stress, when bonds are low in prices, the man who has heretofore been a dealer is afraid to buy bonds and risk his money in it. He does not risk his customer's money; he risks his own. So he goes out to people who have bonds and buys them and sells them to his customers for a brokerage, and that is the way he subsists, the way he pays his living. Take that business away from him and you might just as well take the hand off a cobbler.

Senator GORE. That fellow you described there, isn't he the man that might work off a lot of these worthless bonds on innocent purchasers?

Mr. GIBBONS. Senator, if a man in the municipal-bond business decides to do a brokerage business instead of being a dealer, and he decides to work off worthless bonds on the public, he absolutely would do it anyway, and the mere fact that you prevent him from acting at a dealer would not make one atom of difference.

Senator GORE. They sold liquor even when it was against the law.

Mr. GIBBONS. Yes; and drank it, too. But the investment bankers Code requires, that when you sell bonds to your customer you advise him whether you act as a dealer or broker.

Senator GORE. That is the rule now?

Mr. GIBBONS. That is the rule under the Code, and that is something to inform a man. If you, for instance, were buying some

Tulsa bonds would you care whether you got them from me as a dealer or, John Smith as a broker?

Senator GORE. I would not know how to react in either case. It would not make any difference.

Mr. GIBBONS. Not a particle.

Senator GORE. I would not know——

Mr. GIBBONS (interposing). What he meant. There are many others too, Senator.

Mr. ROOSEVELT. Neither will the dealer and the broker.

Mr. GIBBONS. Section 14 does not specify what constitutes making a market. If the publication of quotations constitutes making a market, this section would seriously restrict the purchase and sale of municipal securities and also make it impossible to value them for appraisal, which is a very important function.

For instance, bonds of the city of Buffalo, or a city of a small population, for instance, may not have sold for 6 months. The man that owned them may not be able to sell them. But the city of Rochester may have sold at 80, and they are practically worth the same. So you would be using your judgment as to what the market is in advising these people that the Buffalo bond they had that day was in your opinion worth 80. The only way you can tell is that the bond of such-and-such a place is worth 80 and others are about the same. You see, you have got to make quotations.

Mr. PECORA. Mr. Gibbons, are you overlooking that provision of section 14 which in effect states that a broker or dealer in the over-counter market may make or create a market in accordance with rules and regulations which the Federal Trade Commission may prescribe?

Mr. GIBBONS. I have not overlooked it.

Mr. PECORA. As you have just discussed the section, one would be led to the inference that the section absolutely prohibits unqualifiedly the making of a market.

Mr. GIBBONS. Well, if it required me to go to the Federal Trade Commission to ask them whether I could tell you that Rochester bonds were 85 cents on the dollar, it would delay me.

Mr. PECORA. This does not provide any such thing.

Mr. GIBBONS. I did not read from the bill. I just took it from you.

Mr. PECORA. As you read the bill——

Mr. GIBBONS. I have read the bill, but have not——

Mr. PECORA. You are discussing section 14, and apparently are ignoring the provisions that say that it shall be unlawful for any broker, dealer, and so forth, to use the mails or any means or instrumentality in interstate commerce for the purpose of making or creating or enabling another to make or create a market in any security listed on a national securities exchange, and so forth.

Mr. GIBBONS. Mr. Pecora, I asked this question on that. I did not state it as a criticism. I said this section does not specify what constitutes making a market.

Mr. PECORA. The Commission is going to define the circumstances under which it may be made.

Mr. GIBBONS. All right; but the section does not specify it.

Mr. PECORA. That is why it is left to the Commission. If the section did specify it, the Commission would not have to define it.

Mr. GIBBONS. My remark was a question.

Senator GOLDSBOROUGH. You mean in lines 6 to 11, where they prescribe their regulations of all transactions?

Mr. PECORA. Yes, sir.

Mr. GIBBONS. It was a question—if publication of quotations consist in making the market, this section would seriously restrict the purchase and sale of municipal securities. I am simply stating my reaction to that section It would also make it impossible to value them for appraisal, a most important function.

Now, the next section and the last one here, is section 16. Municipal bond dealers as such have no objection whatever to having their books examined and their operations otherwise investigated by the properly constituted authorities. This section, however, could easily result in a great hardship on the dealer. It could place an unsupportable burden on any dealer, and repeated investigations could be made ruinous to him. The provision for the charging of the expense of the investigation against the person examined should be eliminated from this section, in our opinion. You might have an examiner in their once a week or once a month, and it would be a great burden.

Senator GORE. Would it help it to provide that the expense would not be charged against the concern other than once in a given period of time?

Mr. GIBBONS. If you fixed a maximum expense and made it nominal, it would be grand.

Mr. PECORA. Fixed a maximum expense and made it nominal?

Mr. GIBBONS. If you fixed the limit—that the charge should not exceed a certain amount in any one year—that would simply be another tax; and I don't care how I pay my taxes, one way or the other; it would be the same.

Senator GORE. You would know it in advance?

Mr. GIBBONS. I am limited in the liabilities which I can incur in the buying of bonds, but I am unlimited in the liabilities the Government may force upon me in examining my books and business.

The CHAIRMAN. How would it do to have a provision to charge $25 in there for each examination?

Mr. GIBBONS. If you charged a dealer not exceeding $25 in any 1 year I would not say anything about it.

The CHAIRMAN. $25 for each examination—how would that be?

Mr. GIBBONS. Not more than one payment in a year, regardless of the number of examinations. Suppose they came in every week at $25?

Mr. PECORA. Do you really feel that way, Mr. Gibbons?

Mr. GIBBONS. No; $25 an examination is fine. It is all right.

Mr. PECORA. Do you really feel that examiners would come into a bond dealer's office and make an examination once a week?

Mr. GIBBONS. I had an income-tax man come in there and live for 2 months once. If I had been paying him by the day at a high rate I would have felt very badly. I felt that way anyway, bad enough.

Mr. PECORA. But in discussing this bill do you feel that it would be necessary to make an examination once a week?

Mr. GIBBONS. He might come in there and stay 2 months.

Mr. PECORA. You still do an extensive business?

Mr. GIBBONS. Yes; and I might do it for a great many years, and he might go back over all of it.

Mr. PECORA. With bank examiners they examine 50 banks in 2 months' time.

Mr. GIBBONS. They tell me they just about live in the banks year in and year out.

Senator GORE. But you say you did enjoy the company of that income-tax examiner?

Mr. GIBBONS. I liked his company, Senator, but he stayed too long and it was too costly.

The CHAIRMAN. Do you have any other questions of this gentleman? If not, we are very much obliged to you, Mr. Gibbons, and you are excused.

Mr. GIBBONS. Thank you, gentlemen.

Senator GOLDSBOROGH. I move we adjourn.

The CHAIRMAN. After the recess we will hear Mr. Smith and Mr. Whitney. We will take a recess now until 2:30.

(Accordingly, at 1:05 p.m., a recess was taken until 2:30 p.m.)

AFTERNOON SESSION

The committee resumed at 2:30 p m., on the expiration of the recess.

The CHAIRMAN. The committee will come to order, please. Mr. Butcher is here from Philadelphia, representing the Philadelphia Stock Exchange, and says he desires a few minutes before the committee. I think we had better take him right now.

Mr. BUTCHER. Thank you very much, Mr. Chairman.

The CHAIRMAN. Have a seat right here at the table. Please give your name, place of residence, and whom you represent.

Mr. BUTCHER. My name is Howard Butcher, Jr. I am president of the Philadelphia Stock Exchange, Philadelphia, Pa.

STATEMENT OF HOWARD BUTCHER, JR., PRESIDENT OF THE PHILADELPHIA STOCK EXCHANGE, PHILADELPHIA, PA.

The CHAIRMAN. Now, Mr. Butcher, have you seen the revised bill, H.R. 8720?

Mr. BUTCHER. Yes, sir; I have read that bill very carefully.

The CHAIRMAN. Well, you appeared before the committee once before——

Mr. BUTCHER (interposing). Yes, Mr. Chairman.

The CHAIRMAN (continuing). And if you want to make a statement now in regard to the revision of the bill, you may do so.

Mr. BUTCHER. I will be very glad to do so.

The CHAIRMAN. You may proceed.

Mr. BUTCHER. When I was here the last time you were good enough to tell me, Mr. Pecora, that we would not have to close up shop. I want to say, after reading this bill very carefully, it is my considered opinion that the Philadelphia Stock Exchange would not be able to operate under it. There are at least 8 or 9 provisions in it, if not more, that would oblige us to close before the bill became operative.

The CHAIRMAN. Will you state what provisions of the revised bill would bring that about? Let us have something specific, not simply some general allegation of apprehension.

Mr. BUTCHER. The provision for margin requirements in my opinion is quite unworkable. Those requirements are too large in some cases too high, and too low in others. They vary in such a way that it would be almost impossible as a practical question to operate under the margin provisions of the bill.

The CHAIRMAN. That is section 6, is it?

Mr. BUTCHER. It is section 6, paragraph (a).

The CHAIRMAN. All right. Proceed with your statement.

Mr. BUTCHER. The limitations under section 6, paragraph (d) do not give sufficient elasticity in regard to questions of credit.

The CHAIRMAN. Did you say section 6, paragraph (d)?

Mr. BUTCHER. Yes, sir. A broker at times would have to make a material loan, and it might be on Government bonds, or it might be on the highest grade of State or city bonds, or it might be on some other security, and the broker might have to make a very considerable loan, perhaps only for a few days. But under this paragraph he would be placed in a position where he would be willfully committing a breach of the regulations, and would be obliged to suffer the penalty of 10 years in jail or a $25,000 fine, or both.

It is my considered opinion that it is entirely unfair to take a group of men who have had an honorable existence, as in our case since 1790, and arbitrarily inflict a 10-year jail penalty or a $25,000 fine, or both, for what has heretofore always been a perfectly routine matter of business, a matter of business that is not adverse to the public interest, that is not adverse to individual morals, that is not contrary to the laws of our land as they have existed for very many years. I think it would be a very great injustice, indeed.

The CHAIRMAN. What next do you object to in the revised bill?

Mr. BUTCHER. As to the question of specialists, the segregation and the limitation of the activities of brokers, specialists, and dealers, under section 10, paragraph (a), I think I am probably in accord with what the drawers of the bill would like to do as proposed or as is indicated by this section, but I am entirely opposed to the means whereby they are attempting to do it. The specialist-broker-dealer matter may not be, in our community at least, segregated as it is proposed in this bill and permit us to live. We must have, sometimes in 1 day, all three functions. And that would apply, I should think, to many other cities. And it can be done and has been done with perfect honesty to customers. A bond broker must also be a bond dealer, the transactions it may be only 5 minutes apart. And in my opinion it is a very wrong way to set a hard and fast law, as is now written in this bill, to require one given regulation for everybody under all circumstances at all times.

If this were left to a study by the Commission to whom you are going to refer the matter—the Federal Trade Commission or whatever other commission it might be—it would be much better to have them study it and consider it more carefully than has been done here. As now written, these things would compel my firm to liquidate, and I might add that my firm and our predecessors have been engaged in business for approximately 60 years, and so far we have had an honorable existence, and we certainly do not propose at this late date to do anything that is not in the interest of and helpful to our clients, as we have always done in the past.

The CHAIRMAN. You are speaking now as a broker and not as a member of the Philadelphia Stock Exchange, I take it?

Mr. BUTCHER. I am simply one of about 206 members of the Philadelphia Stock Exchange.

The CHAIRMAN. What is the name of your firm?

Mr. BUTCHER. It is Butcher & Sherrard.

The CHAIRMAN. All right. You may continue your statement.

Mr. BUTCHER. As to odd lots, that also is a material part of the business of our exchange and similar exchanges, but they could not be traded in under this regulation. We simply could not function in the way provided here. That is a highly technical matter, and I do not want to take up too much of your time, as you have given me a second hearing today; but that is very definitely my opinion of the matter. You see, in the case of our exchange—and I guess in the case of many other exchanges—the odd-lot business is done by specialists, and a specialist may be a bond broker one minute, a bond dealer another minute—or not the next minute, but the two transactions might be 5 minutes apart—and the specialist and the odd-lot man—well, a person might have all four functions in the course of a day's work, and still they would all be perfectly ethical all the way through.

I sometimes wonder whether you, Mr. Chairman, and the other Senators interested in this bill, have thought for a moment what it would mean to the real-estate people of your own State, Florida, and other places, if the last liquid source of securities were to be frozen. If this bill is enacted in anything like its present form the market for securities would be down and out unless done through bootleggers. In other words, securities would have to be bootlegged, just like liquor was handled recently.

Mr. PECORA. Why do you say that?

Mr BUTCHER. For the reason that I told you informally the last time I had the pleasure of talking to you. I mean to make an understatement rather than an overstatement when I say that in case at least 8 or 10 paragraphs of this bill are enacted into law I would not be willing to stay in business. And there are hundreds of other brokers who have just as high standards as I have, and possibly even higher, who would not stay in business. Then, the business would have to be done, no doubt, by men who would not mind taking the chance under the bill.

Mr. PECORA. Why couldn't you stay in business and conduct it in the manner that this bill would permit you to do it?

Mr. BUTCHER. Because I would be handcuffed and hog-tied.

Mr. PECORA. The bill allows specialists and dealers to be members of stock exchanges. It would allow odd-lot dealers to be members of exchanges.

Mr. BUTCHER. But it would not allow an odd-lot dealer to be a bond broker, a bond dealer, a specialist, and an odd-lot man all at the same time. And that is what our men are.

Mr. PECORA. If you assume the functions in one capacity; that is, in one where it is inconsistent with another, it puts you where you are frequently called upon to make a choice between serving your own interest and serving the interest of your customer. Don't you think that is bad in principle?

Mr. BUTCHER. No; I do not think it is bad in principle because it cannot be helped. A decision has to be made a great many times, and that is the thing we do, and I think 99 percent of the brokers do. We may own bonds, and we sell them and take a profit on them if the customer desires them. Otherwise the customer would take something else.

Mr. PECORA. The evidence which has been introduced before this committee will show that when dealers have in their inventories such securities they may and some have passed them on to unsuspecing clients who face a loss on them. It is only natural to assume that where an individual is called upon to serve two interests, the one his own and the other his customer's, there is a strong temptation that the advice he will give to his customer will be that advice which will best serve the dealer's own interest.

Mr. BUTCHER. I am entirely in accord with you on that phase of it, but——

Senator KEAN (interposing). Isn't it your practice, and in fact practically the rule of the exchange that if you own a security you must tell the customer you own it, and that you are selling it to him without any commission?

Mr. BUTCHER. Absolutely.

Mr. PECORA. Is it a rule of the exchange?

Mr. BUTCHER. Yes. You cannot be a broker and an agent at the same time. You cannot charge a commission on something you buy or sell.

Mr. PECORA. That is true, but at the same time if you are selling a security as a dealer and you inform a customer that you are selling him your own merchandise, that customer might be induced to buy that merchandise from you on your advice.

Mr. BUTCHER. Naturally; but in that case——

Mr. PECORA (continuing). Which advice might be tinctured by your desire to serve your own interest and not your customer's interest.

Mr. BUTCHER. But that is a recognized human element which you cannot erase and which you cannot prevent in all cases.

Mr. PECORA. But that is a temptation that ought to be removed, for a broker-dealer to cater to his own interest in a given situation as against the interest of his customer.

Mr. BUTCHER. Mr. Pecora, you must remember——

Mr. PECORA (continuing). This bill is designed to promote the greatest good for the greatest number, and the greatest number in my humble opinion is the public.

Mr. BUTCHER. I will have to take very polite but every definite issue with you on that. The bill is not so drawn as to bring about that result. The bill would do the greatest harm to the greatest number.

Mr. PECORA. I cannot see that. You are stating general conclusions. You haven't given us any facts or examples to illustrate the soundness of your conclusions. Why not do that?

Mr. BUTCHER. Well, in order to give illustrations I must be a little bit personal, which I am sorry to have to be, but I have been a broker or bond dealer for over 30 years, and during that time I have had a part in a great many million dollars' worth of transactions, involving a great many hundred thousand individual transactions, and

I have yet to be called to task for any one of them. And I believe there are a great many other brokers in the same situation.

Mr. PECORA. Well, if all brokers conducted their business in the way you say you conduct yours there probably would not be any agitation for the enactment of such a law as we now propose. Legislation, you know, follows exposure of evils as a rule, it does not anticipate them.

Mr. BUTCHER. You are looking at this thing, and very naturally, from the standpoint of the prosecutor.

Mr. PECORA. No, sir; I am not. I gave up being a prosecutor several years ago and do not want to return to that role. Twelve years of it is enough in any man's lifetime.

Mr. BUTCHER. Well, I do not wish to send you back there.

Mr. PECORA. And I haven't any prosecutor's complex. Neither have I a banker's complex, nor a broker-dealer's complex.

Mr. BUTCHER. Well, I don't think I have any complex, or if I do it is only such complex as would come after 30 years' trying to engage in square dealing with my clients. And also let me say this, that I have longer experience in the matter of disciplinary proceedings as to brokers than you have, because I have been upon the board of governors of the Philadelphia Stock Exchange for many years, and when I speak of myself as a personal matter I am only the average broker, or mine is only the average experience, and I believe that the very great majority of the members of exchanges have the highest standard of ethics there is. But here in this bill we are to be treated as a bunch of criminals, and in saying that I do not mean to be emotional on the subject.

Mr. PECORA. I think the purpose of the bill might be said to be, to make all broker-dealers function in the way you say you have functioned for the last 30 years. But we have too many pages of testimony taken before this committee to accept that view, for much of the testimony shows that they have not all functioned like that, and that the public has paid the price.

Mr. BUTCHER. I do not believe it is possible by means of legislation to prevent any and all dishonesty.

Mr. PECORA. Oh, no. You cannot prevent any and all dishonesty. You can only hope to provide a deterrent influence through fear of punishment for infractions of law. The laws against burglary have not prevented burglary from being committed, not entirely so. And that may be said with regard to any and all of our penal statutes. But I venture to say there would be no difference of opinion if I were to assert the fact that having such laws, defining such acts to be crimes punishable as such, has prevented the commission of more such crimes than otherwise would have been committed.

Mr. BUTCHER. That I think is almost axiomatic and almost unanswerable. But don't you yourself feel, Mr. Pecora, that it would be almost impossible for a man with a clean record, or for a stock exchange with a clean record like that to function under this bill.

Mr. PECORA. No. I do not agree with you on that.

Mr. BUTCHER. Well I am sorry. At the same time I am clearly convinced that that would be the case.

The CHAIRMAN. We are hoping to cause them to function more efficiently and more satisfactorily than heretofore.

Mr. PECORA. Do you think the effect of reducing the number of persons engaged in this business might not be unwholesome? You will recall that during 1928 and 1929 brokerage houses established branch offices on a scale never before attained, and that was a bad thing because it aided and abetted and encouraged speculation that led to the crazy situation of 1929.

Mr. BUTCHER. Mr. Pecora, don't you believe any brokers?

Mr. PECORA. Why, of course I do.

Mr. BUTCHER. I was getting the feeling that——

Mr. PECORA (interposing). Of course, I believe brokers.

Mr. BUTCHER. I was getting the feeling from what you have told me that——

Mr. PECORA (interposing). I do not challenge the good character and the integrity of every individual when I advocate the enactment of a law that would make kidnaping a crime merely because a very small percentage might be addicted to that crime. Because I advocate the enactment of a law against kidnaping is no reason why every individual should feel that if the law is enacted they are potentially regarded by lawmakers as criminals. Such a law is designed to reach those individuals who are anti-social.

Mr. BUTCHER. Well, there have been a number of men to testify here, and I have heard some of them myself, who have said perhaps about the same things that I have, and still this bill comes back in supposedly revised form, but with almost no change whatever

Mr. PECORA. Why, Mr. Butcher, other persons who are not bankers or brokers, have come before this committee, only this morning I might say, and after having made a careful and intensive study of the bill, have called the committee's attention to the very marked changes which have been made in this revised draft as compared with the original draft. And I might cite none other than Governor Black of the Federal Reserve Board, who expressed his views in that respect this morning.

Mr. BUTCHER. I do not believe Governor Black has ever had to make a living out of the brokerage business.

Mr. PECORA. And it may be that is why he has not the broker complex and is able to view this bill with an impartial mind.

Mr. BUTCHER. And that may be why he does not see some other things in it that are injurious.

Senator KEAN. Perhaps Governor Black does not understand the brokerage business.

Mr. BUTCHER. That is quite likely.

The CHAIRMAN. As I understand, the rules of the exchange require certain things of brokers, and you approve of such rules, and yet you do not want them put in the shape of a law.

Mr. BUTCHER No, sir; I haven't said that. I haven't that thought.

The CHAIRMAN. Well, that seems to me to be the effect of what you are saying.

Mr. BUTCHER Oh, I beg to differ with you there.

The CHAIRMAN. All right. You may proceed with your statement.

Mr. BUTCHER. Under the rules of stock exchanges, as I know them, a man may not be on the same transaction as broker and dealer. But on the same day, or even within a very few minutes,

he may be dealer, broker, odd-lot man, and specialist on our exchange. Now, this bill very definitely prohibits that and subjects him, for something he has been doing, if he has lived as long as I have, every day for 30 years to the penalty of a 10-year sentence or a $25,000 fine, or both. There is no justice in that.

Mr. PECORA. This bill is simply designed in that respect to put such a person in a position where he will not have dangling before him the temptation to serve his own interest as against the interest of his customer.

Mr. BUTCHER. Mr. Pecora, I can say to you that there will be nothing dangling before me if you pass this bill in this form, if you pass this bill in this form, except to go out and grow cotton or wheat.

The CHAIRMAN. Well, that is a mere conclusion. Let us go on with any specific objections you may have to offer to the revised bill.

Mr. BUTCHER There is one other statement I should like to make if I may.

The CHAIRMAN. Very well You may proceed.

Mr. BUTCHER. Under this proposed regulation, under this bill, I think I may say in justice to the exchanges, that as well as regulating them, governoring them, managing them, it takes from the board of governors practically all of their responsibilities. At the present time from the time a man comes in until he is expelled or otherwise leaves the exchange he is subject at all times to the rules and regulations of the Federal Trade Commission or whatever other commission you may decide to refer this matter. In my opinion that is a grave mistake. Things must be decided promptly, and in a very great majority of cases, I should say in over 99 percent of the cases, they are decided honestly and fairly. Our standards today are probably above, from the ethical standpoint, the ordinary laws of Pennsylvania or of the United States. A client who is dealing with a member of an exchange can bring his complaint before the secretary's office and get almost immediate satisfaction—or, not satisfaction, perhaps, but almost immediate justice. And this is a very serious matter.

Senator ADAMS. You mean an immediate decision, don't you?

Mr. BUTCHER. Yes, sir; a decision almost immediately, instead of having it dragged over perhaps 2 or 3 years.

The CHAIRMAN. What section do you refer to?

Mr. BUTCHER. I am not familiar with the bill by sections. But I think that is in section 18 of the bill.

The CHAIRMAN. All right.

Senator ADAMS It is on page 43 of the bill.

Mr. BUTCHER. That would result almost immediately in the bootlegging of securities. When your stock exchanges close people must find a market somewhere, and they will find a market somewhere, and it will likely be through people who are not controlled by any rules or regulations, except their individual wishes, and that would result in my opinion in a very much worse situation than has ever been, a condition very much worse than Mr. Pecora suspects us of.

The CHAIRMAN. All right. Is that all?

Senator TOWNSEND. Mr. Butcher, I was not present when you first began your statement. How long have you been in the stock-brokerage business?

Mr. BUTCHER. As distinguished from that of bond broker?

Senator TOWNSEND. Either one.

Mr. BUTCHER. I started in the bond business in 1901, and I became a member of the Philadelphia Stock Exchange I think in December of 1909.

Senator TOWNSEND. Do you think this bill would put brokers out of business, that is, if it should be enacted in its present form? Is that your contention before this committee?

Mr. BUTCHER. My very definite conclusion, after a careful study of the revised bill, is that the Philadelphia Stock Exchange could not continue.

Senator WALCOTT. That is, that the exchange could not continue?

Mr. BUTCHER. Yes, sir. It could not continue, and it would compel my firm to liquidate. The Philadelphia Stock Exchange was started in 1790. It has a most honorable record and has rendered a great service to the community. I think while some of you gentlemen have the idea that you will prevent crime or wrongdoing you are taking the very serious responsibility upon yourselves of closing stock exchanges and of compelling brokers to liquidate, involving the throwing out of employment of many thousands of people and the doing away of salaries which would mean $300,000,000.

Mr. PECORA. Then I take it your argument is based on the belief that all stock exchanges and all brokers are going to be put out of business in event of the enactment of this bill.

Mr. BUTCHER. I should not like to speak for all exchanges, although I am authorized to speak for the Philadelphia Stock Exchange. And I say that quite definitely for the Philadelphia Stock Exchange.

Mr. PECORA. But the Philadelphia Stock Exchange hasn't a pay roll of $300,000,000 a year.

Mr. BUTCHER. No, sir.

Mr. PECORA. You were referring, when you mentioned such a pay roll, to all exchanges?

Mr. BUTCHER. Yes, sir.

Mr. PECORA. And you think they are going to be put out of business in the event of the enactment of this bill?

Mr. BUTCHER. That is my opinion.

Mr. PECORA. Didn't the bankers make a similar direful prediction a score of years ago when the Congress was considering the enactment of the Federal Reserve Act?

Mr. BUTCHER. No, sir.

Mr. PECORA. That is my recollection of the situation.

Mr. BUTCHER. I do not think that was a parallel case.

Mr. PECORA. It was parallel in that direful predictions were made, predictions that were not realized after the event.

Senator WALCOTT. Mr. Butcher, I came in just as you were concluding with section 10 of the bill. On page 27, line 21, I find certain language. Suppose we were to strike out the sentence:

> It shall be unlawful for an odd-lot dealer to act as a broker

That provision, as I understand it, is one of the serious difficulties of this bill. If we should strike out that language, you would then

be subject to regulations as imposed by the Federal Trade Commission, which are recited on pages 28 and 29. What about that?

Mr. BUTCHER. That would be a big help, unquestionably, if that language were stricken out. Yes; it would be a great help.

Senator WALCOTT. You are in favor of doing that?

Mr. BUTCHER. Yes, sir. I do not believe you gentlemen realize on how small a margin brokers have been doing business for the last 4 years. We have been just on the ragged edge of doing business in the red. And many of us have been in the red all the time.

Mr. PECORA. Well, that is true of all businesses.

Mr. BUTCHER. No, sir; not of all businesses.

The CHAIRMAN. I think the committee has pretty well concluded to strike out that language.

Mr. BUTCHER. Well, that would be a help. Then if you would go on and give specialists relief. May I say one more thing, Mr. Chairman?

The CHAIRMAN. Yes.

Mr. BUTCHER. I am a member of what we call an out-of-town commission firm in Philadelphia. A lot of our orders are executed on the New York Stock Exchange. They go to specialists. Ordinarily, if anybody were to make complaint about what a specialist does on the New York Stock Exchange, it would come from me or my partners or associates. But I want to be perfectly outspoken in my commendation of the members there, of what the specialists on the New York Stock Exchange have done and are doing today for the general public. Where one man might have slipped—and you know Mark Twain has said "there is a yellow dog in every pack of hounds", and perhaps there is; and there may have been times when one or two specialists have slipped, but by and large over the years these specialists on the New York Stock Exchange have stood there and taken punishment; yes, a punishment that you gentlemen would have found very difficult to withstand day after day and have rendered a service to the public that I feel is quite outstanding. And I am one of those who would be quick to criticize, or from whom criticism would be expected to come if criticism were due, but they have given service time and time again. Some of them have made money and some have not. For more than 99 percent of the time they have given us, and I mean by "us" the public, the people from the smaller towns and communities who send business through us to the New York Stock Exchange or the New York Curb Exchange; I say to you that these specialists have given good work. We have had exonerated before this committee practically all but one or two men, and while they were being criticized we have heard practically nothing of the 250 or 253 other men who have rendered outstanding service, whose outstanding labors and clean-cut work is more or less overlooked.

Senator ADAMS. Do you have specialists on the Philadelphia Stock Exchange?

Mr. BUTCHER. Yes, sir; but they function a little differently from the way a specialist functions on the New York Stock Exchange or the New York Curb Exchange. The specialist there handles odd lots also. He does not handle hundreds—but I do not

want to take up your time going into these details of technical matters unless you wish me to do so.

Senator KEAN. Have you figures for all these margins that would be required under this bill?

Mr. BUTCHER. Yes, sir. I stated the last time I appeared before your committee that I thought the margin requirements were fantastic.

Senator KEAN. Well, are they still fantastic under the revised bill, or are they better under this bill?

Mr. BUTCHER. This is more reasonable. The Federal Reserve Board under certain circumstances may have something to say, but very little. If they were all left to the Federal Reserve bank, I would be satisfied. These margin requirements are too great in some cases and not as great as my firm would require in other cases. It should be elastic. If you want the business to be continued to be conducted, it must be elastic. That, Senator Kean, is a thing that would compel my firm to close. We could not do business under it as it is written in the revised bill. And if you were to look into the matter of the margin requirements, you would find them very satisfactory as now required under the rules and regulations of the exchanges.

Senator ADAMS. What percentage of the business going through your firm is now a margin business?

Mr. BUTCHER. That varies very much according to the activity of the market and the year. If we were to speak of 1933, while I have made no particular study of it, I should think that very much more than three fourths of our business has been for cash, and that only about one fourth of the business has been on margins. The amount of money we were lending to our clients in 1932 was about 7 percent of that loaned in 1929. And the fact that we could liquidate down to that point shows that we carried proper margins.

Senator GORE. Have you taken much by way of losses?

(Before the witness could answer, the next question was propounded, as follows:)

Senator TOWNSEND. Mr. Butcher, I have a letter from a very large corporation saying if this bill were enacted into law they would have to withdraw from the exchanges; that is, withdraw their stock. He does not give the reasons. Could you assign any reason why that would have to be done?

Mr. BUTCHER. I think that would be because the presidents of companies would want to stay out of jail. These provisions from a corporation standpoint, I think, are almost prohibitive. I mean that a corporation man——

Mr. PECORA (interposing). Can you specify in what respect they are prohibitive? Tell us what provisions particularly you think would lead to a withdrawal of securities of a big corporation from the New York Stock Exchange.

Mr. BUTCHER. The obligations imposed on them in reference to registering their securities. If there should be some little bit of a slip occurring somewhere, and perhaps a perfectly honest mistake, they face a penalty of 10 years in jail and a fine of $25,000. No corporation man is going to take that chance, if he values the welfare of his family and his own reputation.

Mr. PECORA. Don't you realize that one little slip would not be a criminal act; that it would have to be a willful violation; and that it is just exactly what this bill states?

Mr. BUTCHER. Mr. Pecora, I took that point up with you the last time I was here, and we came to the same conclusion. This bill is so drawn that any act is a willful act. For instance, if the corporation continues to exist it continues to exist willfully.

Mr. PECORA. I beg pardon. Look at the penalty section of the bill and see for yourself.

The CHAIRMAN. If the officer of a corporation tells the truth and sets forth the facts, do you mean he is a criminal?

Mr. BUTCHER. Under this bill he could very readily be declared a criminal.

Mr. PECORA. Section 25 of the bill is the one providing the penalties, and it starts off with the sentence:

Any person who willfully violates any provision of this act—

Mr. BUTCHER. Well if a person signs a report, and that report——

Mr. PECORA (interposing). It says:

or any person who willfully and knowingly—

is responsible for any statement in any application which is false or misleading. But it has got to be willfully false, and a mere slip would not be a willful violation.

Mr. BUTCHER. I am sorry but I cannot agree with you. And the language of your bill does not protect one from an innocent mistake.

Mr. PECORA. Then you are closing your eyes to the language of the bill which says:

Any person who willfully violates any provision of this act.

Mr. BUTCHER. Yes; I say that word "willful", and I understand what willful means, I think—and I might say that I have by my wife been accused of being willful, but——

Mr. PECORA (interposing). With all due respect to Mrs. Butcher, I might say that she probably hasn't a judicial mind.

Mr. BUTCHER. Well, judicial to the extent of being the last word in that matter. [Laughter.]

Senator ADAMS. Perhaps your wife may be carrying the burden there.

Mr. BUTCHER. Well, she is always right. I know that. And, Mr. Pecora, the "willful" part here is all right, perhaps—and now please don't think I am trying to be personal in saying this, but this is simply what I call a "technicality", and I just don't like technicalities.

Mr. PECORA. Oh, no. It is not a technicality at all. It is a very substantial provision, and is intended to mean just what it says. There is a great difference between a willful violation of a penal statute and an innocent violation of it. Yes; there is all the difference in the world between the two.

Mr. BUTCHER. Well, Mr. Pecora, I am not an engineer and I am not an expert accountant, although I have spent some time on accountancy matters. But suppose somebody who goes over some property makes an engineering report and makes a mistake in his figures of, say, 100,000 pounds in relation to the weight of a certain piece of machinery, a perfectly honest mistake on his part. Then he

sends in his engineering report, and it goes on down the line, and the president and treasurer of the corporation sign it. If the president signs that report that is a willful act.

Senator ADAMS. Oh, no.

Mr. PECORA. Do you mean if he signs it with knowledge of its falsity?

Mr. BUTCHER. Oh, no.

Mr. PECORA. Do you think that would be a willful violation of the act?

Mr. BUTCHER. I do not see how it would be considered in any other way.

Mr. PECORA. It depends on whether he willfully does the thing.

Senator ADAMS. Mr. Butcher, your construction of "a willful act" would seem to refer to the fact that he had the will to do it but without any intention to do a wrong.

Mr. BUTCHER. It is my idea that this bill is written with that idea in view.

Senator ADAMS. And in this section there is another limiting statement:

> Which statement is, in the light of the circumstances under which it was made, false or misleading in any matter sufficiently important to influence the judgment of an average investor

In other words, the trifling errors you speak of would not come within that provision.

Mr. BUTCHER. Have you ever seen the average investor?

Senator ADAMS. Well, I think I have been one.

Mr. BUTCHER. Well, I think you are above the average.

Senator ADAMS. I appreciate the compliment and wish it were true.

Senator KEAN. In regard to these margins, I have a letter from Edward B. Smith & Co.—and they are large brokers in your city, aren't they?

Mr. BUTCHER. Yes, sir; and in good standing.

Senator KEAN. They say that under the figuring in this bill if one were to buy 100 shares of General Motors at $36 per share, and borrowed on it, they would then have to put up 33⅓ percent. Under the present custom of the exchange you would put up $1,200 as a margin, but under this bill they would have to put up $900 more. Is that the way you figure it?

Mr. BUTCHER. I haven't figured it.

Senator KEAN. This would mean a 150 percent margin. Is that the way you figure it? Or you can take the letter and read it. After you have read the letter, I should like to propound that question to you.

(While Mr. Butcher was reading the letter, the following occurred:)

The CHAIRMAN. What do you want Mr. Butcher to do, Senator Kean—confirm the statement made by Edward B. Smith & Co.?

Senator KEAN. Yes. And I want to put the letter in the record.

Senator BULKLEY. There would be no purpose in the witness confirming it unless the letter is put in the record.

The CHAIRMAN. Let the letter go in and it will speak for itself.

Mr. BUTCHER (after reading the letter). Do you want me to say anything, or do you just want me to present the letter?

Senator KEAN. I will ask you about the letter.

Mr. BUTCHER. I have read the letter hastily and believe it to be correct.

The CHAIRMAN. The letter may go in the record.

Mr. BUTCHER. The 150-percent margin referred to is on the debit balance, not on the market price of the stock.

Senator KEAN. Let the record be completed by inserting the letter.

(The letter is as follows:)

EDWARD B SMITH & Co,
15 Broad Street, New York, March 22, 1934

Senator HAMILTON F KEAN,
Senate Office Building, Washington, D C

DEAR SENATOR In reference to our conversation over the telephone this morning and in connection with the hearings which I understand are to be reopened upon the "National Securities Exchange Act of 1934", I wish to point out a question which we discussed in reference to section 6 of the bill, which I believe is causing some confusion not only in Congress but in the minds of exchange members Section 6 of the bill allows the member of an exchange to loan 40 percent of the market price of a security which is qualified as collateral within the meaning of the act It is the universal practice among brokers to speak of the margin requirement in terms of the percentage of the debt balance, or in other words, the amount which the borrower owes when he purchases the security that he intends to use as collateral for his loan with the broker For example, take the case of a customer who wishes to buy 100 shares of General Motors at the present price of $36 per share—the total purchase price of this stock would be $3,600 The broker would, under the present requirement with the customer, i.e, that the equity be 33⅓ percent of the debit, require upon such purchase that the customer deposit one third of $3,600, or $1,200 This would mean that the customer has an equity in the account of $1,200 and owes to the broker $2,400. This would leave the account just adequately margined.

Upon the margin as required in the bill that the broker may loan 40 percent of the market price it would be necessary that the customer deposit 60 percent of $3,600, or $2,160, which would be the customer's equity in the account, and the account as previously adequately margined would need additional margin to the extent of the difference between $2,160 and $1,200, or $960, which the customer must deposit or render it necessary to sell a part of his stock in order to comply with the law.

This uncertainty in speaking of margin in one instance in the terms of the loan the act allows upon the stock, and in the other instance in terms of the amount that the customer owes the broker, is a question that is causing a great deal of confusion. Under the bill as it is now drawn when a broker may only loan 40 percent of the market value of the stock, the customer has an actual margin, according to our method of computation, of 150 percent, since the customer's equity of 60 percent is 150 percent of the debit balance of 40 percent which remains unpaid.

I believe it would be extremely helpful if some expression of opinion could be obtained from the Treasury Department or the Federal Reserve Board and possibly written into the bill which would clarify the question.

Please allow me to thank you for the opportunity of bringing this matter to your attention.

With kindest personal regards.

Yours sincerely,

(Signed) JOHN W. CUTTER

The CHAIRMAN. Is that all, Mr. Butcher?

Mr. BUTCHER. Yes, Mr. Chairman; and I wish to thank you very much.

The CHAIRMAN. Are there any further questions by members of the committee?

Senator GORE. Mr. Butcher, you were discussing a minute ago the functions of specialists. I was talking to an old friend the other

night who is a mere layman and yet he has given a good deal of thought to the pending bill. He used this illustration of what might result if too much limitation were placed upon specialists, dealers, and brokers. He said American Telephone & Telegraph might close some afternoon at 115, we will say, and the ordinary citizen buying it occasionally might take it for granted that it would open around that figure the next day, and yet under this bill he thought it might drop something like 15 or 20 points. Could that happen; and if so, why? And did you say the other day, Mr. Pecora, that that section had been amended?

Senator KEAN. Mr. Pecora did not hear your question, Senator Gore.

Mr. PECORA. What was that, Senator Gore?

Senator GORE. You said the other day that the point I mentioned had been amended, but never mind. Mr. Butcher, will you answer the question?

Mr. BUTCHER. You are asking me a question which will take a moment or two to answer.

Senator GORE. My friend seemed to think that a specialist in that sort of case would make a market to protect the purchaser against such a drop as I have suggested, which he referred to as just a sinking spell. How about that?

Mr. BUTCHER. A specialist under the New York Stock Exchange regulations has the right to buy for his own account after the stock has first been offered to the group around him. In other words, after he has announced the offering he may take it himself if nobody else wants it. Or that is the way I understand it. But he always is at a disadvantage as compared with the group around him to the extent of one eighth or to the extent of no offering or no bid. He can only take a stock when it is not wanted by anybody else. That tends to bring the spread in the stock closer together. If American Tel. & Tel. closed at 119 and the next morning there is no bid, or a bid of only 114, and the stock is offered at the market, he could technically take it at 114⅛. But very likely under those circumstances he would take it a point away from the close of the night before, knowing that sooner or later somebody would come forward and there would be more activity. The specialist, instead of being one who abuses the public, is the man who helps the public. I do not believe it would be possible for the New York Stock Exchange to handle 2,000,000 shares a day without specialists, and if the New York Stock Exchange cannot handle the business and handle it right as it has done in the past, there is very serious injury being done to the general public.

Senator GORE. That is, the specialist is a sort of stopgap.

Mr. BUTCHER. Yes; and sometimes they win and sometimes they lose. But the specialist is there, and makes the market very often when nobody is prepared to do it. He hopes, of course, to win, but he takes his chances.

Senator GORE. As the market is operating now he would be in that situation a protecting influence against a tendency to drop 10 or 15 points if nobody was there to buy the stock.

Mr. BUTCHER. I do not quite understand your question.

Senator GORE. As the market is operated now the specialist would be there and would be in a position to get the stock on the way down and thus prevent its dropping 10 or 15 points.

Mr. BUTCHER. Yes, sir. He also prevents too great a rise. He acts as a sort of shock absorber either way. And he is functioning now better than ever before in the history of American business.

Senator GORE. Do you think this pending bill lays too severe limits upon his functions?

Mr. BUTCHER. Undoubtedly so, in my opinion. I might say that I am one of those who is ordinarily supposed to be hostile to specialists, for specialists are constantly executing my orders.

The CHAIRMAN. Are there any other questions?

Senator KEAN. Yes, one more: Mr. Butcher, if you wanted to buy 100 shares of stock for yourself under this bill, and you telegraphed to your broker in New York to buy such stock, and you were prevented from giving an order to anybody on the New York Stock Exchange under this bill, how could you do it?

Mr. BUTCHER. Well, there wouldn't be any market except through some bootleg source, and I would have to keep the money and could not buy the stock. That is what I spoke about, that it would freeze up tight like real estate, and it will be a tremendous blow to Florida if you pass this bill. And, Mr. Chairman, I enjoyed being down there in January.

Now, Mr. Pecora, you told me the last time I was here that I would not have to close up shop. I am going to hold you to that.

Mr. PECORA. I hope you are not looking to interest me as a partner.

Mr. BUTCHER. Partners are not so willing to take the risks these days.

The CHAIRMAN. All right, if that is all. Mr. Butcher, you spoke about Florida, and I have a telegram from a man saying that perhaps under the bill the State of Florida next winter will very much resemble the State of Nevada. I do not know what he means. Do you?

Mr. BUTCHER. I can tell you later, after your hearing.

Mr. PECORA. Perhaps he means that the wives of brokers will seek divorces. [Laughter.]

The CHAIRMAN. I think Nevada is doing very well.

Mr. BUTCHER. Well, I think I know what he has reference to, but I would rather tell you after the hearing closes today.

(Mr. Butcher left the committee table.)

The CHAIRMAN. Mr. Smith was supposed to come before us first this afternoon, but Mr. Butcher wanted to go back home in Philadelphia, and promised that he would not take very long, and in order to give an opportunity for more members of the committee to be in attendance we delayed hearing Mr. Smith. Now, Mr. Smith, if you will take a seat at the committee table opposite the microphone, and will state your name, residence, and occupation.

Mr. SMITH. My name is Tom K. Smith. I am president of the Boatman's National Bank, St. Louis, Mo., temporarily acting as Assistant to the Secretary of the Treasury.

STATEMENT OF TOM K. SMITH, ASSISTANT TO THE SECRETARY OF THE TREASURY, WASHINGTON, D.C.

The CHAIRMAN. Mr. Smith, have you considered some portions, anyhow, of this bill, H.R. 8720? If so, we would like to hear your views about the bill.

Mr. SMITH. Mr. Chairman, if you please, I should like to make a prepared statement first.

The CHAIRMAN. Very well; you may proceed.

Mr. SMITH. The Nation has experienced undoubtedly the most severe depression in its history. There seems to be no doubt that excessive speculation and harmful practices that developed in the securities market—particularly on the stock exchanges—were among the major causes of economic disaster.

We have started on our way to recovery. It is of supreme importance that a repetition of old mistakes should not wreck our efforts to bring about a broad and lasting economic improvement. The time is appropriate for legislation to remedy stock-exchange abuses and to place stock-market activities under reasonable and adequate regulation in the public interest. Those who wish to invest their savings, and industries having legitimate need for capital funds, must alike be protected from the evils of wild and unchecked speculation.

The general purposes of the National Securities Exchange Act of 1934 is to attain these ends. And, incidentally, I am referring to the House bill as revised. But, I take it that is understood.

Mr. PECORA. You mean H.R. 8720.

Mr. SMITH. Yes.

The CHAIRMAN. You may continue your statement.

Mr. SMITH. The general purposes of the National Securities Exchange Act of 1934 is to attain these ends. Its major objectives are:

First. To establish Federal supervision over securities exchanges.

Second. To prevent manipulation of security prices and to protect the public against unfair practices.

Third. To prevent excessive fluctuations in security prices due to speculative influences.

Fourth. To discourage the use of credit in the financing of excessive speculation in securities.

With these general objectives the Treasury is in full accord.

The Treasury has been consulted on certain parts of the bill which are of direct concern to it. Within the limited time available, these have been studied to determine whether they would have an unduly adverse effect on the marketing of Government securities or on the national financial structure. Changes which were regarded as necessary within the framework of a general regulatory measure were suggested to the counsel for the committees of the Senate and House and were, in all material respects, incorporated in the bill.

The Treasury has not considered those provisions of the bill which relate to the strictly technical matters of stock-exchange practice and regulation. Failure to comment on those provisions does not mean that the Treasury is opposed to them, but only that they have not been the objects of our study. The Treasury is, therefore, not in a position to express an opinion on them.

Mr. Chairman, I am submitting that statement with the approval of the Secretary of the Treasury. I will be glad to answer any questions the members of the committee may desire to ask.

The CHAIRMAN. Are there any questions?

Senator ADAMS. Personally, I should like to have Mr. Smith's views about the bill.

The CHAIRMAN. He has given them to us.

Senator GORE. How well is this bill designed to attain the desires ascribed to it?

Senator ADAMS. He has not given us very much about the bill so far.

Mr. SMITH. That is all that I can give you.

Senator KEAN. What portions of the bill did you study?

Mr. SMITH. We studied the portions that had to do directly with Government financing.

Senator KEAN. Which ones were those?

Mr. SMITH. I would have to go through the bill in order to be able to tell you. They are parts of sections all the way through the bill. It would be better, perhaps, for you to ask me about particular sections of the bill, and then I can tell you.

Senator KEAN. Did you study the section in regard to margins?

Mr. SMITH. No, sir.

Senator KEAN. Don't you think that that section might seriously affect the banks?

Mr. SMITH. I cannot answer that question because the subject of margins was not submitted to us for study.

Senator KEAN. Suppose that the president of the Chemical National Bank and the president of the Guaranty Trust Co. were down here and they said in regard to the other bill, and this bill is practically the same, that it would make for tremendous liquidation in a number of their loans. Wouldn't that affect banking if that were true?

Mr. SMITH. I am instructed by the Secretary of the Treasury only to comment on those sections that we studied at the request of the committee.

Senator WALCOTT. What sections of the bill did you study?

Mr. SMITH. We studied section 10.

Senator WALCOTT. There is no reference in your statement to what portions of the bill you studied.

Mr. SMITH. It is impossible to do that.

Senator WALCOTT. We would like to know for our information.

Mr. SMITH. Well, we studied section 10 of the bill, which has to do with brokers-dealers.

Senator GOLDSBOROUGH. You answered Senator Kean that you had not studied section 6 with reference to margin requirements, I believe.

Senator ADAMS. He goes beyond that, Senator Goldsborough, and says he is instructed not to comment on other sections of the bill.

Senator GOLDSBOROUGH. Then I do not care to ask him any questions.

Senator WALCOTT. What sections of the bill can you speak to us about?

Mr. SMITH. Only the sections submitted for our study.

Senator ADAMS. And you are under instructions not to give a personal opinion about things? I had supposed you were more or less an expert and student of this bill.

Mr. SMITH. We studied section 6 inasmuch as we considered the question of regulation by the Federal Reserve System of the flexibility of the control of bank loans.

Senator GOLDSBOROUGH. Does the Treasury Department approve of that section?

Mr. SMITH. Not in its entirety.

Senator TOWNSEND. How would they want it modified in order to comply with the desires of the Treasury Department?

Mr SMITH. We are not asking for any modification.

Senator TOWNSEND. You understand, I take it, that we are engaged here in an effort to get this bill in shape and are very anxious to have the ideas and recommendations of the Treasury Department.

Mr. SMITH. We were asked to study certain sections of the bill, Senator Townsend, and that is what we have done.

Senator GORE. Well, your statement does not contribute very much, and you will probably agree with us that it is not very helpful in solving the problem before us.

Senator BULKLEY. Mr. Smith, are you instructed not to tell which sections of the bill you have studied?

Mr. SMITH. No, sir.

Senator WALCOTT. Well, what sections have you read?

Mr. SMITH. All of them.

Senator WALCOTT. What sections are you now speaking of?

Mr. SMITH. If you care to ask me questions about sections of the bill, I will tell you whether we were asked to study them or not; and if we did study them, we will give you our views.

Senator ADAMS. Do you have permission to give expression as to whether or not this bill, if put in operation as it stands, would affect seriously the operations of stock exchanges as a legitimate market for securities?

Mr. SMITH. I will let my prepared statement answer that question.

Senator ADAMS. My reason for asking you that question is this: That the stock market as it stands is one of the places where Government securities are sold. You realize that?

Mr. SMITH. Yes, sir.

Senator ADAMS. And therefore, if the bill had a tendency to destroy that as an open market, it would have a very decided effect upon your department. I thought you would be interested in that general effect of the bill.

Mr. SMITH. It was not a question of what we were interested in but what we were asked to report on.

Mr. PECORA. Mr. Smith, may I ask you a question right there?

Mr. SMITH. Certainly.

Mr. PECORA. In your prepared statement you say the Treasury has been consulted on certain parts of the bill which are of direct concern to it. Now, what were those parts of the bill?

Mr. SMITH. You will recall that at the first conference we were asked to give our views as to the effect on Government financing and bank credits as well as other subjects of direct concern to the Treasury and were not consulted about the regulatory provisions of the bill.

Senator GORE. Who asked you about those?

Mr. SMITH. The Secretary of the Treasury, or those were the instructions I received from the Secretary. The chairman of your committee and Mr. Pecora understood that.

Senator KEAN. Did Mr. Pecora ask you that?

Mr. PECORA. I gave no instructions. I was not presumptuous enough to try to give instructions to the Treasury Department.

Mr. SMITH. Well, you understood the nature of the request, Mr. Pecora.

Mr. PECORA. And I also understood that——

Senator TOWNSEND (interposing). Who gave you the instructions?

Mr. SMITH. The Secretary.

Senator TOWNSEND. Who wrote this bill?

Mr. SMITH. I cannot answer that question.

Senator WALCOTT. Weren't you allowed to answer that question?

Mr. SMITH (laughing, without making answer).

Senator WALCOTT. Mr. Smith, I am perfectly serious in asking you that question. I am studying this bill, and we are simply wasting your time and our own if you cannot answer questions.

Mr. SMITH. Well, Senator Walcott, did you hear the question he asked me?

Senator WALCOTT. Yes. But I do not understand why you cannot answer these questions.

Mr. SMITH. He asked me who wrote this bill.

Senator WALCOTT. It was done down in the Department, wasn't it?

Mr. SMITH. This bill?

Senator WALCOTT. Yes. Or you say you do not know who wrote it.

Mr. SMITH. The first time I heard of this bill I was asked to get in touch with the chairman of your committee, and I did so, and he asked Mr. Pecora to meet us. Previous to that time we had gotten in touch with the chairman of the House committee, who asked us to meet his counsel, Messrs. Corcoran and Cohan.

Senator ADAMS. Were you as cautious in advising Mr. Pecora as you have been in advising this committee?

Mr. SMITH (simply laughing, without making answer).

Senator WALCOTT. Did you get in touch with Mr. Corcoran and Mr. Cohan?

Mr. SMITH. Yes; but I do not know who wrote this bill.

Senator GORE. Did you talk with them at all?

Mr. SMITH. If they had any questions to ask about the bill.

Senator WALCOTT. Well, our questions are entirely related to the bill, but you do not answer any of them.

Mr. SMITH. I do not know who wrote the bill. It was not written in the Treasury Department.

Senator GORE. I think Mr. Smith better go back and tell them to stop tattling.

Mr. SMITH. Did you have the impression that the bill was written in the Treasury?

Senator WALCOTT. I was told it was partly written there.

Mr. SMITH. We made suggestions regarding the revised copy.

Senator WALCOTT. What suggestions did you make?

Mr. SMITH. We made suggestions as to the separation of broker-dealer, and as to the question of bank loans, and as to the question of Government financing.

Senator KEAN. Well, Mr. Smith, wouldn't it be to the advantage of the Treasury and to the advantage of the United States and to the advantage of everybody if this thing were put under the Federal Reserve Board or the Treasury Department instead of being placed under some other department not interested in credits?

Mr. SMITH. As the bill was submitted to us it showed a division of the work between the Federal Trade Commission and the Federal Reserve Board, and insofar as that touched the subject of our study, it was perfectly satisfactory. We were not asked to decide between the two except to say whether it was satisfactory.

Senator GORE. If you were on this committee, would you recommend any changes in the bill?

Mr. SMITH. As a representative of the Treasury, Senator Gore, I cannot answer that question.

Senator TOWNSEND. Mr. Smith, are you familiar with or do you know whether the same questions were put to the Federal Reserve Board that were put to the Treasury on this bill?

Mr. SMITH. No, sir; I could not answer that.

Senator TOWNSEND. Did the Federal Reserve Board and the Treasury sit in on the bill?

Mr. SMITH. Yes, Senator. Some of our studies were made at joint meetings with the staff of the Federal Reserve Board.

Senator WALCOTT. When you met Mr. Corcoran and Mr. Cohan, what did you have to say to them? You said they directed you to do something.

Mr. SMITH. We were directed to make a study of these certain provisions with them and to give them our suggestions, which we did.

Mr. PECORA. And those suggestions have been substantially incorporated in the revised bill?

Mr. SMITH. Yes, sir. I will be glad to answer as to any particular section. We did not keep a record of them.

Senator WALCOTT. We cannot read your mind, Mr. Smith. We asked you a plain question, to state what was said about this bill in these conferences and those in which you had any influence, and you refused to tell us.

Mr. SMITH. I did not refuse to do that. I beg your pardon, Senator. I will go through the bill section by section if you wish.

Senator GORE. He asked your present opinion about it.

Senator WALCOTT. He said he was not allowed to answer that.

Senator BULKLEY. No, he said he was allowed to answer that.

Mr. SMITH. No, I will answer that. I will take the bill up section by section but I suggest for the sake of brevity that you inquire about any particular section that you are interested in.

Senator WALCOTT. We are interested in them all.

The CHAIRMAN. Did you have your general counsel and other assistants to assist in this?

Mr. SMITH. Yes, sir; we had our staff.

Senator TOWNSEND. Did Mr. Cohen and Mr. Corcoran represent the Treasury, or whom do they represent?

Mr. SMITH. No, sir. In this case we were to meet them as representatives of the House committee and Mr. Pecora as a representative of the Senate committee.

Senator TOWNSEND. And Mr. Corcoran then represented the House?

Mr. SMITH. Yes, sir.

Mr. PECORA. Mr. Smith, I understood after our first conference, which was held as I recall it a week ago Tuesday, that the gentlemen assigned by the Treasury Department to the consideration of this bill, as well as the gentlemen assigned by the Federal Reserve Board to a similar duty, desired to make a further independent study and analysis of the entire bill for their own information, and for that reason further conferences were deferred from Tuesday of last week until Friday of last week. I, frankly, was under the impression that the intervening time was spent by the gentlemen representing the Treasury Department, as well as those representing the Federal Reserve Board, to such an independent study and analysis of the entire bill. Apparently I was in error so far as the Treasury Department was concerned.

Mr. SMITH. The entire bill?

Mr. PECORA. Yes, sir.

Mr SMITH. No, sir. Of course, you were not at the final conference, Mr. Pecora. Our position was very clearly stated at that conference where you asked Messrs. Cohen and Corcoran to represent you

Mr. PECORA. The final conference was held last Sunday?

Mr. SMITH. Yes; Sunday evening, at which we stated——

Mr. PECORA (interposing). I did not know the conference had been fixed for that time or I would have made arrangements to be present.

Senator GORE. Were there any Senators or Congressmen in that conference?

Mr. SMITH. Congressman Rayburn was there.

Senator GORE. Any others?

Mr. SMITH. Congressman Rayburn, Mr. Corcoran, Mr. Cohen, and Mr. Landis.

Senator WALCOTT. Do you think Mr. Cohen had anything to do with the drafting of the bill?

Mr. SMITH. I have heard him mention that he did.

Senator WALCOTT. And Mr. Corcoran?

Mr. SMITH. Yes.

Senator WALCOTT. All right; as to section 10, is that a section on which you were allowed to speak?

Mr. SMITH. Yes, sir; a section we studied as far as its effects on——

Senator KEAN (interposing). Then this bill is not the Treasury bill?

Mr. SMITH. No, sir; it is not a Treasury bill.

Senator KEAN. Nor is it a Federal Reserve Board bill?

Mr. SMITH. I could not answer that.

Mr. PECORA. But whatever recommendations for revision were made by the Treasury Department representatives had been incorporated in this revised bill, isn't that so?

Mr. SMITH. We studied certain sections of the bill, made recommendations concerning those sections, and you adopted them.

Mr. PECORA. Yes, sir.

Mr. SMITH. Concerning those sections.

Senator KEAN. Did they adopt your words, or were they words of their own?

Mr. SMITH. We did not attempt to put words in their mouths. In some of these cases it is principles.

Senator TOWNSEND. Were all of your recommendations incorporated in the bill, Mr. Smith, from the Treasury?

The CHAIRMAN. I will state that S. 2693 was referred to the Treasury and other departments for report.

Senator TOWNSEND. Were the Treasury recommendations all incorporated in the bill?

Mr. SMITH. In all material respects.

Senator WALCOTT. Do you approve in section 10 of this provision to this end, that it shall be unlawful for an odd-lot dealer to act as a broker?

Mr. SMITH. That is the part of the technique of the New York Stock Exchange about which we were not supposed to make any investigation or study, and I do not know whether it is sound or not. Provisions there as to the separation of the broker and dealer do meet with our approval.

Senator WALCOTT. Then on the next page you take that back by saying that it may be allowed, provided it meets with the approval of the Federal Trade Commission. One contradicts the other.

Mr. SMITH. The principle of that section as far as we are concerned is that it permits the broker-dealer to continue to act as long as he discloses his position in regard to a security and does not extend credit on his own underwritings for a period of 6 months after they are offered. We felt that the dealer-broker was necessary in the Government interest and that he should be allowed to continue in business for that purpose.

Senator WALCOTT. And would you approve of the exemption under exemptions of leaving out municipal bonds, State bonds, and others?

Mr. SMITH. The clause regarding exemptions gives the Federal Trade Commission full power to extend those exemptions.

Senator WALCOTT. If you were a broker dealing in municipal bonds almost exclusively outside of some of the large cities would you be satisfied with taking that risk?

Mr. SMITH. We felt, as far as it affected our study, that the provision was satisfactory.

Senator KEAN. And all your study was in United States bonds?

Mr. SMITH. We were studying it from the Government's standpoint. It affects other Government bonds.

Senator WALCOTT. You evidently do not consider it important, then, to keep brokerage houses throughout the country, to have a ready market for these securities, like municipals, for instance?

Mr. SMITH. Well, a broker-dealer will feel that need.

Senator WALCOTT. But not if he is denied the privilege of selling——

Mr. SMITH (interposing). We did not see that the broker-dealer was not protected in no. 10. It was our impression that he was protected.

Senator ADAMS. You were not concerned with the securities and obligations of States?

Mr. SMITH. We felt that the provision giving the option to the Federal Trade Commission was sufficient protection.

Senator ADAMS. That is, you thought it was sufficient to give the Federal Government the right to determine whether State securities should be marketed or not?

Mr. SMITH. Well, you are giving the Federal Trade Commission certain powers here over government that the option to exercise——

Senator ADAMS (interposing). I am asking you, Why did you make the distinction in bonds between a Federal bond and a State bond?

Mr. SMITH. Because of a perfectly obvious reason; you must distinguish between securities of the United States Government in these days and those of States. You cannot draw any general conclusions.

Senator ADAMS. I am unable to see that it is so obvious, if you theoretically were representing the people generally, not merely the department. That is, the bill was being drawn for the benefit of the people as a whole, not merely for the benefit of one particular class of securities.

Mr. SMITH. You could not exempt State bonds in their entirety at the present time, Senator.

Senator ADAMS. Why not?

Mr. SMITH. Because they do not all fall in the same class.

Senator ADAMS. Why not?

Mr. SMITH. Because they are not all the same. Some States of our Union are in default at the present time.

Senator ADAMS. Therefore you would exclude all of them?

Mr. SMITH. You would have to exclude them from an action of this sort.

Senator WALCOTT. But you exclude them all.

Mr. SMITH. Well, you give authority to the Federal Trade Commission. I am not arguing for the provision.

Senator WALCOTT. In other words, you want to put in the hands of the Federal Government an agency——

Mr. SMITH (interposing). No; I beg your pardon, Senator. The bill as submitted to us puts that power there and gives an option. We were not asked to state whether that was satisfactory but it is satisfactory to us.

Senator WALCOTT. You, as an American citizen, are willing to have a special board of the Federal Government have absolute authority as to the credit of a State or a municipality. You must be. You must take that position, if you take the position you do.

Mr. SMITH. I am sorry, I cannot agree with you.

Senator KEAN. I think the position that he took was a position that he was an officer of the Treasury and was not acting in any other capacity, and therefore, as long as the United States bonds were excluded, why, that was the extent that he went.

Senator ADAMS. I suppose if he had represented district 20 from your county, all he would want would be the bonds of district 20.

Senator KEAN. Absolutely.

Senator ADAMS. But that would not help this committee.

Senator TOWNSEND. What have you to say as to whether the authority should be lodged in the Federal Trade Commission instead of the Treasury or the Federal Reserve Board?

Mr. SMITH. We were asked whether the arrangement as submitted was satisfactory, and we said, "Yes; it is." We were not asked any preference at all; just, is the section as submitted satisfactory?

The CHAIRMAN. Mr. Smith, may I ask you, outside of your official position, without regard to speaking for the Treasury or anybody else, but as a banker and as a citizen, do you see any objection to including in the exemption State and municipal bonds?

Mr. SMITH. Mr. Chairman, if you please, I prefer not to express a personal opinion, but as we considered that subject in our studies and felt that there should be some distinction between the State issues as such.

Senator GORE. Mr. Chairman, I move we excuse Mr. Smith from further testifying and strike his statement from the record.

Senator TOWNSEND. I want to ask one question: Mr. Smith, you state that you were asked to approve this set-up. Who were you asked by?

Mr. SMITH. Asked to approve what?

Senator TOWNSEND. To approve the set-up as given to you. Who submitted it to you?

Mr. SMITH. The bill was submitted to us by Messrs. Corcoran, Cohen, and Pecora.

Senator GOLDSBOROUGH. Finally, so that I may get it, I understand the Treasury is not in a position to express any opinion as to the matters of stock-exchange practices?

Mr. SMITH. That is correct. It was not submitted for our study.

Mr. PECORA. Mr. Smith, in order to clear up any possible misunderstanding, from an answer that you made to a question that I believe was put to you by Senator Kean about whether or not the Treasury Department approved the provisions of section 6, section 6 is the section that deals with margins, and you said, as I recall it, that it might be construed as a statement that the Treasury Department did not approve section 6. Did you mean to say that you had no opinion to express bout section 6 one way or the other because that section was not referred to you by the Secretary for study?

Mr. SMITH. Part of it was submitted to us for study and approved, and the other part was not submitted, and therefore we have no opinion concerning the other part of it. There is no disagreement between us about that at all.

The CHAIRMAN. Very well; we are much obliged to you, Mr. Smith. Now, Mr. Whitney.

Senator ADAMS. Mr. Chairman, I rather think that there is some disclosure in this little memorandum of some things which I do not think the Treasury really wanted to let us know, because they have discovered one or two things in reference to unfair practice in the stock exchange, and I do not believe they mean to express any opinion even as to the purpose of the bill.

The CHAIRMAN. Well, they did express it.

Now, Mr. Whitney, will you take the stand?

STATEMENT OF RICHARD WHITNEY, PRESIDENT NEW YORK STOCK EXCHANGE, NEW YORK CITY—Resumed

The CHAIRMAN. Mr. Whitney, you wrote me a letter, which I might put in the record, asking to be heard on this matter; and you stated, I think—

I shall be glad to appear before your committee at any time you may designate and state the reasons for my conclusions I am also prepared to suggest to the committee the changes which would be necessary to make the bill workable without in any way limiting the power to control credit and regulate stock-exchange practices

That is very interesting, and we will be glad to hear from you, Mr. Whitney.

(The letter is as follows:)

NEW YORK STOCK EXCHANGE,
Eleven Wall Street, March 21, 1934

HON DUNCAN U FLETCHER,
Chairman Committee on Banking and Currency,
Senate Office Building, Washington, D C.

MY DEAR SENATOR FLETCHER I am informed that the new Rayburn bill, now pending in the House committee, will be considered by your committee. Recalling your statement that when amendments to the original Fletcher-Rayburn bill were prepared persons interested would be given a hearing, I respectfully request that time be allowed to me to state to the committee the objections of the New York Stock Exchange to the new measure.

I believe that the new bill will prove unworkable in essential features and will seriously affect security markets and security prices It differs from the original bill in its treatment of many important points, but its effects will be almost as destructive as those of the original bill

As this bill is of vital concern not only to stock exchanges but also to all business and industry, it deserves the most serious consideration

I shall be glad to appear before your committee at any time you may designate and state the reasons for my conclusions. I am also prepared to suggest to the committee the changes which would be necessary to make the bill workable without in any way limiting the power to control credit and regulate stock-exchange practices.

Faithfully yours,

RICHARD WHITNEY, *President.*

Mr. WHITNEY. Mr. Chairman, I haven't a very long statement to make. I do think if it could be made consecutively without adjournment, it would be better for all of us. Would you prefer having me appear tomorrow, or may we have about an hour?

The CHAIRMAN. I think we had better go on now, Mr. Whitney.

Senator ADAMS. How long a statement have you?

Mr. WHITNEY. Depending upon the questions, Senator Adams.

The CHAIRMAN. I think you better make your statement without interruptions.

Mr. WHITNEY. I am very glad to be interrupted as much as you wish.

The CHAIRMAN. We can ask questions afterwards.

Senator WALCOTT. I suggest, Mr. Chairman, he be allowed to read straight through and then have the questions asked afterwards.

The CHAIRMAN. Yes; that is the proper thing to do, to save time.

Mr. WHITNEY. I understand that the bill introduced in the House of Representatives by Mr. Rayburn and numbered H.R. 8720 is being considered by this committee as if it were an amendment to the Fletcher-Rayburn Bill. The New York Stock Exchange is op-

posed to the new Rayburn bill because it contains in substance the same objectionable features as the Fletcher-Rayburn bill. The Rayburn bill, which for the purpose of this discussion I will consider as a bill pending before this committee, contains modifications of some of the provisions of the original bill. Our basic objections to the old bill apply, however, with equal force to the Rayburn bill.

There is not time to discuss all of its provisions and I shall, therefore, confine my remarks to the most vital sections. I shall deal only with sections 6 and 8, which refer to margin requirements and the restrictions on members' borrowings; section 10, which deals with segregation of the functions of broker and dealer; sections 11 and 12, which deal with the requirements for the registration of securities and the reports which will be required of corporations whose securities are registered on an exchange; and section 18, which deals with the powers of the Commission over exchanges. There are many other sections of the bill which, in my opinion, should be amended.

Before discussing any provisions of the bill I want to make my position absolutely clear. I think this bill is unworkable and will have destructive effects not only upon stock exchanges but also upon the value of securities and the business of the country. I do not believe that sound legislation can be based on the framework of this bill. However, I understand that the committee would like to have constructive suggestions for the improvements of the Rayburn proposal. I shall, therefore, suggest specific amendments to the sections of the bill which contain the most harmful and unworkable provisions. In making these suggestions I do not wish to be understood as qualifying in any way my fundamental objections of the bill.

The amendments which I shall propose did not emanate solely from the New York Stock Exchange. They were discussed with representatives of the New York Curb Exchange, the Boston Stock Exchange, the Chicago Stock Exchange, and also with the president of the Association of Stock Exchanges, which is composed of 18 stock exchanges located in all parts of this country. The representatives of these exchanges have indicated to me their entire approval of the suggestions which I am about to make.

Section 6, with regard to margin requirements: Section 6 of the bill purports to vest control of margin requirements in the Federal Reserve Board. However, it restricts the power given to the Federal Reserve Board by prescribing rigid minimum margin requirements, which are based upon percentages of current market value or of the lowest price which a security has reached within 3 years preceding the date of the loan, provided, however, that until July 1, 1936, the lowest price at which a security has sold since July 1, 1933, may be taken in lieu of the lowest price in the 3-year period preceding the loan. Different minimum margin requirements are established for the initiation of a loan and its maintenance.

Furthermore, there is a provision to the effect that loans existing on the date of the enactment of the bill will not be subject to the minimum margin provisions until January 31, 1939. This last provision was admittedly intended to prevent a forced liquidation of existing loans, which would necessarily follow if the margin requirements of the bill became immediately operative. Let me call to your

attention that declining markets resulting from the enactment of this bill would bring in their train the very liquidation you seek to forestall by this provision.

I have already said that I consider the margin requirements of the original Fletcher-Rayburn bill excessive. While the margin requirements of the pending bill are more liberal at this moment due to prevailing market prices, they would in the event of a rise in security values reach the same excessive level as was fixed in the Fletcher-Rayburn bill. In brief, the margin requirements of this bill and the Fletcher-Rayburn bill are both defective, in that they base credit solely upon a percentage of market value or upon the lowest market price reached within arbitrary periods of time.

Earnings, likewise, cannot be used as the sole criterion of value for securities. The loan value of a security must be determined by a consideration not only of earnings and market value but of the size and activity of the particular issue, its distribution among investors, the extent to which it is held in loans or margin accounts, the volatility of the security and the general condition of the market and of the industry in which the security represents an interest. These are the factors which reasonable men must consider in determining the amount of credit which can be advanced upon security collateral, and they cannot be reduced to a formula.

The control of credit necessarily involves the use of judgment, and excessive speculation in securities can only be prevented if the persons controlling credit are thoroughly familiar with credit conditions and have full power to raise or lower margin requirements as circumstances may require. In our opinion, therefore, the Federal Reserve Board, which is already vested with power to control the credit resources of the country and which now has the responsibility for such credit control, should be given full power to fix such margin requirements as it may deem necessary in view of economic conditions.

To accomplish this result, I suggest that section 6 of the bill be amended to read as follows:

SEC 6 It shall be unlawful for any member of a national securities exchange or for any broker or dealer transacting a business in securities through any such member, directly or indirectly, to extend or maintain credit to or for any person in contravention of such rules as may be adopted from time to time by the Federal Reserve Board for the purpose of preventing the excessive use of credit for speculation

Another section which directly refers to credit conditions is subsection (a) of section 7, which deals with brokers, borrowing from nonbanking institutions. We believe that the Federal Reserve Board should likewise be given full power over this subject, and we, therefore, suggest that section 7 be amended so as to read:

SEC 7 It shall be unlawful for any member of a national securities exchange or for any broker or dealer who transacts a business in securities through the medium of any such member, directly or indirectly, to secure the repayment of any money borrowed by the pledge or hypothecation of any securities in contravention of such rules and regulations as may be adopted from time to time by the Federal Reserve Board for the purpose of preventing the excessive use of credit for speculation

We suggest that the substance of the other subsections of section 7 be transferred to section 18 of the bill, which I will discuss later on.

Section 10 dealing with the functions of broker and dealer: Section 10 of the bill deals with the segregation and limitation of the functions of broker, specialist, and dealer. It has been changed so as to permit members to combine, under certain safeguards, the functions of dealer and broker, provided they do not act as dealers on the floor of the exchange.

The section still prohibits the function of broker and dealer being combined by a member when on the floor of the exchange. This limitation will effectively put out of business all bond brokers, because they customarily act as dealers and also will put out of business all specialists. It will make it impossible for the odd-lot business to be carried on except on the New York Stock Exchange, which, alone of all the exchanges in the country, has some members who engage exclusively in the odd-lot business.

I cannot believe it is wise to make such a revolutionary change in the accustomed method of doing business until it is shown that any possible abuses cannot be eliminated in some less drastic manner. I suggest, therefore, that this section be amended so as to allow the Commission to adopt such rules and regulations as it may deem necessary in regard to members of an exchange combining the function of dealer and broker when actually engaged in business on the floor of the exchange. This suggestion will give the Commission full power to change and correct its rules as conditions may require. Such a power is essential to experimental regulations in so technical a field and is not possible under fixed rules of law.

I suggest, therefore, that section 10 be amended so as to read:

SEC 10 (a) It shall be unlawful for a member of a national securities exchange, while on the trading premises of such exchange, to act as a dealer and broker in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors

(b) Subject to such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to insure compliance with the provisions of this subsection, the rules of a national securities exchange may provide for the registration of members with the privilege of acting as dealers, and any member so registered shall have the privilege of acting as a dealer and as a broker within the limitations of this subsection It shall be unlawful for a member with the privilege of acting as a dealer who also acts as a broker to effect any transaction in a security by use of any facility of a national securities exchange or otherwise, (1) if in connection with any such transaction he directly or indirectly extends or maintains or arranges for the extension or maintenance of credit for a customer on any security (other than an exempted security) which was a part of a new issue offered to the public by him as a dealer or distributor within 6 months prior to such transaction, or (2) unless, if the transaction is with a customer, he discloses to such customer in writing any interest he may have in connection with the security which is the subject matter of the transaction and offers the customer of a reasonable time, not exceeding 10 days, to refuse the transaction after the disclosure if the disclosure is not made at the time of the taking of the order and confirmed in writing substantially simultaneously therewith

Sections 11 and 12, registration requirements for securities, corporate reports: Sections 11 and 12 deal with the registration requirements for listed securities and the reports to be made by listed corporations. These provisions are among the most vital in the bill. I have already expressed our opposition to them. In view of the technical nature of these provisions and particularly of those dealing with accounting, I have secured from Mr. J. M. B. Hoxsey, execu-

tive assistant to the committee stock list of the New York Stock Exchange, a memorandum discussing these provisions and suggesting the changes which in the light of his experience he believes necessary. Mr. Hoxsey has been engaged in active business for many years and has had a very wide experience in analyzing corporate accounts and corporate affairs. Since he came to the exchange about 10 years ago it has been his sole duty to analyze corporate accounting from the point of view of developing for the benefit of stockholders and investors the most informative type of corporate reports. As Mr. Hoxey's memorandum is quite lengthy, I shall not read it, but I have had copies of it prepared which I shall submit to you.

(Copies of the memorandum were distributed to members of the committee.)

In line with my attempt to make concrete suggestions, I am having these sections of the bill redrafted in order to carry out the recommendations made by Mr. Hoxey and I shall submit copies of these proposed amendments as soon as they are prepared.

The CHAIRMAN. May I ask, Mr. Whitney, if you will indicate when those will be presented?

Mr. WHITNEY. The memorandum is here in printed form, and the others will be in your hands in printed form by Monday morning.

Mr. PECORA. May I take advantage of this interruption to ask you a question, Mr. Whitney? The last time I heard of Mr. Hoxsey was about 3 weeks ago, when Mr. Altschul, one of your board of governors, was before this committee. He then said Mr. Hoxsey was in South America. Has he returned?

Mr. WHITNEY. He has returned, yes. I think he got back about a week and a half ago.

Powers of Commission over exchanges; referring to section 18:

I have already suggested that certain provisions of section 7 should be transferred to section 18 which deals with the disciplinary powers of the Commission over exchanges. In order to carry out this suggestion and also to make clear that the Commission shall have power to require exchanges to adopt rules and regulations to prevent excessive speculation or unfair practices in security transactions, I suggest that subdivision (5) of section 18 be amended so as to read:

SEC 18 The Commission is authorized—

Then, gentlemen, leaving in the present subsections 1, 2, 3, and 4, we come to subsection 5

If after appropriate request in writing to a national securities exchange that such exchange should effect on its own behalf specified changes in its rules and practices, and after appropriate notice and opportunity for hearing, the Commission determines that such exchange has not made the changes so requested, to require such exchange to adopt and enforce such rules and regulations as are necessary for the protection of investors or for the insuring of fair dealing in securities traded in upon such exchange Without limiting the general power contained in this subsection, the Commission shall have power to require any national securities exchange to adopt rules and regulations with respect to—

(*a*) Market letters, advertising, or other publicity by its members and the solicitation of business by its members or their employees

(*b*) Pools, syndicates, and joint accounts formed for the purpose of stabilizing or otherwise influencing the market price of any security registered on a national securities exchange and also with respect to options, puts, calls, straddles, or other similar privileges

(c) The amount and nature of the capital employed in his business by a member of such national securities exchange carrying margin accounts and the ratio which must be maintained of such capital to the liabilities of such member.

(d) The short sale of any security upon such national securities exchange

(e) The acceptance and execution of stop-loss orders by members of such national securities exchanges

(f) The hypothecation of securities carried for the account of any customer by a member of such national securities exchange or the lending of such securities without the written consent of such customer or the use of such securities for delivery on any contract in which such member is, directly or indirectly, interested.

(g) The fixing of a fair settlement price in respect of any contracts in any security registered on such national securities exchange which has been cornered or of which any person or persons have acquired such a control that such security cannot be obtained for delivery on existing contracts except at prices or on terms arbitrarily dictated by such person or persons

(h) The books and records to be maintained by members of such national securities exchange and the right of such exchange to require, periodically or otherwise, reports in regard to the transactions and affairs of the members of such national securities exchange and the duty of such members to permit the officers or representatives of such national securities exchange and of the Commission to examine such books and records

In some respects these suggestions go further than anything contained in the bill. If they are adopted, a large part of section 7 and the whole of sections 9 and 16 should be eliminated.

These provisions give the Commission ample power to require exchanges to adopt rules for the prevention of excessive speculation and unfair practices in security transactions. To correct these abuses it is not necessary to give the Commission power to prescribe the method of electing officers and committees, the hours of trading, the time and method of making settlements, payments, and deliveries by members and customers, and so forth. To exercise such powers is not to supervise or regulate exchanges, but is actually to operate them.

Other provisions: There are many other provisions of the bill which should be amended or qualified. This is true of section 8, which describes manipulative transactions in very broad terms; of section 13, which makes the solicitation of proxies a crime; of section 15, which prohibits officers, directors, and principal stockholders of listed corporations from buying and selling equity securities of such corporations within any 6 months' period; of section 25, which imposes excessive criminal penalties; and of section 30, which imposes registration fees on national securities exchanges.

I mention these sections only in passing because of the limitation of time. They are of very grave importance, but are less so than those which I have chosen to discuss in more detail. I trust some means may be found to convert them and other sections which I have not mentioned into fair and temperate legislation.

My conclusion: Finally, I wish to state as emphatically as I can that it is my belief, based upon my experience, that the adoption of the bill in its present form would seriously disrupt our organized security markets and American business. It is impossible to forecast all of the consequences of such an event, but at least it is certain that it would cause great loss to individual security owners and would delay for an indefinite period the present recovery program. In addition, it would also tend to drive the security business of the country away from the organized stock exchanges and into the un-

organized over-the-counter markets which exist in every financial center. Proper and orderly regulation of security practices is possible when transactions take place on stock exchanges, but it is almost impossible to regulate unorganized over-the-counter markets.

The New York Stock Exchange has been charged with opposing the bills pending before this committee for the sole purpose of avoiding any form of Federal regulation. There is no foundation or truth whatever for these charges. The exchange authorized me when I appeared before this committee last month to make a definite proposal looking toward the adoption by Congress of a sound regulatory law.

These untrue charges arise out of a fundamental difference of opinion between the proponents of the bill and the authorities of the stock exchanges as to the proper scope of Federal control. The theory of the proponents of the bill is to provide a measure of Federal control far beyond the limits of what is necessary to correct possible abuses. They insist that certain rigid and unworkable statutory provisions be substituted for the discretion of the administrative agencies which they have selected to control the security business of the country. Our proposal is to give the Federal Reserve Board unrestricted power to control credit for the prevention of excessive speculation and to give to an administrative Federal authority ample power to make, amend, and modify rules for the regulation of exchange practices after having achieved thorough knowledge of the subject as a result of careful study. It is our view that the scope of Federal control should be limited to the minimum necessary to prevent unfair practices in security transactions, leaving to the exchanges the responsibility for actual operation.

We are in entire agreement with the proponents of the bill in the belief that the law should be provided with "teeth" and should impose criminal penalties upon all unfair practices on exchanges.

The New York Stock Exchange and the other leading exchanges of the country have suggested amendments to the Rayburn bill, not because they consider it a sound measure but solely for the purpose of correcting the entirely unworkable and destructive provisions of the bill. The purpose of the exchanges in making these suggestions is to preserve for the benefit of the American people the safeguards which exist today by reason of the public character of transactions on organized stock exchanges.

We are in the process of recovery. If normal conditions are to be restored business must revive. The securities dealt in on American stock exchanges represent a large part of the liquid capital of the Nation. The market value on March 1, 1934, of the securities listed on the New York Stock Exchange alone exceeded $73,000,000,000, or substantially one quarter of the estimated total wealth of the entire Nation. This is no time for hasty or ill-considered legislation which might freeze such a large part of the liquid resources of the country.

The New York Stock Exchange and, I am sure, every other exchange in the country stand ready to furnish your committee with all the technical and expert advice at their command and to assist in drafting amendments to the pending bill or in drafting a new bill, which will give whatever administrative authority may be chosen, full power to prevent excessive speculation and to regulate unfair

practices in security transactions. They are, however, united in opposing legislation which may destroy the security markets of the Nation.

The CHAIRMAN. Are there any questions of Mr. Whitney?

Senator WALCOTT. I would like to ask you, Mr. Whitney, whether you think, in addition to what you state there, that there would be very severe withdrawals on the part of large corporations from the stock exchange if we pass such a bill? I have received word from three of the largest in the country that they would immediately withdraw. What is your impression of that?

Mr. WHITNEY. Senator Walcott, I am confident that there would be tremendous, if not universal, withdrawal if the bill is passed in the present form.

Senator WALCOTT. In that event it would throw those securities open to street barter, would it not?

Mr. WHITNEY. To the so-called "bootleg" markets; yes, sir.

Mr. PECORA. If the bill were to be revised in accordance with the suggestions embodied in this statement, do you think those withdrawals of listed securities would also follow?

Mr. WHITNEY. No, sir. I think it would very greatly diminish any such withdrawals along the lines of the amendments suggested by Mr. Hoxey and ourselves.

Senator ADAMS. Mr. Whitney, I gathered from one of the earlier parts of your statement that you are of the opinion that the enactment of the bill would result in a decline in values of securities, both listed and unlisted.

Mr. WHITNEY. I believe so, sir.

Senator ADAMS. We had an instance before the committee some time back of a very large institution that withdraw its securities from the stock market rather because the effect of their being listed was to reduce their value, due to the fact that they felt that they were better able to retain their values without that free interchange of opinion which takes place on the stock exchange.

Mr. WHITNEY. If we are speaking about the same security, then we were in a very different position as far as world-wide conditions were concerned. We were in a rising market and, insofar as the exchange has knowledge, Senator Adams, at that time the reason was that the very wide fluctuations in that particular bank stock that took place on the exchange and were printed on the ticker and got such universal or world-wide notoriety were injurious to the stockholders of the bank.

Senator ADAMS. I gather from the use of the last words that you and I agree.

Mr. PECORA. You might recall, Mr. Whitney—if you and I are thinking of the same bank stock—that following the withdrawal of that stock from the exchange and its trading in the over-the-counter market the fluctuations became much wider than they had been while the security was listed.

Mr. WHITNEY. I would not be a competent witness. Some of the bank-stock dealers could tell you that. I do not know that.

Mr. PECORA. That is my recollection, based upon evidence presented to this committee by me about a year ago.

Senator ADAMS. The point I had in mind was whether or not there was any direct connection between the listing and the other.

Of course, if your market were closed, the available opportunities to sell would be withdrawn and the available opportunities to buy would be withdrawn, and you might have a result, it seems to me, either way. The fact that you break down the lines of commerce and exchange might have the effect of raising as well as lowering. That is, your stock exchange acts, in a measure, as an equalizing place where the different currents of opinion meet until they reach a point of agreement.

Mr. WHITNEY. Yes, sir; but you asked my opinion of the effect of the entire bill if passed as it is, and in my opinion—and that is all I am here to give, sir, together with such advice as the stock-exchange authorities can give thereon—this would be of an extremely disastrous and deflationary nature. I do not want it understood in any regard, Senator Adams, that I am casting any aspersions on the bank-stock dealers as such, of which there is an association in New York of the highest standing. Bank stocks happen to have, particularly New York bank stocks, a pretty well organized over-the-counter market. They are rather the exception. If you put the flood of listed securities in the over-the-counter market——

The CHAIRMAN. We had some testimony from Detroit bankers to the effect that they did not think it wise to list the bank stocks on the exchange.

Mr. WHITNEY. I understand that view is fairly widely held. I think they come in a different category than the ordinary listed security.

Senator WALCOTT. Speaking of equity stocks generally, would you not say that withdrawal from the large exchange, from the national exchange, to either a curb or to street bargaining or bootlegging, which might be the result of a drastic bill, if it were too drastic, would tend to increase the spread because it reduces the purchases and sales?

Mr. WHITNEY. Unquestionably. That is one of our prime arguments against section 10, preventing specialists from trading for their own account. It would increase the spread.

Senator WALCOTT. That, in turn, increases your gambler's chance of making turns.

Mr. WHITNEY. Exactly.

Mr. PECORA. Mr. Chairman, Mr. Whitney in his statement makes certain specific suggestions for modifications of the present bill. It is somewhat interesting to note that on page 12 he says that some of those suggestions go further than anything contained in the bill. It is some comfort to know that we have been conservative in some respects anyway.

He also has indicated that other amendments which he would like to propose to the present bill would be presented here in written form on Monday. I think it might be profitable to defer any further consideration of these things with Mr. Whitney until we have before us all those amendments in the definite form in which he wants to propose them. Then, beginning with Monday morning, we could begin to go over all your suggestions, those presently made and those to be presented on Monday. In that way we would not have to take two bites at the cherry.

Senator ADAMS. Will your statement be available?

Mr. WHITNEY. The statement that I have just made, sir?

Senator ADAMS. Yes.

Mr. WHITNEY. It will be available, I think, tomorrow. This statement, Senator Adams, is very nearly identical, with some changes, with what I said to the House yesterday morning. That is printed. This will be printed, also. The amendments, at least, are identical.

Senator WALCOTT. Of course, they apply to the same bill.

Mr. WHITNEY. Mr. Pecora, to those further amendment to which I referred, they are contained in the printed form that I just gave you, compiled by Mr. Hoxey. The reasons are given in that printed form, and in order to clarify it and make it more simple, we are drafting a paper that will show merely the amendments.

The CHAIRMAN. It will show these amendments that are mentioned in this memorandum?

Mr. WHITNEY. Exactly; it is really supplemental to that. But, of course, if it is your wish for me to appear here Monday, I shall be delighted to.

The CHAIRMAN. I do not want to ask an impertinent question, Mr. Whitney, and I suppose it is unnecessary. If these amendments which you propose were incorporated in this bill would there be any further objections to the bill?

Mr. WHITNEY. There would be objections to the bill, as to some of the other sections which I have not specifically touched on today. I think we would be prepared, sir, to answer those specifically, section by section, sometime next week if that is your desire.

Mr. PECORA. Why would it not be proper, then, to have Mr. Whitney submit his specific objections to such other provisions, so that they may be considered during the present stage of the hearings, while the committee is engaged in considering objections to the bill in its present form? I think it ultimately would prove a timesaver and a labor saver.

Mr. WHITNEY. We shall be very glad to submit, together with these amendments we have already presented, amendments to each and every section of the present pending bill by Monday morning, we hope. This is quite a task, gentlemen, as Mr. Pecora knows himself. We have spent most of our nights recently on this thing.

Senator WALCOTT. Let me understand. Mr. Whitney, you listed at the close of your remarks certain sections that you thought ought to be changed somewhat. I have a note of them here.

Mr. WHITNEY. Yes, sir.

Senator WALCOTT. Let us see if we understand—sections 8, 13, 15, 25, and 30.

Mr. WHITNEY. That is right, Senator Walcott, and there are some others too.

Senator WALCOTT. You mean that by Monday you think you could have something for us to consider on all those points?

Mr. WHITNEY. On all sections of the bill where we suggest changes or amendments, having already given you those applying to sections 6, 7, 8, 9, 10, 11, 12, 13——

Senator WALCOTT. Not 13.

Mr. WHITNEY. No; sections 18; and 16 to be eliminated.

The CHAIRMAN. You suggested the elimination of only two, as I recall, sections 9 and 16.

Mr. WHITNEY. Nine and 16; and 7 largely eliminated, and what was left put into section 18.

Senator WALCOTT. Mr. Chairman, I move that we request Mr. Whitney to prepare these data for us and submit them to us at the earliest possible date, not later than Tuesday, and that he be here himself to present the case.

(The motion was duly seconded and agreed to.)

The CHAIRMAN. I think that is all agreed to, Mr. Whitney.

Mr. WHITNEY. Thank you, sir. We shall be here.

Senator GORE. Have you an extra copy of your statement?

Mr. WHITNEY. Yes, sir.

Senator WALCOTT. Mr. Whitney, for the sake of your authority when you come here next week, can you not consult with some representatives, for instance, of the Philadelphia, Washington, and Chicago exchanges, and so forth?

Mr. WHITNEY. I was just going to suggest that——

Senator WALCOTT. So that we may have a concrete illustration of the principal exchanges here.

Mr. WHITNEY. What I have just read to you, and the amendments contained therein, has the approval of the representatives of the Chicago and Boston exchanges, and of the president of the Association of Stock Exchanges, as well as the representatives of the New York curb. We would not think of presenting anything here that was our idea alone. We will certainly get the criticism and advice of those others to whom we have already referred. That is your desire?

Senator WALCOTT. Yes. I think that is the better way to do it. It will save a lot of time.

Mr. WHITNEY. We have not any thought of doing it any other way.

Senator WALCOTT. Would you take in, for instance, a mining exchange? Probably not.

Mr. WHITNEY. I do not know of any representatives of the——

Senator WALCOTT. The only one that occurs to me is the one that has been referred to in the various meetings, the Miners' Exchange of San Francisco. I think Senator McAdoo has referred to it two or three times. I do not know that it is important at all.

Mr. WHITNEY. There is a representative here from Los Angeles with whom we would certainly desire to consult.

Senator WALCOTT. That would represent California, and you would, of course, take care of the question of open market and over-the-counter transactions.

Senator ADAMS. Mr. Whitney, has the prospect of the passage of the bill had any effect on the value of memberships on your exchange?

Mr. WHITNEY. They have sold down $80,000 between sales; yes, sir. The last sale was $190,000, and this week one sold at $110,000 and another sold at $105,000. I think it is correct to say that on the curb exchange a similar reduction took place, or proportionately so.

Mr. PECORA. That would be due to the fact that they believed undue speculation was going to be curbed?

Mr. WHITNEY. I think it was occasioned by a great many facts.

The CHAIRMAN. And Canadian seats went up.

Mr. WHITNEY. Canadian seats went up—perhaps London, too, but I am not informed. So long as you ask that question, Senator Walcott, this fact might interest you. We were quoted today a cablegram received by a member here in New York from his correspondent in Londong [reading]:

> Considerable amount of straight American orders to buy American stocks coming to London English brokers willing to carry American stocks on 10-percent margin only, one commission to pay for a month's run.

I am not trying to bring up the bugaboo of business running out of the country. This is gratuitous. I did not seek it.

Senator WALCOTT. That is regardless of settlement days, too. They have a fortnightly settlement over there.

The CHAIRMAN. We are very mush obliged to you, Mr. Whitney. We will see you, then, either Monday or Tuesday.

Mr. WHITNEY. We will try to be ready Monday. Will it be proper for us to advise Mr. Sparkman, or Mr. Pecora?

The CHAIRMAN. Advise Mr. Sparkman.

Mr. PECORA. I am going back to New York tonight. If you are not going to be ready until Tuesday, I will not come back until Monday. If you are going to be ready Monday, I will come back Sunday.

Mr. WHITNEY. Thank you, gentlemen. I am sorry to have taken so much of your time.

The CHAIRMAN. There are just two witnesses here, who will be very brief, and it will save our meeting tomorrow if we can hear them now.

Senator ADAMS. Let us hear them.

The CHAIRMAN. Is Mr. Thompson here? Mr. Thompson, you made a statement before the committee with reference to the original bill. Now, with reference to this proposed amendment to the bill, have you some views to express?

Mr. THOMPSON. I have, Mr. Chairman. If you are going to have a session tomorrow I should like the opportunity to present it I have not quite finished my memorandum.

The CHAIRMAN. We would rather go on now and finish if we can.

Mr. THOMPSON. I am not quite ready.

Senator TOWNSEND. Inasmuch as we have to hold a hearing on Monday, if we do not have any out-of-town witnesses, why not let him go on Monday?

The CHAIRMAN. There are no hearings Monday. Can we not go on tomorrow?

Senator ADAMS. We do not want to have a special meeting for those two witnesses.

The CHAIRMAN. Can you not go on now, Mr. Thompson?

Mr. THOMPSON. I have not my data complete. I do not have my memorandum with me.

The CHAIRMAN. You can supply that later for the record.

Mr. THOMPSON. I do not have it with me. It is being written now.

The CHAIRMAN. Is Mr. Chinlund here?

STATEMENT OF EDWIN F. CHINLUND, REPRESENTING CONTROLLERS INSTITUTE OF AMERICA, NEW YORK CITY

The CHAIRMAN. Mr. Chinlund, do you have any views to express regarding this proposed amendment?

Mr. CHINLUND. Representing the Controllers Institute of America——

Senator GORE. That comprises what membership?

Mr. CHINLUND. That represents an institute which is made up of the controllers of corporations of the country. It has about 300 members, which represent the controllers of many of the companies listed on the exchange.

The CHAIRMAN. Proceed, Mr. Chinlund.

Mr. CHINLUND. I submitted a statement to the committee about 2 weeks ago, and in the revised H.R. 8720 I notice that some modification has been made of sections of which I recommended modifications at that time.

I want to state that under sections 11 and 12 I made the statement that the necessary work to be completed prior to the effective date of registration of securities under this bill would not allow ample time for the completion of the work necessary to accomplish that purpose, or to complete the audits provided by certified public accountants under the bill. The revised bill has given authority for a 6 months' extension which, in my opinion, is not adequate if the amount of audit required remains the same.

I made the further suggestion that the purposes of the bill might be better accomplished by giving the Federal Trade Commission, or whatever regulatory body has control, the right of approval of the rules of the exchange for listing, instead of taking on its own shoulders an implied approval of listings by failure to take action during the 30 days provided in the bill.

Senator GORE. State that again.

Mr. CHINLUND. Under the provisions of the bill as originally written, and as still retained in the present bill, the Federal Trade Commission has 30 days after the filing of a registration statement during which period it can question the listing. If they take no action, the exchange has the authority to complete the listing. It seems to me that is an implied approval, even though the Commission may not have had time to study the voluminous data which would have to be filed for that registration. It seems to me that that is a dangerous responsibility for the Government to vest in the Federal Trade Commission, in that investors undoubtedly in many cases will put more weight on the implied approval of the Federal Trade Commission for listing than rightfully belongs there.

Senator GORE. Would you extend the time, or what is your recommendation?

Mr. CHINLUND. My recommendation is that instead of burdening the Federal Trade Commission with the terrific amount of detailed work to approve listings or disapprove listings during the period that they have time to disapprove them, that they modify the bill to give the Federal Trade Commission authority over the rules and regulations of the listing committees of the exchanges, which will accomplish all the purposes of protection of the investor without creating the implied approval by the Federal Trade Commission,

particularly since the period of time they will have to study the data filed is probably not adequate without building up a terrific force.

Senator GORE. And let it go at that, without any final approval?

Mr. CHINLUND. Without any final approval or disapproval of issues. There is no final approval provided for in the bill, but there is an implied approval in the fact that if they do not disapprove in 30 days the exchange can go ahead.

I have various other comments to make, but since intending to make them I have read in the papers of the statement made by Mr. Hoxey. I have not read it in detail, but his recommendation, as I read it in the papers last night, was that the Federal Trade Commission have the authority to approve the rules and regulations of the listing committee, with which the Controllers Institute, as representing the corporate officers who would be responsible for the accumulation of a great part of the information, I am sure are in full agreement.

That is the extent of my statement.

The CHAIRMAN. If that is all, we are very much obliged to you. Are there any questions of this witness. [No response.]

We have notified some people who have inquired that we would hold hearings today and tomorrow and that we would conclude them tomorrow. There are one or two whom we have not heard, and we do not know whether they are coming or not, but they may come. Therefore, I think we had better adjourn until tomorrow at 10:30 and give them an opportunity to be heard at that time.

(Whereupon, at 4:40 p.m. Friday, Mar. 23, 1934, an adjournment was taken until tomorrow, Saturday, Mar. 24, 1934, at 10 30 a m.)

As an amendment to the bill regulating security exchanges, the Federal Reserve Board wishes to reiterate its recommendation made 2 years ago for basing member bank reserve requirements not solely on the volume of deposits, but also on the rapidity of their turnover, in other words, on the extent to which the deposits are utilized

Member bank reserve balances are high-power money On the basis of $1,000,000,000 of excess reserves, member banks can extend credit amounting to between 10 and 15 billion dollars without having to resort to borrowing at the Federal Reserve banks. The volume of excess reserves at the present time is one and one half billion dollars, and these excess reserves furthermore may increase greatly when a period of credit expansion sets in Under existing law national banks can issue an additional $700,000,000 of bank notes, which. when deposited with the Federal Reserve banks add to the reserves of member banks There is also still a billion or a billion and one half of currency that has not returned from hoarding but is likely to be utilized and thus flow back into the banks when an expansion sets in In these circumstances, if an expansion of credit should get under way, the member banks will have a large volume of reserves without recourse to the Federal Reserve banks These banks therefore would be out of touch with the market and thus not in a position to exert a restraining influence through discount policy

The Board's proposal carries out to its logical conclusion the existing distinction between time deposits, which require a 3-percent reserve, and demand deposits, which require a 7-, 10-, or 13-percent reserve, depending upon the location of the bank The proposal would result in an automatic increase of reserve requirements when boom conditions arise and an automatic decrease of reserve requirements in times of depression The proposal furthermore has the advantage of making the increase in reserves applicable not to all banks in all localities alike, but rather to those banks in those communities only where excessive speculative activity is manifesting itself If this proposal were adopted, its operation, together with the authority existing under the Thomas amendment to raise reserve requirements with the consent of the President when an emergency arises from excessive credit expansion, would make it possible for the Federal Reserve Board to combat the recurrence of speculative

excesses. The proposal, therefore, presents a logical complement to the bill for the regulation of security exchanges

The proposal would counteract two abuses that have developed under existing law and have created serious obstacles to credit control One is the evasion of reserve requirements by classifying as time deposits many deposits that to all intents and purposes are demand deposits, a practice that has developed since the classification of deposits in one or the other category has determined the volume of reserves that a bank must carry And the other, the reduction of actual reserves carried through diminishing the volume of till money which under existing law does not count as reserve The proposal would permit banks within certain limitations to count their vault cash as reserves and would therefore close the door to the practice of greatly reducing actual reserves by diminishing cash holdings to a nominal amount

In times of great speculative activity, such as 1928 and 1929, the banks under a law like the one proposed would have had to carry three or four hundred millions of additional reserves and would, therefore, have had to increase their borrowings at the Reserve banks by that amount This would have greatly increased the power of the System to exercise a restraining influence at an early date On the other hand in times of depression when deposits are inactive member bank reserve requirements would diminish and there would be a decrease in the volume of idle funds that the banks would be required to carry as reserves In effect, the plan would supplement open-market operations by the Reserve banks, by withdrawing funds from the market under boom conditions and furnishing additional funds at times of depression

The plan would also work for a more equitable distribution of reserves as between city banks and country banks City banks, owing to their proximity to the Reserve banks, have been able to reduce their vault cash to a very small proportion of their deposits, while at country banks a much more considerable proportion has been necessary As a consequence the actual distribution of effective reserves differs from that contemplated by the law and is much more favorable to banks in financial centers The Board's proposal would do away with this disparity

Most important of all, however, the proposed plan would result in an increase of reserve requirements not only at the time when such an increase will be in the interests of sound banking conditions but also at the spot where speculative excesses get under way, and at the banks where enhanced activity of deposits will be caused by a rising tide of speculation. Big Nation-wide booms develop at financial centers, and this proposal by imposing restraints on speculation in these centers without increasing the burden of idle reserves for banks in those communities to which the boom has not penetrated, will not only be more equitable but will serve the purpose of applying restraining influences automatically at the right time, in the right places, and to the right institutions.

With the heavy responsibilities imposed upon the Federal Reserve System in connection with the possibilities of speculative expansion, the adoption of this plan would place into their hands an instrument that would be of great assistance in serving the interests of trade and industry by restraining the use of credit for speculative purposes

Concretely under the proposal, member banks would be required to carry 5 percent reserves against their net deposits plus 50 percent of the amount of the bank's average daily debits to deposit accounts In order to avoid too heavy burdens in extreme cases, the proposal provides that in no case shall aggregate reserves required of a bank exceed 15 percent of its gross deposits.

In computing their reserves, the member banks would be permitted to count as reserves a certain proportion of their vault cash At banks in cities near the Federal Reserve banks or branches, the banks would be required to carry four fifths of their total reserves as deposits with the Federal Reserve banks, while at other banks they would only be required to carry two fifths of their reserves as balances with the Reserve banks

As an exhibit in connection with this statement I should like to submit the report of a committee of the Federal Reserve System on bank reserves presented to the Federal Reserve Board in 1931 Your attention is particularly called to the chart on page 10 of this report which shows that demand deposits and consequently reserve balances of member banks showed practically no increase during the period of the greatest credit expansion in 1928 and 1929, while bank debits during that period increased at a very rapid rate Another chart on page 19 of the report shows how under the proposed plan reserve requirements would have risen rapidly during the expansion and would have declined much more rapidly than actual reserves after the depression set in.

MEMBER BANK RESERVES

REPORT OF THE COMMITTEE ON BANK RESERVES OF THE FEDERAL RESERVE SYSTEM

With the permission of the Federal Reserve Board, and pending consideration thereof by the Board and the Federal reserve banks, the accompanying report of the Committee on Bank Reserves of the Federal Reserve System is being published for the information of the member banks of the system and others interested in the subject

MEMBERS OF THE COMMITTEE

E L SMEAD, Chief Division of Bank Operations, Federal Reserve Board, Chairman
IRA CLERK, Deputy Governor, Federal Reserve Bank of San Francisco.
M J. FLEMING, Deputy Governor, Federal Reserve Bank of Cleveland.
E A. GOLDENWEISER, Director, Division of Research and Statistics, Federal Reserve Board
L R ROUNDS, Deputy Governor, Federal Reserve Bank of New York
W. W. RIEFLER, Division of Research and Statistics, Federal Reserve Board, *Executive Secretary.*

TERMS OF REFERENCE

The subject of bank reserves is one of the utmost importance, requiring the most careful scientific study by experts devoting their entire time to the matter with a view of drafting a report to the Federal Reserve Board, proposing such amendments to the law or regulations as in their judgment may be necessary to remove any present inequalities or defects and to establish bank reserves throughout the country on a more logical or effective basis than now appears to be possible under present laws, State and Federal (Resolution adopted at the conference of governors of the Federal reserve banks, December 12, 1929)

REPORT OF THE COMMITTEE ON BANK RESERVES OF THE FEDERAL RESERVE SYSTEM

SUMMARY OF COMMITTEE RECOMMENDATIONS

In accordance with its terms of reference, the committee has examined the operation of present legal requirements governing the reserves held by member banks and submits herewith definite recommendations for their improvement. These requirements are established by the Federal reserve act and apply to all banks, both State and National, which and members of the Federal reserve system. Changes in the law recommended by the committee are submitted at the end of this report in the form of a proposed amendment to section 19 of the Federal reserve act In the event this amendment is adopted, Regulation D of the Federal Reserve Board will have to be modified to meet the changes proposed in the law Modifications recommended by the committee are discussed in the body of the report

Defects of present reserve requirements—In the opinion of the committee, our present system of legal requirements for member bank reserves has never functioned effectively since its inception in 1914. It has not operated to relate the expansion of member bank credit to the needs of trade and industry, nor has it adequately reflected changes in the volume and activity of member bank credit Furthermore, the committee also finds that present requirements for reserves are inequitable and unfair as between individual member banks and groups of member banks and do not adequately take into account genuine differences in the character of banking in which a member bank may be engaged.

The committee takes the position that it is no longer the primary function of legal reserve requirements to assure or preserve the liquidity of the individual member bank The maintenance of liquidity is necessarily the responsibility of bank management and is achieved by the individual bank when an adequate proportion of its portfolio consists of assets that can be readily converted into cash Since the establishment of the Federal reserve system, the liquidity of an individual bank is more adequately safeguarded by the presence of the Federal reserve banks, which were organized for the purpose, among others, of increasing the liquidity of member banks by providing for the rediscount of their eligible paper, than by the possession of legal reserves The two main functions of legal requirements for member bank reserves under our present banking structure are, first, to operate in the direction of sound credit conditions by exerting an influence on changes in the volume of bank credit, and, secondly, to provide the Federal reserve banks with sufficient resources to enable them to pursue an effective banking and credit policy Since the volume of member bank credit needed to meet the legitimate needs of trade and industry depends on the rate at which credit is being used as well as on its aggregate amount, it is essential for the exercise of a sound control that legal requirements differentiate in operation between highly active deposits and deposits of a less active character Requirements for reserves should also be equitable in their incidence, simple in administration, and, so far as possible, not susceptible of abuse

Similar principles underlie the present reserve law, which in requiring lower reserves against time deposits than against demand deposits, and lower reserves against the demand deposits of country banks than against the demand deposits of reserve and central reserve city banks may have been expected to impose higher reserves on more active deposits than on less active deposits Notwithstanding the fact, however, that existing requirements would appear to be so arranged as to make reserve requirements vary with the volume and activity of deposits, experience shows that since 1914 and especially since 1922 the proportion of primary reserves held by member banks has steadily declined in relation to the volume of member bank deposits and to their activity.

This outcome has been the result of defects in the definition of reserves, in the method of determining liabilities against which reserves must be carried, and in the classification of banks and of deposits for reserve purposes. The exclusion of vault cash from required reserves of member banks in 1917 has been followed by a reduction in the vault cash holdings of some city banks to a minimum; the rule that amounts due from banks may be deducted only from amounts due to banks has tended to decrease reserves in times of business activity and to increase reserves in times of depression, and the establishment of a low reserve against time deposits in 1914 has facilitated the growth of bank credit without a corresponding growth in reserves Even if these particular defects in the present system of reserves had not existed, however, the rapid increase in the turnover of demand deposits which has occurred in recent years would still have tended to prevent reserve requirements from increasing in proportion to the growth in the effective use of credit by the customers of member banks

Proposals of the committee—Before deciding to recommend fundamental changes looking toward the establishment of a new basis for calculating required reserves, the committee made every effort to frame provisions designed to correct the existing situation through modifications in the classification of cities for reserve purposes and in the classification of deposits subject to reserve, including a more stringent definition of time deposits As these proposals were studied, however, it became more and more evident that they would not be effective and that an entirely new approach to the reserve problem was necessary

The committee proposes, consequently, to abolish completely the classification of deposits into time and demand deposits, and the classification of member banks according to their location, into central reserve city banks, reserve city banks, and country banks. Instead, the committee recommends that all member banks and all deposits be treated alike for reserve purposes, and that the formula used in calculating reserve requirements take into account directly, instead of indirectly as in the existing law, the activity as well as the volume of the deposits held by each individual member bank, without regard to the location of the bank or the terms of withdrawal on which the deposits are

technically held To accomplish this, the committee proposes that each member bank be required to hold a reserve equivalent to (*a*) 5 per cent of its total net deposits, plus (*b*) 50 per cent of the average daily withdrawals actually made from all of its deposit accounts These withdrawals, which are shown by debit entries on the books of members banks, are the only real test of the activity of a deposit account and furnish the only basis by which that activity can be equitably and effectively reflected in requirements for reserves Under this proposal, therefore, each deposit will carry a total reserve based on its activity as well as on its amount A totally inactive deposit will carry a total reserve of only 5 per cent, while a deposit balance which is checked out on the average once a week will carry a total reserve equivalent to 12 per cent of its amount For the average member bank the total reserve under the proposed formula will be equivalent to about 8 per cent of its deposits To prevent this formula from imposing too great a burden in extreme cases, the recommendations of the committee also provide that in no case shall the aggregate reserve required of a bank exceed 15 per cent of its gross deposits

The committee proposes to include in legal reserves, in addition to the funds which member banks have on deposit with their Federal reserve bank, their vault cash, with certain limitations, as both classes of funds contribute to the strength of the reserve banks and have a direct effect on the reserve system's control of changes in member bank credit It proposes also to place country member banks on a parity with city banks with respect to deductions from deposit accounts by permitting banks in calculating net deposits subject to reserve to deduct balances due from member banks and items in process of collection from total deposits instead of from balances due to banks alone, as is the practice at present

Volume of reserves.—The committee feels that the existing volume of reserves is sufficient at the present time to provide the reserve banks with the funds they require to perform their functions. Its proposals, consequently, do not contemplate a change in the total amount of reserves They are intended rather to change the nature of fluctuations in the volume of reserves and to iron out inequitable features in their distribution among the member banks

A comparison of the reserve requirements proposed by the committee with present and past requirements is presented in the following table

SUMMARY OF PAST, PRESENT, AND PROPOSED RESERVE REQUIREMENTS FOR MEMBER BANKS

Classification of banks	Reserve required against—	Reserve held in the form of—

A. NATIONAL BANKS PRIOR TO THE ENACTMENT OF THE FEDERAL RESERVE ACT

	Total net deposits	In vault	In vault or on deposit with designated correspondent banks
	Percent		
Central reserve city banks	25	All	None
Reserve city banks	25	One half	One-half
Country banks	15	Two-fifths	Three-fifths

B. MEMBER BANKS UNDER ORIGINAL FEDERAL RESERVE ACT [1]

	Net demand deposits	Time deposits	On deposit with Federal Reserve bank	In vault	In vault or on deposit with Federal reserve bank
	Percent	*Percent*			
Central reserve city banks	18	5	Seven-eighteenths	Six-eighteenths	Five-eighteenths
Reserve city banks	15	5	Six-fifteenths	Five-fifteenths	Four-fifteenths
Country banks	12	5	Five-twelfths	Four-twelfths	Three-twelfths

[1] This distribution of reserves was to become effective in November, 1917

SUMMARY OF PAST, PRESENT, AND PROPOSED RESERVE REQUIREMENTS FOR MEMBER BANKS—Continued

Classification of banks	Reserve required against—		Reserve held in the form of—
C. MEMBER BANKS AT PRESENT			
	Net demand deposits	Time deposits	On deposit with Federal reserve bank
	Percent	*Percent*	
Central reserve city banks	13	3	All
Reserve city banks	10	3	All
Country banks	7	3	All

	Total net deposits, both demand and time	Daily average deposits to deposit accounts	On deposit with Federal reserve bank	In vault or on deposit with Federal reserve bank
D. PROPOSED BY THE COMMITTEE ON BANK RESERVES				
	Percent	*Percent*		
Member banks in vicinity of Federal reserve banks or branches	5	50	Four-fifths	One fifth
All other member banks	5	50	Two-fifths	Three-fifths

The calculation of net deposits subject to reserve has varied from time to time. At present net demand deposits include total demand deposits of individuals, corporations, etc, plus the excess, if any, of demand deposits due other banks over items in process of collection and funds held on deposit with other banks. Under the proposed plan, net deposits subject to reserve would include total deposits, both demand and time, less items in process of collection and deposits with other member banks in the United States.

United States Government deposits, which have been exempted from reserve requirements since 1917, would require reserve under the proposed formula the same as all other deposits.

Vault cash eligible for reserve excluded national bank notes, Federal reserve notes, and Federal reserve bank notes prior to 1917 Since 1917 no vault cash has been eligible as reserve Under the proposed plan all kinds of currency and cash issued or coined under authority of the laws of the United States which are held in the vaults of member banks would be eligible to count as reserve.

FAILURE OF EXISTING RESERVE REQUIREMENTS

In the opinion of the committee, the principal purposes served by legal requirements for member bank reserves are, first, to help to regulate the volume of credit at member banks in accordance with the legitimate credit needs of trade and industry, and, secondly, to insure that the Federal reserve banks at all times have resources adequate to their responsibilities The committee does not believe that it is the purpose of legal requirements for reserves to insure the liquidity of individual member banks, nor that it is possible for legal reserve requirements to accomplish this purpose.

Liquidity—For many years, the maintenance of liquid assets available to meet withdrawals was regarded as the principal function of commercial bank reserves Nevertheless, prior to 1914, when central reserve city national banks in this country were required to hold vault cash reserves as large as 25 per cent of both time and demand deposits they were forced to suspend payments at times of banking strain. The inauguration of the Federal reserve system with its provisions for the mobilization of banking reserves and for the rediscount of member bank paper was a recognition of the fact that a commercial bank does not guarantee its liquidity by maintaining its legal reserves. To the extent that the member banks since 1914 have remained liquid through

periods of unprecedented banking strain, they have been able to do so not because of the legal reserves that they have carried, but largely because they have been able by borrowing at the reserve banks to convert their eligible assets into cash.

The effect of this borrowing, furthermore, has not been confined to paper which is eligible for rediscount at the reserve banks The mere fact that the reserve banks stand ready to lend on eligible paper has helped to maintain a ready market for all types of sound bank assets Under present conditions, therefore, in which member bank reserve balances cover only 7 per cent of their deposit liabilities, it is clear that the liquidity of the average individual member bank can be more adequately guaranteed by the possession of a substantial portfolio of eligible paper or of other assets readily convertible into cash in the market than by any practicable increase in its requirements for legal reserves

As our banking system is now organized, legal requirements for member bank reserves contribute to the security of bank depositors by providing the reserve banks with funds available for assisting banks in emergencies and by adding strength to the whole banking system through the exercise of credit control rather than through determining the volume of reserves held by individual member banks In order to be able to utilize the strength of the reserve banks in emergencies, however, it is essential that the individual member bank maintain an adequate portfolio of sound assets readily convertible into cash, and, particularly, of assets eligible for rediscount at the reserve banks

Control of credit—The most important function served by member bank reserve requirements is the control of credit This function has a bearing on the liquidity of bank credit, for, in the nature of things, bank credit is most liquid when credit conditions are sound, and unsound credit conditions do not usually develop unless the banking community in general has expanded its credit beyond the needs of trade and industry The overexpansion of credit may take a particular form, such as excessive loans on farm lands, on urban real estate, or on securities, or it may be more general applying to a wide range of bankable assets Whatever its form, it has the effect of temporarily inflating the general purchasing power of the community and also of raising for a time the market value of bank assets beyond their intrinsic worth It is the function of reserve requirements to restrain such overexpansian by making it necessary for banks to provide for additional reserves before they expand their credit. To perform this function adequately, however, it is essential that reserve requirements reflect both the volume and the activity of credit outstanding, for unsound credit conditions can develop either out of an excessive volume of bank credit in relation to the needs of trade and industry or out of an excessive use of a given amount of credit Credit could be expanded indefinitely, for example, without any inflationary effect whatever, provided the bank deposits thus created were never drawn upon to effect an exchange of goods or services Conversely, it is possible for an unsound credit situation to develop without an increase in the volume of deposits, but merely out of an increase in their activity Unsually, unsound credit conditions are accompanied by an increase both in the volume and in the activity of deposits In 1928 and 1929, however, during the most extravagant phases of the stock market boom, excessive credit demands were reflected in an increase in borrowings from nonbanking lenders, and an unprecedented increase in the activity of bank deposits, without an increase in their total volume Reserve requirements, consequently, failed completely during those crucial years to act as a brake on the unsound use of credit.

Progressive diminution of member bank reserves under present requirements—Between 1914 and 1931, the period covered by our present system of reserve requirements, total net deposits of member banks increased from $7,500,000,000 to $32,000,000,000, or more than 300 percent in less than two decades. Some of this increase reflects the accession of State banks to membership in the Federal reserve system, but the greater part reflects the expansion of member bank credit While war financing and the huge inflow of gold which followed the war constituted the immediate driving force back of much of this expansion, it was facilitated by a progressive reduction in effective member bank requirements for reserves Thus, member banks actually hold at the present time about $2,900,000,000 of reserves against $32,000,000,000 of net deposits This includes both the legal reserves which they hold with the Federal reserve banks and cash which they hold in their vaults. If the vault cash reserve requirements of national banks prior to 1914 had been retained in the Federal reserve act up to the present time,

member banks would now be required to hold about $4,400,000,000 in reserves instead of $2,900,000,000 This means that in the aggregate total reserve requirements of member banks are now about 35 percent less in proportion to their deposits than they were before the Federal reserve act was passed It is clear, consequently, that the large expansion of member bank credit since 1914 has been facilitated by a progressive diminution in reserve requirements as well as by large imports of gold Without this diminution member banks would have needed in order to expand their credit to its present volume additional Federal reserve bank credit to the extent of $1,500,000,000 By applying to the reserve banks for this additional credit, the member banks would have correspondingly increased the effectiveness of reserve bank credit policy

Of the total decrease of $1,500,000,000 in present requirements as compared with pre-war requirements, about one-half reflects the effect of the amendment which removed vault cash from required reserves in 1917, while the remainder reflects in part the lowering of reserve requirements by the original Federal reserve act, and in part, the rapidly decreasing proportion of member bank deposits which have been classified as demand deposits since the inauguration of a lower reserve on time deposits in 1914 This decrease has occurred, moreover, during a time when the average turnover of all deposits has increased indicating that differentials in reserves as between time and demand deposits and as between demand deposits at city and country banks have not effectively registered changes in the activity of deposits or in the use of member bank credit by the community. Such figures as are available for earlier years indicate that the average turnover of bank deposits in this country increased steadily from 1914 up to 1929 Between 1925 and 1929, alone, estimates made for the committee indicate that the rate of turnover of the average dollar deposited in member banks increased from 24 times a year to 33 times a year, notwithstanding the fact that 64 cents of this dollar was classified as a demand deposit in 1925 as against 59 cents in 1929.

Failure of existing requirements to reflect credit developments.—In the accompanying chart there is portrayed the extent to which existing legal requirements for reserves have failed to reflect credit developments at member banks in recent years The upper line reflects movements in the total dollar volume of transactions which pass through the deposit accounts of customers of member banks. The middle line shows member bank time and net demand deposits combined and reflects movements in the total volume of member bank deposit liabilities The bottom line shows the reserve balances which member banks have maintained with the Federal reserve banks During the period covered by the chart all the legal reserves have been held in this form The lines are plotted as index numbers with January, 1924, equal to 100

This chart brings out the failure of member bank reserve balances under our present reserve requirements to reflect fundamental changes in the demand for credit In the first year shown on the chart, 1924, the total volume of debits or check payments made through member-bank accounts was low, reflecting a relatively inactive business situation Member-bank requirements for reserves, however, increased in 1924 more rapidly than in any other year shown on the chart because the inactive local demand for funds throughout the country caused banks to redeposit funds with their correspondent banks in the larger cities, which were required to hold reserves of 10 or 13 per cent against these funds As a consequence, an inactive demand for funds from trade and industry in 1924 was reflected in a sharp increase both in member-bank deposits and in member-bank requirements for reserves During 1925 and 1926, on the contrary, when business became more active, these redeposited funds were withdrawn from correspondent banks and loaned directly in the market, with the result that aggregate requirements for factor in the credit situation in 1928 and 1929 when an extraordinary demand for funds from the stock market was met without an increase in reserve requirements of member banks In fact, the aggregate legal requirements of member banks for reserves were about $75 000,000 lower in September, 1929, at the very peak of reserves remained for two years at about the level of December, 1924, failing completely to reflect an increase in the market demand for funds

The failure of reserve requirements to reflect fundamental changes in the demand for funds and to operate in such a manner as to bring these changes under control became a major factor in the credit situation in 1928 and 1929 when an extraordinary demand for funds from the stock market was met without an increase in reserve requirements of member banks. In fact, the aggregate legal requirements of member banks for reserves were about $75,000,000 lower in September, 1929, at the very peak of the stock-market boom than in

December, 1927, despite a situation in intervening months in which the demand for stock exchange loans was sufficient to require brokers to increase their borrowing by over $4,000,000,000 at rates which in some months averaged nearly 10 per cent. This situation arose because corporations and other nonbanking lenders, seeking to profit by high rates, drew upon their balances with member banks and loaned funds in huge volume directly to brokers, permitting an extraordinary demand for credit to be met without any increase in the deposits against which member banks were required to maintain reserves The activity of these deposits increased rapidly, however, as is shown by the chart Had reserve requirements reflected the activity of deposits, this sharp increase in turnover of deposit accounts, which helped materially to finance speculative developments in 1928 and 1929, would have caused an equally sharp increase in member bank requirements for reserves, and this increase in turn would have acted as a powerful restraint against unsound credit developments.

Vault cash—After reviewing member bank operations during recent years the committee is convinced that the removal of vault cash from required reserves in 1917 has had undesirable consequences that were not forseen at the time Prior to 1917, member banks in central reserve cities were required to hold aggregate reserves equal to 18 per cent of their demand deposits, the corresponding percentages for reserve city and country member banks being 15 and 12 per cent respectively At the same time, the requirement against time deposits was 5 per cent at all classes of member banks Part of these reserves were held as balances with the reserve banks and part as cash in the vaults of the member banks Federal-reserve notes and national-bank notes held by member banks, however, could not be counted as legal reserves Under the 1917 amendment, reserve requirements against demand deposits were reduced by 5 per cent and against time deposits by 2 per cent at all classes

of banks, and at the same time member banks were required to hold all of their legal reserves on deposit with the Federal reserve banks.

The main purpose of the 1917 vault-cash amendment was to concentrate the gold holdings of the country in the Federal reserve banks. Up to that time, member banks had been required to hold their vault-cash reserves in gold or lawful money, with the result that the monetary gold resources of the country were only partially mobilized in the Federal reserve banks, a large proportion being absorbed in the form of circulating notes held by the member banks and the public The 1917 amendment corrected this situation by removing the inducement for member banks to hold their vault cash in the form of gold rather than Federal-reserve notes and so permitted the mobilization of gold in the Federal reserve banks

In addition to concentrating the gold resources of the country in the Federal reserve banks, however, the 1917 vault-cash amendment incidentally opened the door for a gradual diminution in the actual reserves of the member banks In the last 14 years, the amendment has permitted a reduction in aggregate reserves, amounting at the present time to over $700,000,000 Had this amendment not been passed, consequently, member banks today would be required, other things being equal, to hold aggregate reserves more than $700,000,000 larger than their present legal reserves plus their holdings of vault cash. These additional reserve requirements would have exercised a wholesome restraint during the boom period which culminated in 1929 and the policy pursued by the Federal reserve system would have been much more effective had the member banks at that time been forced to borrow this additional $700,000,000 from the Federal reserve banks

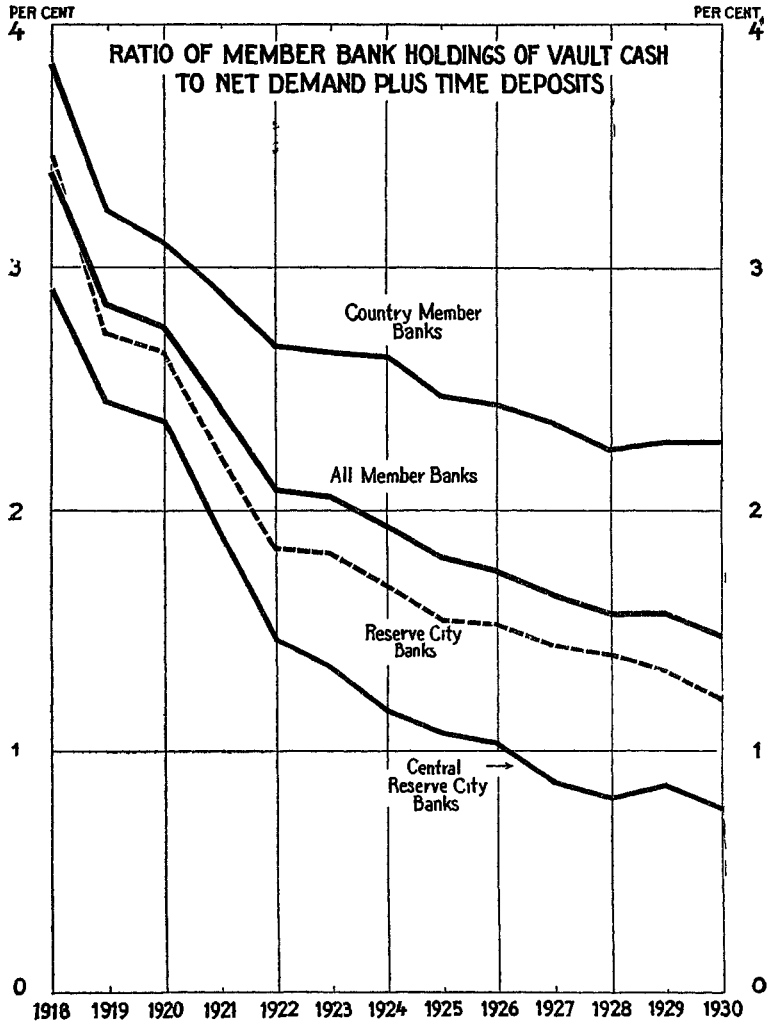
Between June 1917, before the new requirements went into effect, and June, 1930, net demand plus time deposits of member banks increased from $12,000,000,000 to $32,000,000,000, but holdings of vault cash at the same time decreased from about $800,000,000 to less than $500,000,000 By making progressive economies in their use of vault cash at a time of rapid increase in their deposit liabilities, member banks were able to reduce their cash holdings to less than 3 per cent of their net demand plus time deposits by 1919, to less than 2 per cent by 1924, and to less than 1½ per cent by 1930 The chart shows that this reduction has been especially marked at large city banks In New York City member bank holdings of vault cash in June, 1930, were equal to three-fourths of 1 per cent of their net demand plus time deposits and to less than 1 per cent of their net demand deposits alone

Part of this decline reflects a reduction in the operating requirements of banks for vault cash The American public has widespread banking facilities and is thoroughly educated in the use of checks Their demand for pocket currency, consequently, is relatively small since its use is limited largely to transactions in which currency is the only convenient method of payment In recent years there has also taken place a rapid increase in the use of checks for wage payments which has materially reduced the demand for cash for industrial pay rolls While this substitution of checks for currency may reflect a socially desirable development, it does not constitute a logical or valid reason for a reduction in the reserve requirements of member banks since the effect upon business activity and upon the position of the individual member bank is the same whether a depositor's account is drawn upon to make payments by check or by currency

By no means all of the economies in the use of cash which member banks have been able to effect since 1917, however, reflect the substitution of checks for currency in making payments On the contrary, a special study of the daily vault cash holdings of member banks has shown definitely that location in the vicinity of a Federal reserve bank or branch is the largest single factor accounting for the reduction in member bank holdings of cash This investigation showed that member banks situated close enough to Federal reserve banks or their branches to be able to deposit surplus currency at the reserve banks or to obtain additional currency supplies from the reserve banks within a few minutes, maintained vault cash holdings equal on the average to only 1 38 per cent of their net demand deposits This group of member banks holds about 60 per cent of the total deposits of all member banks

During the same period, the remaining member banks held vault cash equivalent to 4 64 per cent of their net demand deposits, or more than three times the proportion that was held by member banks close to the reserve banks The investigation also showed that member banks located within short distances of cities where Federal reserve banks or branches are located held as high a proportion of vault cash, on the average, as country member banks, which

because of their inaccessible location ordinarily can not receive additional supplies of currency until one or two days after it has been ordered. The amount of vault cash reserves which member banks find it necessary to hold at the present time, therefore, depends mainly on whether or not they are located in the immediate vicinity of the reserve banks. If they are close enough, they can deposit with the reserve banks for credit to their reserve balance a large proportion of the vault cash which their business would otherwise require them to hold.



The 1917 amendment eliminating vault cash from legal reserves, consequently, has had two unfortunate effects. First, it has materially reduced the total reserve requirements of member banks and thus further facilitated expansion of bank credit at a time when huge gold imports arising out of war and postwar disturbances were already placing difficulties in the way of the effective administration of the country's credit resources Second, these reductions in aggregate reserve requirements have not been equally available to all member banks but have particularly favored those banks which are located in close geographical proximity to the Federal reserve banks As these member banks

are classified as reserve or central reserve city banks, the amendment has had the practical effect of reducing or eliminating differentials in reserve requirements between different types of banks which are justified by the character of their business.

Up to 1917, time deposits required the same reserve of 5 per cent at all types of banks, while net demand deposits required a reserve of 12 per cent at country banks as compared with 15 per cent at reserve city banks and 18 per cent at central reserve city banks. These differentials were maintained after the 1917 amendment in the form of a 3 per cent reserve against time deposits at all classes of banks and a required reserve excluding vault cash against net demand deposits of 7 per cent, 10 per cent, and 13 per cent at the different classes of banks. However, when the amount of vault cash which member banks find they must actually hold under normal conditions is taken into account, and a 3 per cent reserve against their time deposits is allowed, it appears that central reserve city member banks now hold 14 per cent in reserve against their net demand deposits in contrast to 12 per cent at both reserve city and country member banks. In other words, in its practical effect, the 1917 amendment in addition to reducing reserves against time deposits from 5 to 3 per cent at all member banks reduced reserves against net demand deposits from 18 to 14 per cent at central reserve city banks, and from 15 to 12 pr cent at reserve city banks, while country banks received no reduction whatever in their requirement against demand deposits The present classification of cities for reserve purposes, therefore, does not function equitably.

The purpose of the 1917 amendment to mobilize reserves could have been accomplished without this diminution in total reserve requirements of member banks by retaining the reserve ratios of the original Federal reserve act and at the same time permitting member banks to count Federal reserve notes as part of their legal vault reserve. Federal reserve notes are a liability of the Federal reserve banks, just as the present legal reserve balances of member banks are a liability of the Federal reserve banks Of the two types of liabilities, furthermore, those evidenced by Federal reserve notes which are a first lien on all assets of the Federal reserve banks and in addition are an obligation of the United States Government are the more strongly secured. In recommending, consequently, that the legal reserves of member banks include all kinds of currency and coin as well as balances on deposit with the Federal reserve banks, the committee provides a plan which retains the advantages of a mobilized reserve and also avoids the possibility that member bank reserves will be further diminished through economies in the use of vault cash.

Time deposits.—The committee is also convinced on the basis of the system's experience that there is no practicable way of defining time deposits and demand deposits without opening the doors to evasions of the intent of the law The general principle underlying the existing classification, namely, that more active deposits should carry higher reserves, the committee believes to be sound. Experience has shown, however, that the methods by which this principle is now applied have permitted evasions, which can not in practice be remedied so long as lower requirements for reserves on time deposits furnish a constant incentive to member banks to classify as time deposits accounts which are essentially of an active character.

Deposits classified as time deposits have grown rapidly at member banks since 1914. In that year, when national banks were required to maintain the same reserve against all of their deposits, they held only about $1,200,000,000 in time deposits. Following the lowering of reserve requirements against these deposits, time deposits increased steadily and amounted to about $8,700,000,000 at national banks alone in 1930 During the same period, time deposits of nonnational commercial banks, including both State member and nonmember banks, increased from about $2,800,000,000 to $10,200,000,000 and savings deposits of mutual and stock savings banks from $4,800 000,000 to $10,500,000,000. The increase in time or savings deposits for national banks during the period was over 600 per cent, for nonnational commercial banks over 250 per cent, and for savings banks 120 per cent Considering all of our commercial banks together, both State and National, time and savings deposits have increased from less than one-fourth of total deposits in 1914 to nearly 40 per cent in 1930. In 1914, furthermore, these commercial banks held about 45 per cent of the total time deposits of the country; while by 1930 that proportion had grown to about 65 per cent Of the total increase in time deposits in the interval more than 70 per cent was concentrated at commercial banks. By 1930 more than one-third of all member bank deposits

consisted of time deposits and nearly one-half of the time deposits of the country were held by member banks.

While there have been other factors in the growth of time deposits, it is clear that the introduction of a lower reserve on such deposits has encouraged the growth of savings deposits at commercial banks, in part at the expense of the growth of deposits at specialized savings institutions, with the result that some of our so-called commercial member banks now operate largely with funds that are classified as time or savings deposits. From the point of view of bank reserves, however, the problem to determine is not the extent to which member banks have competed more effectively with other banks for the savings-deposit business of the country, but the extent to which member banks, because of the low reserve against time deposits, have been induced to classify as time deposits, deposits that are essentially demand in character. It has been repeatedly asserted in recent years that this reclassification of deposits, rather than effective competition on the part of member banks for savings deposits, has been responsible for a substantial part of the growth in time deposits at member banks.

While it is the opinion of the committee that the greater portion of time deposits held by member banks, particularly country member banks, represent funds which are genuine savings deposits, the committee is convinced that a significant part of these deposits, especially in metropolitan centers, are not in the nature of savings, but have a considerable velocity of turnover, and should be classified as demand deposits and carry correspondingly larger reserves. The volume of such deposits is sufficient to constitute a major departure from the principles underlying present reserve requirements

A special investigation conducted in May, 1931, revealed the fact that out of $13,000,000,000 of time deposits held by member banks at that time, $3,000,000,000 consisted of individual accounts with balances in excess of $25,000. Even though these accounts may consist of inactive deposits with a low turnover, they are not the typical small savings accounts for the accommodation of which the low reserve against time deposits was primarily instituted Of the $3,000,000,000 held in these large individual accounts, 27 per cent were held in accounts evidenced by savings pass books, 24 per cent in accounts evidenced by certificates of deposit, and 49 per cent in other types of time accounts, chiefly open-book accounts payable in more than 30 days or subject to an agreement by the depositor at the time of deposit to give 30 days' notice before withdrawal.

A further violation of the intent of the law has grown up in certain localities where, to meet the competition of State savings banks, some member banks have devised a special savings account on which checks may be drawn without the presence of the depositor at the bank These accounts are evidenced by savings pass books in which the bank reserves the right to require 30 days' notice before making payment on a withdrawal When the account is opened, a duplicate savings pass book is issued, the original being held by the depositor and brought up to date from time to time, while the duplicate is left with the bank, which enters therein the amount of each withdrawal at the time checks on these accounts are presented for payment So far as the committee can ascertain, this practice of permitting withdrawals from savings accounts by check without presentation of the pass book has not, as yet, spread widely. An investigation of the turnover of these socalled savings accounts indicates that they are less active on the whole than demand accounts in the same banks, but much more active than other time accounts They are, furthermore, no less active than accounts classified as demand deposits in many sections of the country.

In the opinion of the committee even the existence of a low rate of turnover in time-deposit accounts would not necessarily mean that the present system of reserves is functioning in accordance with the intent of the law. It is not necessary to classify deposits incorrectly in order to reduce reserve requirements under existing conditions With only a 3 per cent reserve required against time deposits, there is an inducement for member banks to persuade or permit commercial customers to classify a large part of their working accounts as time deposits and then to permit a very rapid turnover on that small part of these accounts that remain in the demand-deposit classification In such cases, the customers' aggregate deposits constitute the working balance, but all of the checks are cleared through the demand accounts, with the consequence that relative inactivity in time accounts is balanced by

a corresponding increase in the activity of the demand balances While it is impossible to ascertain the extent to which this practice has influenced the growth of time deposits at member banks in recent years, it is known that the turnover of demand accounts has increased rapidly. There has also been a growth in the volume and number of time-deposit accounts maintained by corporations While both of these developments have reflected, in part at least, other factors than the effect of the 3 per cent reserve on time deposits, this reserve requirement has facilitated the movement and has undoubtedly been a factor in the decrease of the ratio between total bank reserves and the outstanding volume of bank credit

These conditions the committee is convinced can not be effectively remedied so long as lower reserve requirements on time deposits offer an inducement for evasion Some improvement might be effected by limiting the total amount of time deposits which a bank could hold for the account of any one depositor to a fixed amount, but the net effect of the limitation would probably be small It would not prevent depositors from splitting up larger time accounts among several member banks, and might also encourage further abuses by inducing large depositors to open accounts in the names of employees and others, the pass books or certificates of deposit evidencing such accounts being assigned to the real owner of the funds after the deposits are made Such devices would go far to nullify as well the effects of another suggested restriction which the committee has had under consideration, namely, that the number or amount of withdrawals permitted from a single time deposit account be limited during a stated period Limitation on the number of checks drawn might reduce the apparent activity of a single account, but would be completely ineffective to the extent that it induced depositors to split their existing time-deposit accounts into several accounts and thereby multiply the number of checks which could be legally drawn each month It has also been suggested that the definition of time deposits carried in the Federal reserve act be made more stringent so as to require the presence of the depositor at the bank each time a withdrawal is permitted or to prohibit in all cases withdrawals from these accounts except after 30 days' notice Entirely apart from the annoyance and inconvenience which such restrictions would entail to many time depositors, they could be effectively nullified if banks adopted more generally the practice of making loans on savings pass books to depositors wishing to make an immediate withdrawal Such loans, which can be made to the depositor either in person or through an agent, are secured by the time-deposit account, and entail no loss to the depositor unless the rate of interest charged on the loan is in excess of that paid by the bank on the deposit None of these suggestions, furthermore, offers a remedy for the situation which arises when a depositor splits his balance into a small and extremely active demand-deposit account and into a time-deposit account which is theoretically inactive but which in practice constitutes the balance that justifies the bank in carrying the companion demand deposit

Activity of demand deposits—Studies by the committee of the effectiveness, from the reserve point of view, of the present grouping of member banks into central reserve city banks, reserve city banks, and country banks have convinced it that this classification does not, in actual operation, result in an equitable and economically sound distribution of reserves. While it is true that, on the average, the activity of deposits is much higher in New York City than elsewhere in the country, and also that the activity of deposits at reserve city banks is higher on the average than at country banks, there remains within these general averages a great diversity in deposit activity both between cities and between banks in the same city In numerous small cities, where reserve requirements are those of country banks, deposit activity is materially higher than in many reserve bank cities, while in some country towns the activity of demand deposits is apparently as low or lower than the activity of time deposits at many city banks Within cities, moreover, the same divergence occurs between the activity of deposits at neighboring banks There are individual member banks in New York City carrying 13 per cent reserves against deposits that are less active than those of many country banks carrying a 7 per cent reserve It is not possible, in fact, to arrive at any classification of banks based on size of cities or their location which will reflect with accuracy the average activity of demand deposits at individual member banks. Since it is the committee's conviction that the reserve of an individual bank should fluctuate with changes in the volume of transactions financed by its deposits

and that in the country as a whole aggregate reserves should change with the volume of business done, it is necessary in order to accomplish this purpose to discard completely the present system of basing reserve requirements on the location of banks and to adopt instead a reserve formula which will take direct account of the activity of each individual bank's deposits

COMMITTEE RECOMMENDATIONS

The committee recommends, therefore, that the reserves required to be carried by each individual member bank be determined, first, on the basis of the total volume of deposits held by the bank irrespective of whether they are held by city or country banks or whether they are classified as time deposits or demand deposits, and, secondly, on the basis of the actual activity of these deposits, that is, the actual dollar volume of charges which are made to these accounts More specifically, the committee proposes that each bank be required to hold a reserve equivalent to 5 per cent of its net deposits plus 50 per cent of the average daily debits or charges made to these deposit accounts on the books of the bank As already indicated the reserves thus determined are to include both cash in vault and collected balances with the Federal reserve bank. For a bank with stationary deposits, this is equivalent to a total reserve of 5 per cent, for a bank with deposits which turn over once a month, it is equivalent to a reserve slightly under 7 per cent of total net deposits, while for a bank with an average turnover of once a week, the total reserve is about 12 per cent of total net deposits

This formula will eliminate all of the classifications of deposits at present used to determine required reserves It makes no distinction between a deposit classified as a time deposit and a deposit classified as a demand deposit and so avoids all of the complications which have accompanied the attempts of the Federal Reserve Board to define time deposits The formula, furthermore, eliminates the distinction between demand deposits held by banks classified as central reserve city banks, reserve city banks, and country banks, and so avoids the problem of determining which cities should properly be classified as central reserve or reserve cities for reserve purposes The formula automatically distinguishes between these cities, nevertheless since the average member bank in a central reserve city, where the turnover of deposits is higher, will be required to carry larger reserves than the average bank in a reserve city or the average country member bank which has a low rate of turnover. The proposed formula also distributes the total volume of reserves more effectively and more equitably among member banks, because in the central reserve cities high reserves will be carried only by such banks as have active deposits, while banks in these cities having less active deposits, that is, banks whose business resembles more closely that of a country bank, will be required to carry reserves equivalent to those of a country bank At the same time, the active country bank engaged in business different from its neighbors and more nearly resembling that of a city bank will be required to carry reserves equivalent to those carried by a city bank

This formula, therefore, by basing reserve requirements directly on the volume and activity of the deposits of the individual member bank, places each member bank on an effective parity with respect to the type of banking business in which it is engaged, and achieves in practice those distinctions which theoretically should but actually do not result from the present classification of cities and deposits for reserve purposes.

Deductions from deposit accounts—The committee recommends that net deposits subject to a 5 per cent reserve be determined by subtracting from gross deposits the sum of all balances due from member banks in the United States and their domestic branches and all checks in process of collection and other cash items payable upon presentation in the United States This recommendation differs from present practice with respect both to the deposits from which deductions are permitted and the items which member banks are permitted to deduct

At the present time, the law states that deductions may only be made from "balances due to other banks," that is, deposits held by one member bank to the credit of another bank These balances include, according to the present Regulations of the Federal Reserve Board, all amounts due to banks, bankers and trust companies, and certified, cashiers' and treasurers' checks outstanding.

This provision has given rise to widespread protest, especially from country banks which are not in a position to take advantage of deductible items because they hold little or no amounts due to banks from which to subtract them. The city banks, on the other hand, holding, because of their correspondent relationships, large balances due to other banks, have been able to decrease their deposits subject to reserve by the full amount of their deductible items At the present time this factor is equivalent to about 1 per cent on the average in the required reserves against net demand deposits of country banks; that is, the aggregate reserves held by country member banks against net demand deposits are in effect equal to 8 percent, rather than 7 per cent, if an adjustment is made for their inability to utilize items now deducted from deposits by banks in large cities

In making its recommendation the committee also noted the fact that the present provision governing deductions permits many city member banks to carry banker's balances without thereby increasing their requirements for reserves, since a bank with deductible items normally in excess of its balances due to banks can accept bankers' deposits up to the point where this excess no longer exists without increasing the reserves which it must hold In recommending that deductions be made from gross deposits, consequently, the committee provides for a more equitable treatment of country member banks and also provides a formula by which any bank which increases its balances due to other banks will thereby increase its reserve requirements

The committee also recommends a new definition of items which may be deducted from gross deposits. At present, these items are defined in the law as balances due "from other banks." This phrase has been construed by the Federal Reserve Board to include items with Federal reserve banks in process of collection, amounts due from banks and trust companies in the United States, balances payable in dollars due from foreign branches of other American banks, and exchanges for clearing house and other checks on local banks In effect, consequently, deductible items now include all funds deposited with other banks in this country, dollar balances deposited with branches of other American banks abroad, and the bulk of checks and other items in process of collection

The committee recommends that this definition of deductible items be changed to include only "balances due from other member banks and their branches in the United States" and "all checks in process of collection and other cash items payable upon presentation in the United States" The principle which the committee has followed in making these recommendations is that, in so far as it is administratively practicable, the aggregate body of reserves maintained by member banks should reflect changes in the volume and use of member bank credit by the public, since it is the public's use of credit which has a direct relationship to the volume of the country's business Aggregate reserves should not, as a matter of principle, be affected by purely interbank transactions which do not directly reflect the public use of credit, but, instead, changes in transactions between banks which are on a large scale in our banking system because of the large number of unit banks.

A system of reserve requirements would not be sound under which aggregate reserves might decrease during the next decade solely as a result of some change in our bank relationships which would materially reduce the volume or proportion of interbank deposits now held by member banks The proposal advanced by the committee avoids this contingency since the aggregate net deposits of member banks subject to reserve will not be affected by changes in the volume of balances kept by one member bank with another Under this recommendation, also, the individual member bank which is responsible for the maintenance of reserves against a member bank deposit will be that bank which lends it to the public, i e, an interior member bank will only hold reserves against those deposits on its books which it lends or invests directly with the public If it passes the deposit on to another member bank in the form of an interbank deposit, it will hold no reserve against it since it will be able to deduct this amount from its gross deposits The bank which will receive this interbank deposit and loan the funds involved back to the public, however, will be the one that will be responsible for the reserve which must be maintained against it

Reserves on United States Government deposits.—The recommendations of the committee make no exceptions with respect to deposits of the United States Government, but treat these deposits for reserve purposes the same as any

other deposits The committee recommends the repeal of the 1917 amendments which relieved these deposits from reserves as an inducement to member banks to participate to the fullest extent in war financing. The fact that deposits are secured by the pledge of government or other securities does not constitute a valid reason for their exemption from reserve requirements. A bank as a matter of necessity must have assets to cover and secure all of its deposit liabilities, but this fact does not relieve a bank from its responsibility to maintain adequate reserves. The security of a deposit has nothing to do with the reserve that should be carried against it. The banks have the use of their United States Government deposits the same as of any other deposits and it is equitable, therefore, that these deposits should contribute to the reserve fund in the same relative proportion.

Operation of proposed formula in recent years—This résumé of the principles and evidence upon which the committee has proceeded in formulating its recommendations indicates that under the system of reserves proposed requirements for reserves will be more equitably apportioned among the member banks. It is even more important, however, that the proposed formula exert a constructive influence toward the preservation of sound credit conditions

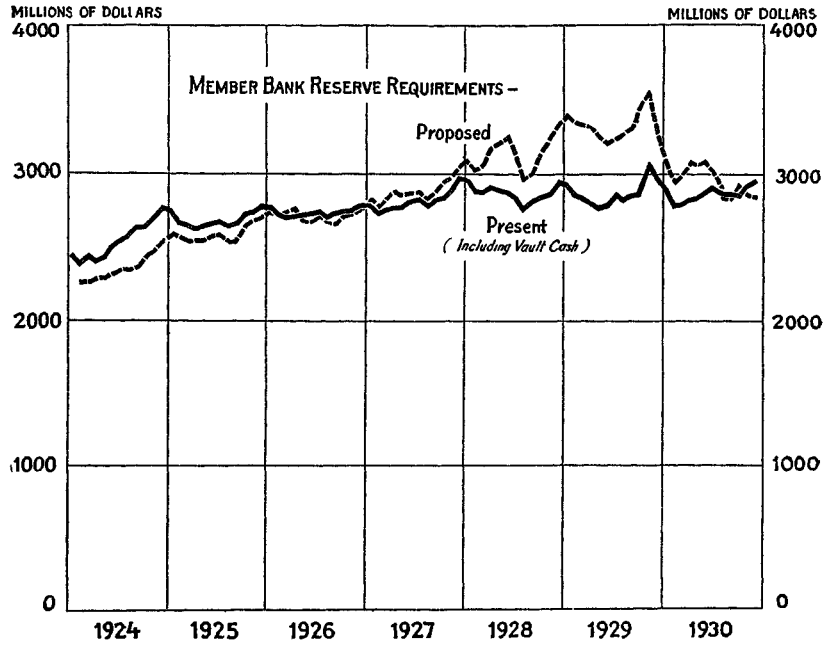
Unsound credit developments arise usually during periods of prosperity when the public is optimistic and both bankers and borrowers are likely to overestimate the value of collateral which is offered to banks as a basis for loans. Such conditions are reflected usually both by an increased demand for bank credit and by increased activity in the deposit balances of those individuals or corporations which deal in the commodities, securities, or services that are acquiring a speculative value. Thus, the speculative value of farm lands, which accompanied the prosperity of agriculture during the war, was reflected both in a sharp increase in the activity of deposit accounts at agricultural banks and in a heavy demand for credit secured by farm mortgages at inflated values. So, also, the prosperity which prevailed in this country during recent years was accompanied by a widespread boom in urban real estate, by speculation in Florida real estate, and finally by an inflation in common-stock prices, each of which was reflected in unsound demands for bank credit at inflated speculative values and in a larger thn average increase in the activity of deposits at those banks whose customers were becoming heavily involved in these speculative situations. In the boom which ended in 1920, the increase in deposit activity was widespread, but the greatest relative increase occurred at the center of farm land and commodity speculation in the Middle West In the boom, which ended in 1929, on the other hand, the greatest increases in deposit activity occurred in New York City and other large eastern cities, where speculation in common stocks was most active

No formula for determining member bank reserves can prevent these speculative situations from recurring, but the proposed formula will operate to check their growth and help to bring them under control It will increase requirements for reserves sharply at those individual member banks whose customers are at the center of an incipient speculative movement, and so set in motion forces of a restraining nature at the focal point of disturbance. These forces will probably take different forms Bankers whose requirements for reserves increase sharply as a result of these activities will find their leading power reduced somewhat and so will be less inclined to finance speculative developments. Customers with highly active accounts will probably be expected to maintain larger deposit balances, or else the member banks will institute service charges based on the activity of accounts The forces set in motion by the proposed formula, consequently, will make it more difficult for an unsound development to obtain credit, will increase the amount of credit needed to finance the development, or will increase its cost of operation The restraining effect of these forces, moreover, will be concentrated almost wholly on speculative credit developments, since the reserves required under the proposed formula will not be such as to effect adversely banks holding the working balances of soundly financed commercial enterprises Very few ordinary business accounts turn over more rapidly than once a week, in which case the effective required reserve under the proposed formula will equal no more than 12 percent This is no larger than the average amount now held in cash and at the reserve banks on all net demand deposit balances at reserve city and country member banks.

In the banking situation as a whole, the effect of the proposed formula on the demand for loans at the reserve banks will be to strengthen Federal reserve policy and thus to exert an influence toward sounder credit conditions This is

illustrated in the chart which compares aggregate member bank holdings of reserves and vault cash under present requirements during the past seven years with an estimate of the aggregate reserves which the formula proposed by the committee would have produced It will be noted that, while under the present formula aggregate reserves did not increase between December, 1924, and the summer of 1927, under the proposed formula they would have increased by nearly $300,000,000 during the same period The greatest contrast between the effect of the two formulas on general credit conditions, however, would have appeared during the years 1928, 1929, and 1930 The failure of present requirements for reserves to exert any influence of restraint in the presence of abnormal credit demands in 1928 and 1929 has been discussed earlier in this report There it was pointed out that aggregate reserves did not reflect the increased use of credit in 1928 and 1929, or exercise a restraint over its growth, because no increase in reserve requirements accompanied the large increase in brokers' loans which, owing to high call-money rates. were supplied

PRESENT MEMBER BANK RESERVES PLUS VAULT CASH
COMPARED WITH REQUIREMENTS UNDER PROPOSED FORMULA



by interior banks, corporations, and others out of funds previously held on deposit with the larger city banks Our present system of reserve requirements thus facilitated an expansion of credit at a time when the situation called for strong restraint It was also pointed out that in 1930, after the break in the stock-market boom, these same factors acted to increase reserve requirements At that time rates on security loans fell below rates on deposits in consequence of a diminished demand for credit in the market, and both corporations and interior banks converted funds previously loaned to brokers into deposits at city banks against which reserves were required

The chart shows that requirements based directly on the activity of member bank accounts, as well as on their volume, in accordance with the proposed formula, would have acted in the direction of sounder credit conditions during these years In 1928 and 1929, an increase in aggregate reserves under this formula would have acted to check sharply an excessive use of credit for stock-market trading, while in 1930 a corresponding decrease in requirements for reserves would have acted to ease credit conditions In all three years, consequently, changes in required reserves would have supplemented the open-market policy of the Federal reserve system, since, in 1928 and 1929, restraint

would have been exerted on the market by increased member bank requirements for reserves, as well as by sales of securities by the Federal reserve banks, and in 1930, the easing effect of purchases of securities by the reserve banks would have been supported by a decrease in member bank requirements for reserves.

Practicability of proposed requirements.—The committee believes that the proposed system of reserve requirements is not only sound in principle, equitable as between the member banks, and constructive in its influence on credit conditions, but that it is also simple to administer and not susceptible of abuses such as those which have grown up around the existing provisions granting a low reserve for time deposits. The committee has canvassed the administrative difficulties which may arise under the proposed system and also the possibility that once introduced it will not operate in the manner expected.

Inauguration of any new system of reserves such as that proposed will require the careful preparation of report forms and of instructions governing their use for the guidance of member banks. Once placed in operation, however, there should be fewer opportunities for administrative difficulties to arise under the proposed system of reserves than under present requirements. In the first place, there are avoided all of the problems attending the classification of member banks for reserve purposes into central reserve city, reserve city, and country banks, and also the classification by member banks of their deposits into time deposits and demand deposits.

Under the committee's proposals, the reserves required of a member bank will depend, first, on its net deposits which are to be determined by subtracting from its gross deposits its balances with other member banks and its items in process of collection, and, secondly, on its total debits to deposit accounts. None of the items used in determining these amounts is difficult for the member banks to obtain from their books or for the bank examiner to check. Determination of daily requirements for reserves, consequently, should be greatly simplified as compared with present requirements.

The committee proposes, moreover, to simplify the problem of maintaining reserves by establishing a system of averaging, by which member banks will know definitely in advance their requirements for reserves and thus be in a position to provide the reserves called for under the requirements.

Since the activity of a bank's deposits on any given day or in any given week is not a reliable indicator of the real activity of its accounts or of the reserves which should be held against them, the committee recommends that in the event the proposed formula is adopted the Federal Reserve Board issue a regulation providing that that part of a bank's reserve which is based on the activity of its deposits shall represent 50 percent of its average daily debits to deposit accounts during the eight weeks preceding its current reserve computation period. In other words, the reserve against deposit activity would not be based on current operations, but on the activity which a member bank might properly expect on the basis of its past eight weeks' experience. While there will be individual cases when this experience is not borne out, investigation has indicated that a period of eight weeks is sufficiently long on the average to give a satisfactory record of the activity to be expected from a deposit account without at the same time removing requirements for reserves too far from current banking developments. On the basis of this eight week's daily average, each member bank would know at the beginning of each reserve computation period the exact amount of reserves against activity which it would be required to hold during that period. The committee recommends that the 5 per cent reserve required on net deposits be computed against net deposits held at the close of the preceding day as at present. The actual volume of reserves held would not have to equal these requirements each day, however, since member banks would have complied with the law if their reserves during a given reserve computation period were substantially maintained and were equal on the average to their average reserve requirements. Changes recommended by the committee in the length of reserve computation periods are discussed later in this report.

The proposed requirements, consequently, should be more simple to administer than present requirements. They should also prove less susceptible of abuse. The committee is aware that banks, when their requirements for reserves will depend directly on their activity, will make an effort to hold down the turnover of their accounts, and the committee expects some resultant decrease in total debits to deposit accounts. There is likely to be some decrease in the turnover of correspondent bank accounts, for example, and

a corresponding increase in the use of the check collection facilities of the reserve banks since correspondent banks will find extremely active balances of other banks less attractive to hold than at the present time There may also be some increase in the use that brokers make of the clearing facilities of the organized security exchanges which will be reflected in a corresponding decrease in the volume of transactions cleared through member bank accounts. Both of these developments will probably reduce somewhat the volume of debits to deposit accounts on which the calculations of the committee are based. On the other hand, the effect of this reduction in total required reserves will probably be offset somewhat by an increase in reserves held against member bank deposits since under the proposed formula member banks will probably require customers having highly active accounts to increase their deposit balances Any net change in aggregate reserves resulting from these operations should not, therefore, be sufficient in volume to affect seriously the functioning of the proposed system once it is effectively placed in operation

Distribution of reserves under proposed system—To check its calculations of the distribution of reserves under the proposed reserve formula, the committee requested all member banks to report for each day of May, 1931, the items on their books which are necessary to calculate their legal requirements for reserves under the plan recommended by the committee The following computations based on these reports include figures for 80 per cent of the member banks holding 96 per cent of total member bank reserves

For these banks as a whole, the proposed formula would have produced during May, 1931, reserves in vault and in the reserve banks equivalent to 99 7 per cent of their actual required reserves plus vault cash under present requirements, i e, for the member banks as a whole, the total body of reserves would be the same under either formula This is in keeping with the intent of the committee, as previously stated, of selecting a formula which would produce at the time of transition the same aggregate body of reserves as is now held under the present law

Of the total reserves produced under the proposed law, 56 per cent would represent the 5 per cent reserve which would be required to be held against total net deposits, and 44 per cent the reserve required against activity of deposit accounts at the rate of 50 per cent of average daily debits. For member banks as a whole, total reserves including vault cash would be 7 8 per cent of their gross deposits, and 8.9 per cent of their net deposits. The average turnover of net deposits in May was at a rate of a little over twice a month.

Of the 6,308 member banks included in the tabulation, the aggregate reserves held by 5,303, or 84.1 per cent of the total, would be reduced under the proposed formula, while those of 349 banks, or 5.5 per cent of the total, would be essentially unchanged, and those of 656 banks, or 10.4 per cent of the total, would be increased Most of the banks whose reserves would be reduced are small country banks which now find it necessary to carry a relatively large volume of vault cash, but this group also includes a number of banks in central reserve and reserve cities which are now required to hold high reserves against demand deposits, the turnover of which is relatively low. Of this group of 5,303 member banks, 808 on the basis of May, 1931, figures would receive a reduction of 10 per cent or less in required reserves under the new formula, 1,247 a reduction of between 11 and 20 per cent, 1,637 a reduction of between 21 and 30 per cent, 1,168 a reduction of between 31 and 40 per cent, and 443 a reduction of more than 40 per cent. More than 90 per cent of the member banks in the San Francisco, St. Louis, Atlanta, Kansas City, and Dallas Federal reserve districts would have some reduction in their reserves under the proposed formula. In the Minneapolis, Chicago, and Cleveland districts, reductions would occur at from 80 to 90 per cent of the member banks, and in the Boston, Philadelphia, and Richmond districts at from 73 to 80 per cent. In the New York district only 65 per cent of the member banks would be in a position to reduce their aggregate holdings of reserves. These reductions reflect largely the fact that under present requirements, member banks located at a distance from the reserve banks must hold more vault cash than more conveniently situated banks.

Most of the increased reserves under the new formula would be carried by the large active member banks situated in cities where Federal reserve banks or branches are located These are the banks where the proportion of aggregate reserves to total credit outstanding has decreased most rapidly in recent years, because their location has permitted them to reduce their holdings of vault cash to a minimum. In addition, this group includes in many instances

banks with a large proportion of deposits now classified as time deposits, and, also, the larger money market banks of the country which hold the exceptionally active demand balances of other banks and of brokers and dealers in securities. Of the 656 member banks in this group as a whole, the increase in total required reserves would be less than 10 per cent in the case of 366 banks, between 11 and 20 per cent in the case of 182 banks, between 21 and 30 per cent in the case of 64 banks, and more than 30 per cent in the case of only 44 banks About 23 per cent of the member banks in the New York district would have some increase in reserves as compared with less than 2 per cent in the Dallas district.

This test of the formula shows that the reserve plan recommended by the committee would produce the total volume of reserves expected and would distribute these reserves more equitably among the member banks, by restoring differentials in reserves held to the proportion justified by the activity of deposits, and by removing advantages now obtained solely from geographical location which enables a member bank to maintain messenger contact with the cash facilities of its Federal reserve bank.

Limitation of total reserve to 15 per cent of gross deposits—The committee has also tested the effect of its proposed limitation of the maximum reserve which a member bank may be required to carry under its formula to 15 per cent of its gross deposits. The purpose of this limitation is to prevent the new requirements from becoming prohibitive in isolated cases where banks have specialized in accounts that turn over at a much higher rate than ordinary business deposits These accounts consist mostly of brokers' balances and balances at stock-yard banks. During May, 1931, only two member banks would have been affected by this maximum limitation. In the summer and fall of 1929, when stock-market speculation was reflected in an extremely high rate of deposit activity in New York City, it is estimated that the limitation would have been effective in the case of not more than 15 member banks. The number of member banks with sufficient deposit activity to be affected by the maximum limitation, consequently, is small

This maximum limit is based upon gross deposits rather than net deposits because banks holding highly active accounts necessarily hold also a large volume of uncollected checks The net deposit in an abnormally active account is small, since it is computed by subtracting all of the checks on other banks deposited by a customer from his gross deposit A maximum limitation based upon net deposits, therefore, would not produce anything like adequate reserves and would defeat the whole purpose of the committee's proposal which is directed toward making active deposit accounts carry the largest reserves

Limitations on amounts of vault cash included in reserves.—In order to assure that each member bank will at all times maintain an adequate deposit balance with its Federal reserve bank, the committee proposes to limit the amount of vault cash which a member bank may include in its legal reserve. It recommends that member banks located in the vicinity of a Federal reserve bank or branch be required to hold four-fifths of their total legal reserve in the form of a deposit balance with their Federal reserve bank These are the member banks which do not need to hold a large volume of vault cash since they can obtain quickly additional currency from their Federal reserve banks. In the case of member banks not so situated, the committee recommends that reserves held as deposit balances with the reserve banks comprise at least two-fifths of total legal requirements for reserves

A test of the effect of these limitations in May, 1931, indicated that they would have permitted about 70 per cent of the member banks to count as legal reserves all of the vault cash which they held at that time About 30 per cent of the member banks, however, held more currency last May than they would have been permitted to count as legal reserves under the formula recommended. The total amount of this excess vault cash was in the neighborhood of $40,000,000 for all the member banks affected, and did not constitute an appreciable burden for the great majority of these banks

Kinds of vault cash eligible for reserves—The committee recommends that banks be permitted to count as reserves all kinds of cash now in circulation. It also recommends that in computing reserves cash in transit between a member bank and its Federal reserve bank be counted as the equivalent of cash in vault.

Debits subject to reserve—The committee recommends that debits subject to reserve shall include all debits to all accounts included in gross deposits, except charges resulting from the payment of certified, cashiers' or other officers'

checks The exception of debits resulting from the payment of certified checks is due to the fact that a debit entry is made at the time of certification The second debit made when these checks are finally paid should not, therefore, also be included in the reserve computation since to do so would involve duplication. Debits resulting from the payment of cashiers' and other officers' checks are also excepted, because they represent either transactions similar to certified check transactions or else payments made by member banks on their own account Such payments do not represent the use of member bank credit by the public and should not be subject to reserve

Administration and enforcement of reserve requirements—At the request of the committee the counsel of the Federal Reserve Board has prepared a draft of an amendment to section 19 of the Federal reserve act embodying the recommendations of the committee for the new system of member bank reserve requirements discussed above This draft, which appears at the end of this report, repeats certain provisions in the present law which are not concerned directly with member bank reserves but are included in the proposed amendment in order to facilitate the legislative drafting of the bill These provisions, which are carried in paragraph (m) of the proposed amendment, have not been considered by the committee and make no changes in the wording of the present act.

It is the purpose of the committee to make the determination and enforcement of the reserve requirements recommended in the draft as simple as possible The committee recommends, consequently, that Regulation D of the Federal Reserve Board be changed to permit member banks located in the vicinity of a Federal reserve bank or branch to compute their reserves over a period of one week, and other member banks over a period of four weeks. Within these reserve computation periods the committee recommends that member banks be permitted to average their daily holdings of reserves against their daily reserve requirements, provided they are not continuously deficient for three or more consecutive business days if they are located in the vicinity of a Federal reserve bank or branch, or for six or more consecutive business days if they are not so located. Member banks with consecutive deficiencies for three or six days respectively would lose the privilege of averaging their reserves during the entire reserve computation period in which they were continuously deficient, and pay a penalty to their Federal reserve banks for all actual deficiencies occurring during such period The committee also recommends that the board amend its regulation to permit a Federal reserve bank, with the consent of the Federal Reserve Board, to require any member bank in its district to maintain reserves each day in accordance with requirements for that day The purpose of this recommendation is to provide a method for dealing with individual member banks which flagrantly abuse the privilege of averaging their reserves against their requirements

At the present time, a member bank is prohibited from declaring dividends or making new loans while its reserves are deficient and is required pay a penalty to its Federal reserve bank on all average deficiencies in its reserves within a reserve computation period If it declares dividends or makes new loans on any day or at any time when its reserves are deficient, it violates the law and its directors are presumably liable for all losses accruing to the bank therefrom This provision, the committee thinks, is too drastic in its present form, since it is almost impossible for a member bank to tell whether its reserves are deficient or not at any given time during the day when a new loan application is under consideration The committee would modify this provision, consequently, to read that "if any member bank shall fail for 30 consecutive calendar days to maintain the reserves required by this section, it shall not declare or pay any dividend, or make any new loan or investment until its reserves are restored to the amount required" This means that only a definite failure to maintain reserves over a period will make directors personally liable for losses arising from violation of the law, and not technical deficiencies in reserves that may arise from a variety of circumstances at any time during the ordinary course of bank operations The committee also recommends that the Federal Reserve Board provide in its regulation for the notification of the directors of a delinquent member bank in advance of the expiration of the 30-day period specified in the proposed law, such notification to state that their bank is incurring continued deficiencies and that unless steps are taken to correct the situation the directors will become subject to the penalties prescribed in the Federal reserve act for violation of the law

The committee would also modify the provision governing penalties to be paid by member banks for reserve deficiencies At the present time penalties for deficiencies in a member bank's reserve are assessed by its Federal reserve bank at a rate of 2 per cent per annum above its current rediscount rate. In some Federal reserve districts, a progressively higher penalty rate is assessed for reserve deficiencies prevailing over long periods The committee recommends that the provision relating to progressive penalties be eliminated from the Federal Reserve Board's regulation, since in most cases progressive rates are incurred by member banks not as the result of negligence or indifference but as the consequence of conditions that make compliance with requirements difficult if not impossible The committee also feels that when discount rates are below 4 per cent the present penalty rate is too low to prevent member banks from becoming negligent with respect to their reserves. It, therefore, recommends that the penalty rate be 2 per cent above the discount rate on 90-day commercial paper but that in no case shall such penalty rate be less than 6 per cent

Effective six months after enactment—In event the proposed amendment to section 19 of the Federal reserve act is adopted, the committee recommends that a 6-month period be allowed before changes in reserve requirements become effective.

E L SMEAD, *Chairman,*
IRA CLERK
M J. FLEMING
E A GOLDENWEISER,
L R ROUNDS

W. W RIEFLER,
Executive Secretary.

PROPOSED AMENDMENT TO SECTION 19 OF FEDERAL RESERVE ACT

A BILL To amend section 19 of the Federal reserve act, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 19 of the Federal reserve act (United States Code, title 12, sections 461 to 466, inclusive, and section 374) as amended be further amended and reenacted to read as follows:

"BANK RESERVES

"SEC 19 (a) Each member bank shall establish and maintain reserves equal to 5 per centum of the amount of its net deposits, plus 50 per centum of the amount of its average daily debits to deposit accounts; but, in no event, shall the aggregate reserves required to be maintained by any member bank exceed 15 per centum of its gross deposits

"(b) Each member bank located in the vicinity of a Federal reserve bank or branch thereof shall maintain not less than four-fifths of its total required reserves in the form of a reserve balance on deposit with the Federal reserve bank, and every other member bank shall maintain not less than two-fifths of its total required reserves in the form of a reserve balance on deposit with the Federal reserve bank The remainder of the total required reserves of each member bank, over and above the amount required to be maintained in the form of a reserve balance on deposit with the Federal reserve bank, may, at the option of such member bank, consist of a reserve balance on deposit with the Federal reserve bank, or of cash owned by such member bank either in its actual possession or in transit between such member bank and the Federal reserve bank

"(c) The term 'gross deposits', within the meaning of this section, shall include all deposit liabilities of any member bank whether or not immediately available for withdrawal by the depositor, all liabilities for certified checks, cashiers', treasurers', and other officers' checks, cash letters of credit, travelers' checks, and all other similar liabilities, as further defined and specified by the Federal Reserve Board; *Provided, however,* That the term 'gross deposits' shall not include any liability of a foreign branch

"(d) The term 'net deposits', as used in this section, shall mean the amount of the gross deposits of any member bank, as above defined and as further defined by the Federal Reserve Board, minus the sum of (1) all balances due to such member bank from other member banks in the United States and their

domestic branches, and (2) checks and other cash items in process of collection which are payable immediately upon presentation in the United States, within the meaning of these terms as further defined by the Federal Reserve Board.

"(e) The term 'average daily debits to deposit accounts', as used in this section shall means the average daily amount of checks, drafts, and other items debited or charged by any member bank to any and all accounts included in gross deposits as above defined and as further defined by the Federal Reserve Board, except charges resulting from the payment of certified checks and cashiers', treasurers', and other officers' checks.

"(f) The term 'cash', within the meaning of this section, shall include all kinds of currency and coin issued or coined under authority of the laws of the United States.

"(g) The term 'reserve balance,' as used in this section shall mean a member bank's actual net balance on the books of the Federal reserve bank representing funds available for reserve purposes under regulations prescribed by the Federal Reserve Board.

"(h) The term 'vicinity of a Federal reserve bank or branch thereof', as used in this section, shall mean the city in which a Federal reserve bank or branch thereof is located, unless otherwise defined by the Federal Reserve Board.

"(i) With respect to each member bank, the term 'Federal reserve bank,' as used in this section, shall mean the Federal reserve bank of the district in which such member bank is located

"(j) The Federal Reserve Board is authorized and empowered to prescribe regulations defining further the various terms used in this act, fixing periods over which reserve requirements and actual reserves may be averaged, determining the methods by which reserve requirements and actual reserves shall be computed, and prescribing penalties for deficiencies in reserves Such regulations and all other regulations of the Federal Reserve Board shall have the force and effect of law and the courts shall take judicial notice of them

"(k) Subject to such regulations and penalties as may be prescribed by the Federal Reserve Board, any member bank may draw against or otherwise utilize its reserves for the purpose of meeting existing liabilities: *Provided, however,* That if any member bank shall fail for thirty consecutive calendar days to maintain the reserves required by this section, it shall not declare or pay any dividend or make any new loan or investment until its reserves are restored to the amount required by this section.

"(l) All penalties for deficiencies in reserves incurred under regulations prescribed by the Federal Reserve Board pursuant to the provisions of this act shall be paid to the Federal reserve bank by the member bank against which they are assessed.

"(m) No member bank shall keep on deposit with any State bank or trust company which is not a member bank a sum in excess of 10 per centum of its own paid-up capital and surplus. No member bank shall act as the medium or agent of a nonmember bank in applying for or receiving discounts from a Federal reserve bank under the provisions of this act except by permission of the Federal Reserve Board.

"(n) National banks, or banks organized under local laws, located in Alaska or in a dependency or insular possession or any part of the United States outside of the continental United States may remain nonmember banks, and shall in that event maintain the reserves and comply with all the other conditions provided by law regulating them prior to the enactment of the Federal reserve act; or said banks may, with the consent of the Federal Reserve Board, become member banks of any one of the Federal reserve districts, and shall in that event take stock, maintain reserves, and be subject to all the other provisions of this act.

"(o) The provisions of section 7 of the first Liberty bond act, approved April 24, 1917, section 8 of the second Liberty bond act, approved September 24, 1917, and section 8 of the third Liberty bond act, approved April 4, 1918 (United States Code, title 31, section 771), which exempt deposits of public moneys by the United States in designated depositaries from the reserve requirements of this act and all other acts or parts of acts in conflict with this act are hereby repealed only in so far as they are in conflict with the provisions of this act."

SEC 2. This act shall become effective six months after its approval by the President of the United States.

MEMORANDUM REGARDING "NATIONAL SECURITIES ACT OF 1934" (H R 8720) AS AMENDED, WITH PARTICULAR RELATION TO ACT AS IT AFFECTS LISTED CORPORATIONS DIRECTLY OR THE RELATIONS BETWEEN STOCK EXCHANGES AND LISTED CORPORATIONS

This comment is confined specifically to Sections 11, 12, 13, one clause in Section 18, with references to Section 3 (13)

Insofar as any of the provisions of the foregoing sections involve a form of regulation of corporations, it would appear, upon the whole, wiser, to the extent that such legislation may be needed, to provide a well considered separate act, dealing directly with the corporations through the medium, perhaps, of a national incorporation act

It would seem that certain phases of the government's dealing with this matter indirectly may not be satisfactory. The following comments are therefore subject to the foregoing general views

Section 11 (a) This section makes it unlawful for any person to effect any transaction in any security on a national securities exchange unless a registration is effective as to such security, as provided, and unless such security has been issued This section must be considered in connection with Section 3 (13), which defines the term "security" in a broad sense, but contains certain exceptions and permits others to be made by the Commission It must also be considered in connection with Section 11 (e) which provides that the Commission may permit securities listed on any exchange, at the time of registration of such exchange, to be registered provisionally for a period ending not later than April 1, 1935, without complying with the preceding paragraphs of Section 11

There are numerous securities now listed upon stock exchanges as to which no one has any present interest in making an application for listing or a registration statement In some cases, these listings represent minority interests which the majority owners would be glad to see removed by default from the exchanges, thus depriving minority holders of a market and perhaps compelling them to accept terms not regarded by them as favorable There are also corporations in receivership which are out of the control of their officers and directors, foreign securities or American Shares representing foreign securities, and perhaps others To require that trading upon exchanges should cease in regard to securities for which no registration statement would be made would inflict grave injury upon security holders, and would restrict the basis of credit.

As to securities the present sponsors of which desire that they shall continue to be listed upon stock exchanges, the provision that the act becomes, in this respect, effective on April 1, 1935, imposes what appears to be a great burden of useless work and expense upon the corporations, the Commission, and the stock exchanges It is to be assumed that the stock exchanges have acted in good faith in admitting securities to listing, and this legislation should be concerned more with the future than with the past

The requirement for audits, unless suspended by the Commission, would increase gravely the difficulties and expense, and the burden of scrutinizing and considering seriously the registration statements to be filed would interfere with the efficient progress of work on the exchanges as regards new listing applications

The Bill contains provisions permitting the Commission to classify exchanges, and if it is felt that this section can not be modified in the manner to be immediately suggested as to all exchanges, it is suggested that Section 11 (a) be at least amended in such manner as to exempt securities listed on a Class I exchange, prior to a date thirty days later than the passage of the Act, from the necessity of filing an additional registration statement, but requiring, of course, application and registration statements for all additional securities issued by such corporation and not covered by then existing approved listing applications.

If it be argued that the filing of a registration statement (or listing application) requires the corporation to assume certain undertakings and obligations, the listed corporations might be readily required to make such undertakings and assume such obligations as may be regarded as essential, without the filing of additional registration statements The provision as it stands is not practical. If, however, it cannot be changed as above suggested, then it is suggested that the language of Section 11 (a) permit the Commission, in its discretion, to exempt from registration, for all time, particular types of securities now listed, such as those outlined in the earlier portion of the comment upon this paragraph.

This paragraph also forbids trading in securities upon an exchange unless the security has been issued Presumably this is to prevent "when issued" listings It is believed that exchanges are careful not to grant such "when issued" listings unless it is in the public interest, but at times the "when issued" market serves to aid in the business of providing capital for industry, and it would appear desirable to omit this reference and not to forbid the existence of such a market.

Section 11 (b) (I) · This provision requires that the issuer undertake to comply with rules and regulations made or to be made under the act, and not to lend funds except upon exempted securities at the money post of any exchange or to specified individuals, except in accordance with such rules and regulations as the Federal Reserve Board may prescribe

This constitutes an undertaking so serious that there is reason to fear it may interfere with the listing of securities upon registered exchanges and drive them into unorganized markets

It would seem well to make the undertaking apply only to compliance with rules already made, for the reason that authority will remain in the hands of the Commission and/or the exchange to strike from the list securities of any corporation refusing to agree to any reasonable rules and regulations,thereafter to be made

It is quite possible that there may be periods when the Federal Reserve Board may not think it necessary to promulgate specific rules and regulations as to the lending of funds, and it would seem well to amend the last part of this paragraph so as to constitute an agreement on the part of the issuer to observe such rules, if any, as the Federal Reserve Board may, from time to time, prescribe in regard to the subject matter of the paragraph.

Section 11 (b) (II): This requires from issuers such information as to the issuer and affiliates as the Commission may, by rules and regulations, require This provision would appear to require the Commission to issue, on its own motion, rules and regulations regarding the act of listing. It is suggested that, for a considerable period of time, at least, any Commission charged with the administration of this act will find it difficult to acquire sufficient detailed information to enable it to issue wise rules and regulations in this respect.

Moreover, the action of an exchange in admitting a security to listing is an affirmative action The action of the Commission in this respect, in not forbidding or deferring such listing, is a negative action. The exchange has the direct contact with the issuers, and it would appear to be in the interest of that flexibility which is essential in the business of dealing in securities to allow the exchanges to make the rules and requrements for listing, with provision for approval by the Commission if such rules or requirements are to have the force of law, and with the provision that the Commission may direct the making of rules and regulations, if any particular exchange appears to be lax its duty in this respect.

This comment will apply to all future sections where rules and regulations affecting registration statements are to be made by the Commission

This difficulty could be removed by making the first sentence of Section 11 (b) (II) read·

"Such information as to the issuer and affiliates as the exchange, with the approval or at the direction of the Commission may, by rules and regulations, require as necessary or appropriate in the public interest or for the protection of investors in respect of * * *".

Further in this connection, it is noted that Section 11 (a) and Section 11 (a) (I) both refer to rules and regulations under the act, without stating by whom such rules and regulations are to be made It might be well to amend the two paragraphs just referred to to include similar language, and thus carry out the idea advanced throughout this comment The present language of these two sections, however, is sufficiently flexible if it appears better not to amend them

Section 11 (b) (II) (4): The requirement for making public the names of the principal security holders does not seem to be necessary in the public interest, and it is suggested that it be omitted

The requirement to state the remuneration of directors and officers is believed to be adverse to the interest of security holders A large part of the business of this country is in the hands of corporations, and inducements are needed to insure to corporations, now and in the future, a proper type of corporate officer. The average stockholder is of small means, and will tend to bring pressure upon directors to reduce salaries, entirely reasonable in them-

selves, but much larger than the income of the individual stockholder There is reason to believe that, in spite of conspicuous instances to the contrary, the corporate officials of this country are, on the whole, under-paid in relation to the responsibilities assumed by them, and anything tending to prevent ambitious and able men from going into corporate employ is to be deplored

In addition, disclosure of this information would frequently be of competitive disadvantage.

Many of the ablest corporate officials have relatively small financial interests in the company which they serve No good reason is known for requiring that the interests of officers and directors in the securities of companies should be stated. It is suggested that this paragraph be rewritten to require a statement of the names of directors, officers and underwriters, the remuneration of the underwriter in connection with the particular issuance for which listing is desired, together with any continuing remuneration to the underwriter, and a statement of any contracts, other than contracts of employment, between directors and/or officers on the one hand, and the issuers and its affiliates on the other.

Section 11 (b) (II) (5) · For the same reason as is given above, it is suggested that this paragraph in regard to stating the remuneration to others than directors and officers exceeding $20,000 per annum be omitted altogether

Section 11 (b) (II) (6) This requires a statement of particulars regarding bonus and profit-sharing arrangements Insofar as it may require disclosure of names of individuals benefitting by bonus and profit-sharing arrangements or payments to particular individuals described by title or otherwise, it is believed to be subject to the same objections outlined to (4) and (5) above In addition, it is frequently advisable to select particular individuals for special remuneration of this nature, and the disclosure of the fact to others not thought by the officials to merit such treatment would cause serious jealousies and disturbances

It is suggested that this provision be modified by the substitution of an agreement to submit, in the future, all such plans in general terms to stockholders for ratification before they may become effective, and that, both as to past and future arrangements of this nature, all annual reports published should restate such general terms and the total amount of bonus payments or profits shared thereunder

Section 11 (b) (II) (7). This provides for disclosure of the particulars of management and service contracts The meaning of this paragraph is very obscure, and what constitutes management and service contracts should be better defined in order that the issuers may be able to fulfill the requirements

Section 11 (b) (II) (9): It is suggested that this paragraph be stricken on account of its difficulty of administration The determination of what constitutes a material contract and as to what is a material patent is to difficult that the only safe means of compliance may be the publication of particulars regarding all contracts not made in the ordinary course of business and a description of all patents, which, in the case of many companies, would burden the record with an enormous mass of worthless material

Section 11 (b) (II) (10) This requires submission of balance sheets for preceding years, certified by independent public accountants or otherwise as the Commission may prescribe

The number of years is not stated It is suggested that the provision should be made more definite by making it apply to the last three fiscal years of the corporation, if it has been that long in existence, and to permit specifically that certified statements, when required, shall not be required for a longer period than the last fiscal year, unless the reports for such longer period have been previously certified by independent public accountants

It is particularly suggested that the words "fiscal year" be inserted in all references to annual reports, with the idea in mind of having corporations, as far as practicable, adopt a natural fiscal year, in order that the work of auditing may be spread more evenly throughout the year, instead of being concentrated, as it now is, largely, in a few months in the early part of the year

Section 11 (b) (II) (11) The number of years' profit and loss statements to be filed is not stated. It is recommended that amendments similar to those suggested for Section 11 (b) (II) (10) be made in this respect

Section 11 (b) (II) (12) · This requires, in regard to any matters similar to the preceding sections, such information as the Commission deems necessary to insure the proper protection of investors and fair dealing in the

security It is recommended, in view of the immediately preceding text, and in view of the comment above on Section 11 (II), that this be changed to read:

"Any similar financial statements, information regarding which the exchange, with the approval or at the direction of the Commission, may deem necessary to insure the proper protection of investors and fair dealing in the security"

Section 11 (b) (III): The same suggestion is made as heretofore, as to the substitution of rules made by the exchange, with the approval or at the direction of the Commission, in place of rules made directly by the Commission.

Section 11 (c): This provides that if, in the judgment of the Commission, reports required under Section 11 (b) are inapplicable to specified classes of issuers, the Commission shall require, in lieu thereof, such reports, if any, as it may deem applicable to such class of issuers. It is recommended that this read:

"The exchange, with the approval or at the direction of the Commission, may determine that any report or reports required under sub-section (b) are inapplicable to any specified classes of issuers, and, in such event, may require, in lieu thereof, the submission of such reports, if any, as it may deem applicable to such class of issuers The exchange may receive and act upon listing applications using its own best judgment in this respect, subject to the right of the Commission to require an amended statement from the issuer, should the Commission not concur in the action taken."

This provision is in the interests of the time element, and to carry out the idea of the Commission working through the exchanges with the applicants.

Section 11 (d) This provides that, upon certification by the exchange authorities to the Commission that the security has been approved by the exchange for listing and registration, the registration shall become effective thirty days after the filing of such certification with the Commission, with appropriate provision for cases in which the Commission does not approve. A certain amount of time is required for the submission, correction, consideration and approval of any listing application by a well-organized exchange, ordinarily, in times of normal volume of business, from ten days to two weeks When thirty days is added to this, the delay becomes so serious that it will materially affect many transactions, and interfere with the business of underwriting new issues for financing capital requirements, and for dealing with the maturities of existing corporations to a serious extent It is suggested, therefore, that the thirty day limit be taken off entirely, and that securities be regarded as fully registered from the date of approval of the listing application by a registered stock exchange, subject to the right, elsewhere reserved to the Commission, to suspend trading in securities, this right to be exercised if the Commission finds such securities not suitable for registration

It is further suggested that the exchanges be permitted to list securities growing out of existing securities, such as certificates of deposit and other like instruments, in advance of registration, upon request by letter, accompanied by an assurance that a listing application, in form required by the exchange, will be forthcoming within a reasonable time This action, of course, would also be subject to the Commission's right to suspend.

Section 11 (e): This provides that the Commission may, by such rules and regulations as it deems necessary or appropriate, permit securities listed on any exchange at the time of the registration of such exchange as a national securities exchange becomes effective, to be registered provisionally for a period ending not later than April 1, 1935, without complying with the provisions of this Section.

Reference is made to the comment upon this feature in connection with Section 11 (a) on pages (2) and (3) of this Memorandum It is urged that this Section, in the general public interest, should be amended in accordance with the recommendations just above referred to

Section 12 (a): This is subject to the preceding remarks, that the filing of the required information should be in accordance with rules and regulations to be prescribed by the exchange, with the approval or at the direction of the Commission, etc

Section 12 (a) (2): To carry out the idea of this Memorandum, the annual, quarterly, and other reports to be filed should be such as the exchange with the approval or at the direction of the Commission, may prescribe This Section is much more flexible than the similar Section in the preceding draft of the Bill There is no occasion for changing it excepting as stated, but it is

to be hoped that the eventual requirements will not include quarterly balance sheets, which, excepting with investment trusts and like corporations, are illusory, and that the requirements for making quarterly earnings reports will be sufficiently flexible to avoid requiring such reports from corporations in cases where such reports would be misleading, impracticable, or unduly expensive to the stockholders of the corporation

Section 12 (b) · This section should really be left out in its entirety If this cannot be done, it should be set forth that the items or details to be shown in the balance sheet and earnings statement need not be uniform, and that the exchange may adapt its requirements in this respect to the circumstances of individual corporations, subject to the right of the Commission to require the corporation, in future financial statements, to give such additional information, if any, as the Commission may think essential Under no circumstances should the Commission be empowered to prescribe the methods to be followed in the preparation of accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, and in the differentiation of investment and operating income Any attempt to regulate these matters by fixed written rules is doomed by the nature of the subject to failure, and the existence of such rules would tend to crystallize and prevent all future progress in the accounting art

Accounting is, and always must be so much a matter of judgment, that the best that can be done is to try by common consent to narrow in certain instances the limits within which that judgment may be properly exercised

In lieu of the provisions which, as above stated, it is essential to strike, it might be provided that the methods to be followed in the preparation of accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and non-recurring income, and in the differentiation of investment and operating income, shall be in accordance with sound standards of the day as practiced by professioal men of standing This will give ample authority to take measures to remove from the list of all registered exchanges, the securities of corporations whose accounts manifestly are not kept in accordance with such standards

In addition to this, there might well be an additional paragraph in Section 18, requiring each listed corporation to cause a statement of the methods of accounting and reporting employed by it to be formulated in sufficient detail to serve as a guide to its accounting department; to have such statement adopted by its Board, so as to be binding upon its accounting officers, and to file such statements with the Commission, making a copy thereof available to any stockholder upon request, and upon payment, if desired, of a reasonable fee.

Another paragraph might require the listed corporation to give assurances that the methods so formulated will be followed consistently from year to year, and that, if any change is made in the principles, or any material change in the manner of application, the stockholders, the exchange and the Commission shall be advised when the first accounts are presented in which effect is given to such change

There are grave reasons why the filing of the information suggested above. directly with the exchange, would or might be inadvisable, but the filing of such statements within a reasonable period of time, say one year, with the Commission, would have certain marked advantages

Section 13 (b): This Section provides that proxies may not be given, or authorization in respect of any security registered on a national securities exchange and carried for the account of a customer, without a specific written authorization from such customer Some exchanges have this rule already in existence.

There is reason to doubt its wisdom as applied to non-dividend-paying securities. Such securities often pass from hand to hand for years, without change of name. They may pass through a number of hands after leaving the custody of the firm in whose name originally registered, and it is impossible for the firm in question to give the name of the true owner. This makes it difficult and at times absolutely impossible to secure a quorum for necessary action by stockholders, and at times constructive plans of corporations for their rehabilitation have been defeated by the existence of this difficulty. The rule is a good one as applied to dividend-paying stocks, and as to the non-dividend-paying stocks, it should be remembered that the actual owner of a security may at any

time get it and vote it, in spite of any proxy that may have been given in the name of the registrant.

Section 18 (5) This Section empowers the Commission to alter or add to the rules, regulations, and practices of a national securities exchange, including, among other things, rules in regard to the limitation or prohibition of the registration or trading in any security within a specified period after the issuance of primary distribution thereof Attention is called to the comment upon Section 11 (a) in regard to the advisability of not unduly restricting the "when issued" market for securities.

Apart from this, however, the possibility of this limitation or prohibition should not extend to additional issues of the same class of securities as have already been listed by a given corporation

The possibility of such limitation or prohibition is doubtless contemplated only as to original security issues Practically all additional issues must be authorized for listing subject to official notice of issuance, otherwise the business of making additional issues of a listed security would have to cease It is suggested, therefore, that this particular clause be changed to read

"The limitation or prohibition of the registration or trading in the first, or initial, issue of any class of securities made the subject of an application or registration statement, within a specified period after the issuance or primary distribution thereof * * *"

With this alteration, the Section as a whole is flexible enough to enable the Commission to allow "when issued" trading in securities if it thinks it advisable

Section 22 This Section empowers the Commission, Comptroller of the Currency, the Federal Reserve Board, and Interstate Commerce Commission to make such rules and regulations as may be necessary for the execution of the functions granted to them under this act There should be added at the end of the Section language approximately as follows

"Any registered national securities exchange of a class to be determined by the Commission may, with the approval of the Commission, or at its direction, make such rules, regulations, and requirements affecting the listing and retention upon the list of securities, not inconsistent with the provisions of this act, and such rules, regulations and requirements, so approved or directed by the Commission, shall have the same force and effect as though initially made by the Commission Nothing, however, shall prevent the exchange from prescribing other rules, regulations and requirements deemed by it to be necessary in this connection, without formal approval of the Commission Such unapproved rules, regulations, and requirements, however, shall not have the force of law, and may be set aside upon due hearing, in the discretion of the Commission."

The first part of the foregoing addition to Section 22 is for the purpose of carrying out the consistent idea of this Memorandum, that it is better that the Commission should work through the exchanges with listed corporations.

The second part is based upon the fact that nearly all requirements of exchanges have been evolutionary in their nature, and it is necessary to preserve a certain degree of flexibility in regard to them, for which, however, the Commission should not be made responsible, nor should such unapproved requirements have the force of law.

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