STOCK EXCHANGE PRACTICES

HEARINGS

BEFORE THE

COMMITTEE ON BANKING AND CURRENCY
UNITED STATES SENATE

SEVENTY-THIRD CONGRESS

SECOND SESSION

ON

S.Res. 84

(72d CONGRESS)

A RESOLUTION TO INVESTIGATE PRACTICES OF STOCK EXCHANGES WITH RESPECT TO THE BUYING AND SELLING AND THE BORROWING AND LENDING OF LISTED SECURITIES

AND

S.Res. 56 and S.Res. 97

(73d CONGRESS)

RESOLUTIONS TO INVESTIGATE THE MATTER OF BANKING OPERATIONS AND PRACTICES, TRANSACTIONS RELATING TO ANY SALE, EXCHANGE, PURCHASE, ACQUISITION, BORROWING, LENDING, FINANCING, ISSUING, DISTRIBUTING, OR OTHER DISPOSITION OF, OR DEALING IN, SECURITIES OR CREDIT BY ANY PERSON OR FIRM, PARTNERSHIP, COMPANY, ASSOCIATION, CORPORATION, OR OTHER ENTITY, WITH A VIEW TO RECOMMENDING NECESSARY LEGISLATION, UNDER THE TAXING POWER OR OTHER FEDERAL POWERS

PART 16

National Securities Exchange Act (continued)

MARCH 23 TO APRIL 5, 1934

Printed for the use of the Committee on Banking and Currency

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JOHN G TOWNSEND, Jr., Delaware
JAMES COUZENS, Michigan

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

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[1] Retained in the committee's files

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

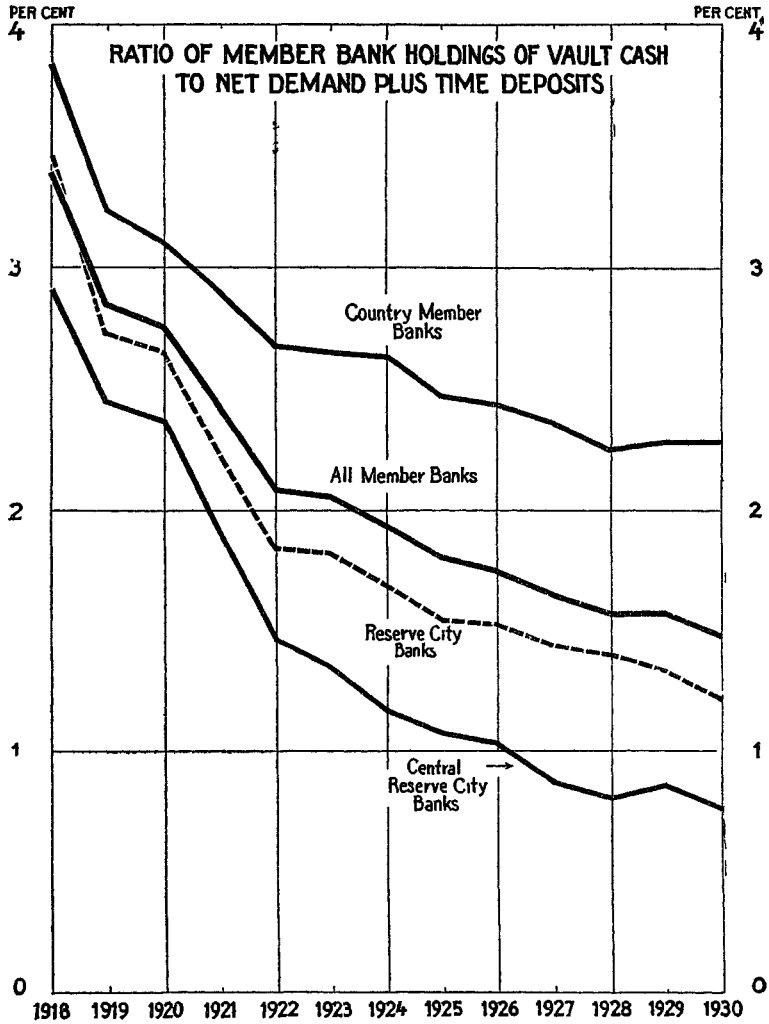
Between June 1917, before the new requirements went into effect, and June, 1930, net demand plus time deposits of member banks increased from $12,000,000,000 to $32,000,000,000, but holdings of vault cash at the same time decreased from about $800,000,000 to less than $500,000,000 By making progressive 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

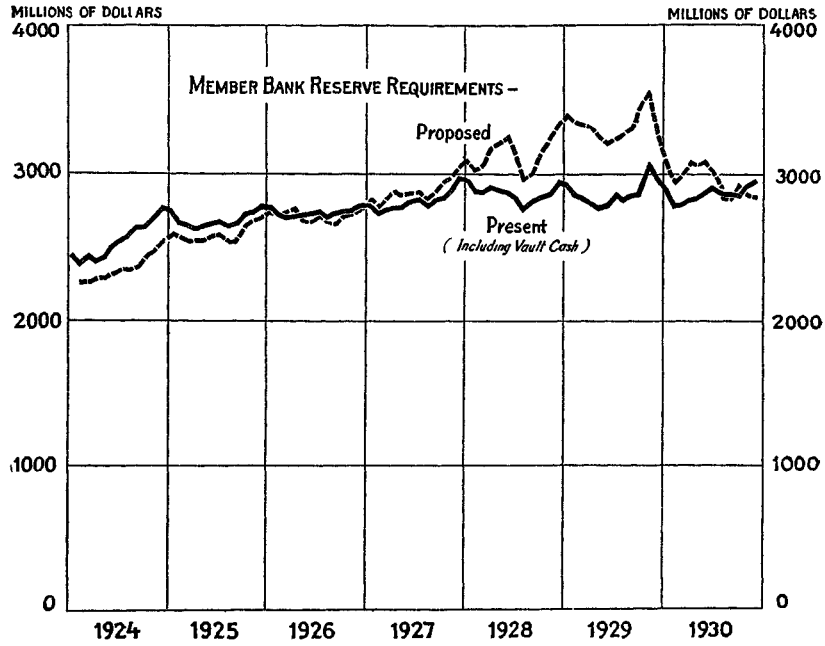
Unsound credit developments arise usually during periods of prosperity when the public is optimistic and both bankers and borrowers are likely to overestimate the value of collateral which is offered to banks as a basis for loans. Such conditions are reflected usually both by an increased demand for 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.

J M B HOXSEY,
Executive Assistant to Committee on Stock List, New York Stock Exchange

MARCH 21, 1934

STOCK EXCHANGE PRACTICES

SATURDAY, MARCH 24, 1934

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

The committee met at 10:30 a.m. pursuant to adjournment on yesterday, in room 301 of the Senate Office Building, Senator Duncan U. Fletcher presiding.

Present: Senators Fletcher (chairman), Barkley, Gore, Byrnes, McAdoo, Adams, Goldsborough, Townsend, Walcott, Carey, Couzens, Steiwer, and Kean.

Present also: Roland L. Redmond, counsel to the New York Stock Exchange; William A. Lockwood, counsel to the New York Curb Exchange; and Eugene E. Thompson, president of the Associated Stock Exchanges.

The CHAIRMAN. The committee will come to order, please. Some people telegraphed me the other day about our hearings and I notified them we were going to close after yesterday and today. I do not know whether they are here today or not. If they are present and ready to be heard we will hear them. Now, any of those who wish to make statements will come forward to the committee table and give their names now.

Mr. THOMPSON. Mr. Chairman, I am president of the Associated Stock Exchanges, and——

The CHAIRMAN (interposing). I know that you are here, Mr. Thompson. Is anybody else present who wishes to be heard? [after a pause:] There was a Mr. Ladd, I think from Pittsburgh, who wired asking permission to be heard, and I answered telling him I would give him a hearing.

Senator GOLDSBOROUGH. There was a Mr. Laird, representing a big firm——

The CHAIRMAN (interposing). No; this was a Mr. Ladd.

Senator GOLDSBOROUGH Well, that is another man.

The CHAIRMAN. Is there anybody else present this morning who wishes to be heard on the bill?

Mr. PAUL. Mr. Chairman, my name is W. G. Paul, of Los Angeles, representing the Los Angeles Stock Exchange. I should like the opportunity to appear before your committee but am not sufficiently prepared to make a statement this morning. We are now working on the suggested amendments which we intend to submit, and I think it would be futile for me to sit down now and take your time.

The CHAIRMAN. Do you now have your amendments in shape to submit to the committee?

Mr. PAUL. No, sir; we are working in connection with Mr. Whitney, and as he stated on yesterday, he will submit his amendments later. I could now merely sit down and chat with you gentlemen, but I think that would be an unnecessary waste of your time.

The CHAIRMAN. Very well, Mr. Paul. Now, Mr. Thompson, you may come forward and we will have your statement.

Mr. THOMPSON. All right, Mr. Chairman.

The CHAIRMAN. Mr. Thompson, whom do you represent?

Mr. THOMPSON. Mr. Chairman and gentlemen of the committee: I represent the Associated Stock Exchanges as their president, the membership of which is composed of 18 local exchanges throughout the United States, plus the Louisville, Ky., Stock Exchange; the Richmond, Va., Stock Exchange; and the Seattle, Wash., Stock Exchange. I will be glad to furnish the committee reporter with a list of our membership.

The CHAIRMAN. All right.

Mr. THOMPSON. Shall I now proceed?

The CHAIRMAN. Yes. You have examined this revised bill, known as H.R. 8720, I take it?

Mr. THOMPSON. Yes.

The CHAIRMAN. Very well. You may go ahead with your statement.

Mr. THOMPSON. My remarks will be directed to H.R. 8720, inasmuch as that is the subject which I understand you have under consideration at the present time.

The CHAIRMAN. Very well. You may go along with your statement.

STATEMENT OF EUGENE E. THOMPSON, PRESIDENT OF THE ASSOCIATED STOCK EXCHANGE, WASHINGTON, D.C.

Mr. THOMPSON. On the occasion of a former recent appearance before this committee, I ventured to assert, in behalf of the Associated Stock Exchanges, of which I am the president, that the then pending bill to regulate the securities exchanges of the country was unworkable; that it would operate to destroy the usefulness of the essential market places for corporate capital; that it would retard materially if not actually prevent the realization of the President's recovery program; that it would tend to turn the corporate securities business of the greatest industrial country in the world into the hands of racketeers and bootleggers, and that instead of being a measure for the protection of the investor it likely would prove to be the most damaging legislation of its character ever enacted by the Congress.

Now a new securities bill has been prepared, or rather the old bill has been rewritten in some of its particulars; but in all the essentialities and insofar as original intents and purposes are concerned the measure remains as it was at the beginning. The form only has been slightly disguised; the substance is apparent and unchanged.

Those of us who have devoted years to deep and earnest study into the problems of the stock exchanges and the securities business have not felt that the bill as drawn in the first instance met, or came anywhere near meeting, the requirements of rational legislation. We do

not consider that the amended bill is better or worse than the original. If we should admit for the sake of argument that the stock exchanges are wholly bad, then we should still be compelled to say in candor that the legislation which is proposed here furnishes only an easy means of jumping the corporate securities business of the country out of the frying pan and into the fire.

Oh, well, some of you might say, this witness and those whom he represents would be antagonistic to any kind of a regulatory law. That would not be an accurate assumption at all. We are not opposed to, but would rather welcome a law of practical design that contemplates and takes into account only those features and phases of the business of handling corporate securities which are in need of and which are susceptible of regulation. Naturally we would not favor a law which we believe would destroy the stock exchanges as institutions; and when I mention stock exchanges in this sense you will understand, of course, that I am speaking only for those located outside of New York City. We would not favor a law which places in the hands of a Federal agency, as this bill does, the power and means for controlling, absolutely and minutely, the business of the country.

Statements have been made to the effect that the general business of the country will not be retarded or affected adversely by the passage of this legislation. Such assertions can only come from those who are ill-advised or ignorant. The stock exchanges are the economic barometers—the business pulse of the country. Those of us who by the circumstances of our lives have been thrown intimately into touch with the stock exchange do not merely thing that general business will be hit hard—we know it will be. There will be an immediate recession of business with the advent of this legislation. There will be deflation and there will be credit chaos. You gentlement at this moment surely sit in a position of exceedingly grave responsibility. Even a favorable report by you on this measure as is now written is a matter fraught with dangers of a nature the nation can ill afford to have thrust upon it at this critical period.

The attempt at control of corporations through the medium of a stock exchange regulatory bill cannot be judged otherwise than as misplaced legislation. If there is to be control of that kind, then surely it should be out in the open—a frank measure providing for such control as may be deemed advisable and proper under a national incorporation act; and that is where it belongs if it belongs anywhere.

We have already had a forerunner of what may happen as a result of this proposed law. Cabled solicitation for American orders in securities already have come from London, and Paris advises are to the effect that recently, in anticipation of what is expected to be done here, there has been an increase of listings in the Paris market. You have all read in the papers that within the last few days stock exchange memberships at Montreal and Toronto, in Canada, have increased in value, while seats on the New York and other exchanges in our own country have been quoted on a basis of a greatly reduced valuation.

May I say that these facts are not to be dismissed as propaganda. If they represent propaganda, then they are the propaganda of

serious truths which cannot be overlooked or treated lightly by any citizen, whatever his position may be in the country's affairs, who has the good of the United States at heart.

In a general sense—because I do not care to dwell again upon those points which were covered in my previous appearance here—the proposed legislation attempts to reach too far. It seems to grope about in the maze of its own complications and in the darkness of its own confusion. As a layman, I should say it needs to be a simpler law and a shorter one.

Let me single out just a few of the provisions changed in the rewriting of the bill which are still in our opinion objectionable.

Now, as to page 8, paragraph 13: This exempts only such securities as are direct obligations of or obligations guaranteed as to principal or interest by the United States; such securities as are issued or guaranteed by corporations in which the United States has a direct or indirect interest and which shall be designated for exemption by the Secretary of the Treasury, and such other securities as the Commission, by such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors, may exempt from the operation of any one or more of the provisions of the act.

The placing in the hands of the Federal Trade Commission of authority over the securities of States and their political subdivisions which, if the provision is actually enacted into law as worded in the bill, may have far-reaching results, and in addition may force the States and their political subdivisions to pay much higher prices for borrowed funds than they have been in the habit of paying, this being due to the uncertainty which will be created as to the qualifications of the securities as "exempt securities."

With reference to page, 13, section 6, item (a): This item, while amended in several particulars, still makes no change over the old bill with respect to loans upon securities, other than exempted securities, which are not listed upon a national securities exchange. We submit that this item would work an undue hardship upon those owning the securities of many small corporations which are entirely solvent and have satisfactory ratings.

Referring to page 19, section 7, item (a): When the broker or dealer in the course of business is prohibited from borrowing on any security—other than exempted security—except from a Federal Reserve bank, or in accordance with rules and regulations prescribed by the Federal Reserve Board to permit limited loans between members and brokers or between members and dealers who transact a business in securities through the medium of a member, or to permit loans from or through others than member banks in localities where there are no member banks, or to meet emergency needs—under these conditions it is apparent that the broker will be forced to do business with a member bank of the Federal Reserve System unless there should happen to be no member bank in the locality where he conducts his business. It is unfair to force upon a broker or dealer the obligation of borrowing through a member of the Federal Reserve System; it is likewise unfair to banking institutions which are not members of the Federal Reserve System to take from them the privilege and opportunity of making such loans.

Going to page 21, section 8, subsection 2, lines 22, 23, and 24, attention is called to the words, "or a false or misleading appearance in respect of the market for such security or securities." In its import and its operation this language is unfair to brokers. A broker may act in the purchase or sale of securities, and in so doing, but not by his design or purpose, there is created a false or misleading appearance in respect to the market. Why, under such circumstances the broker be held accountable when he has only been given orders to purchase or sell? In the case of limited markets, there is almost certain to be that which might be described as false or misleading appearances in respect to the market in the minds of many persons. The vagaries of the human mind are not often changed by legislative enactments. In this connection, in the same section, on page 22, subsection 3, line 5, are the words, "for the purpose of raising or depressing the price." It would be exceedingly difficult for a broker, or for anyone else for that matter, to interpret the meaning and the intent of a customer when he has been called upon to execute either a buying or selling order which is bound to have the effect of raising or depressing prices in limited securities markets.

In subsection 5, line 24 on page 22 and lines 1 and 2 on page 23, we read that it will be unlawful to make any statements inducing a securities transaction which is, in the light of the circumstances under which it is made, "false or misleading in respect of any matter sufficiently important to influence the judgment of an average investor." If this language is allowed to remain in the bill, there will be many days of anxiety on the part of brokers and dealers until they can feel that they may do business without this liability hanging over them.

We direct attention to subsection 8, page 23, line 21, which deals with the proposition of "pegging, fixing, or stabilizing the prices of securities in contravention of such rules and regulations as the Federal Trade Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors or without having prior thereto reported to the Commission such information regarding the purpose and nature of such transactions or operations, the details thereof and the person or persons interested therein as the Commission by rules and regulations may prescribe as appropriate or necessary in the public interest or for the protection of investors." There is likelihood here of great harm being done, perhaps where not intended, by denying an investor the right to support securities in which he has a particular interest, or against which he may have loans, or in the purchase of which he is moved by a desire to accumulate the securities for investment purposes.

As to subsection 9, items (i) and (ii): These provisions fail to give to a broker or dealer the right to acquire options for the purpose of liquidating large blocks of securities held, say, by estates, or against bank loans, et cetera, where the work of distribution involved is considerably greater than if the broker were merely selling stock on the exchange for a commission. Unless proper provision is made to care for such classes of transactions there will be many instances where estates and banks holding large loans will suffer through inability to obtain the services of dealers or brokers in such liquidations.

On page 27, section 10, item (b): This item provides that the rules of the proposed national securities exchange may permit a member to be registered as an odd-lot dealer and as such he will be permitted to buy and sell for his own account so far as may be reasonably necessary to carry on such odd-lot transactions; it also provides that it shall be unlawful for an odd-lot dealer to act as a broker. Evidently in this particular no consideration has been given to the character of business conducted on the smaller exchanges throughout the country and on which nearly every broker does an odd-lot business. As a matter of fact the great bulk of transactions on the local exchanges are in odd lots. This section should be changed or clarified so that the business now transacted on the smaller exchanges will not be taken away from them. Some of the member exchanges already have advised us that if this provision becomes a law they will be forced out of business.

As to section 10, line 6, page 28: It provides here that it shall be unlawful for any member—meaning a member of a national securities exchange—either with or without the privilege of acting as a dealer—except an odd-lot dealer or a specialist dealer—and, while on the trading premises of an exchange, to effect any transaction for his own account, or, as a broker, to give an order to another member to be executed for his own account. The Commission is given the power, when it has been shown that the rules of the exchange prevent excessive trading by members, to permit exchange members to effect transactions for their own account, subject to such terms and conditions as the Commission may prescribe as necessary or appropriate for the protection of investors. I cannot see why the facilities of an exchange should be denied to its members unless it is able to show that its rules prevent excessive trading by members. Just what is meant by excessive trading certainly is not clear. Such a law would undoubtedly tend to drive legitimate trading from the exchanges.

With reference to page 30, section 10, item (e): The rules of the proposed national securities exchange bill may permit the registration of a specialist as a dealer or as a broker; but it shall be unlawful for a specialist registered as a dealer to act as a broker, or for a specialist registered as a broker to act as a dealer. It should be understood that brokers who now act as specialists do not devote their entire time to that line of activity; they act as sepcialists in certain classes of securities only and this occupies, usually, merely a small portion of their time. The rest of the time they act, of course, as brokers. Due consideration should be given to this class of business which apparently was not clearly understood by the framers of the bill.

On page 34, section 11, item (f): The Commission, by this provision, is directed to make a study of trading in unlisted securities on the exchanges and to report the results together with its recommendations to Congress on or before January 23, 1935, but it also appears that in the event Congress does not take action before that time, the exchanges may continue unlisted privileges only until March 1, 1935, unless an earlier date is prescribed by law. It is quite evident that what has been developed into a publicly quoted market for certain unlisted securities will be destroyed unless the Commission is given authority to extend the time until Congress has had an opportunity to act upon the recommendations.

As to page 36, section 12, item (b): It is noted that the present bill retains the provision requiring the Commission to prescribe methods to be followed in the preparation of accounts, in the appraisal and valuation of assets and liabilities, and in the determination of depreciation and depletion. We heartily endorse full and free statements, but we submit that the Federal Trade Commission, or any other regulatory body, should not have the power to appraise and determine the valuation of assets and liabilities or to determine depreciation and depletion. Such authority as given undoubtedly would cause many corporations to de-list their securities from the smaller exchanges.

Going to page 38, section 14, line 20: Regulation and control of over-the-counter transactions appear too indefinite for a dealer to have any comprehension of just what he may or may not be permitted to do. The whole regulation is left in the hands of the Commission and as a guide in this conection the Commission is to use such necessary protection as is comparable in the case of national securities exchanges. We cannot see the fairness of attempting to regulate those engaged in the business of buying and selling securities while allowing those who are not engaged to go out and conduct transactions without any restrictions.

At page 41, section 16: We submit that the business of selling securities should not be subjected to any more outside examinations than other lines of business. The expense for income tax information and other reports is already a burdensome charge upon the business, and to levy further charges for additional examinations is beyond the realm of fairness. The exchanges are amply able themselves to cover the matter of examinations and have always been foremost over other lines of business in such efforts.

In summarizing let me say that we have not attempted to go into many features of the bill which we still feel are vitally objectionable to the continued existence of the local stock exchanges.

We have dwelt upon these in a previous statement, and the fact that they are not again being stressed should not be construed as indicating that our protest is thereby minimized

We wish to emphasize our serious objections to the placing of the regulation of the stock exchanges under te Federal Trade Commission, even though it is to be an enlarged commission; we do not believe that the Commission, or any other commission or body which is not specially organized and its personnel carefully selected for the character of work it will be called upon to perform, is constituted to deal with a business so highly technical and surrounded by so many ramifications requiring prompt specialized treatment.

We wish again to go on record as favoring a coordinating authority in which the stock exchange shall have a voice in their own management. It is our belief that any regulatory body made up entirely of those not representative of the stock exchanges cannot and will not function in a way that will be to the best interests of the public and certainly not to the best interests of the stock exchanges.

Senator BARKLEY. Mr. Thompson, do you think the Interstate Commerce Commission ought to be composed of presidents of railroads inasmuch as it has to deal with railroad regulations?

Mr. THOMPSON. No, Senator Barkley, and we do not suggest that here either.

Senator BARKLEY. Well, I take it that would be a parallel situation.

Mr. THOMPSON. No. With all due respect, I do not think so.

Senator ADAMS. Well, do you think they ought to have any considerable representation on the Commission?

Mr. THOMPSON. We think they ought to have a voice in it, or certainly to the extent of having on the membership those who are acquainted with railroad matters

Senator BARKLEY. Well, even if you think they should have a partial voice in it, by the same theory in setting up any commission to regulate any industry you think it ought to be composed, in part at least, of those engaged in such industry, do you?

Mr. THOMPSON. Well, I think you will agree with me that the Interstate Commerce Commission has been composed at times of some former railroad presidents.

Senator BARKLEY. Well, perhaps once in a while but not often.

Mr. THOMPSON. Well, this is starting out on a new path where some intimate knowledge of the subject is quite needful.

Senator ADAMS. Well, in the case of any active railroad men, when they go on the Interstate Commerce Commission they certainly sever their relations with the railroads.

Mr. THOMPSON. That may be so, but the knowledge is there.

Senator BARKLEY I do not recall that any member has been taken from any important railroad itself.

Mr. THOMPSON. I cannot cite you at this time a case in point, and of course the Interstate Commerce Commission was organized many years ago.

Senator COUZENS. Well, certainly any such man was not put on the Interstate Commerce Commission as representing railroad management.

Senator ADAMS Mr. Thompson, your proposition seems to be that members of stock exchanges should be made a part of the regulatory body proposed here to be set up.

Mr. THOMPSON. Not altogether, but I would suggest——

Senator ADAMS (interposing) At least you suggest that there should be some of them on such a body.

Mr. THOMPSON. I mean along the lines of Mr. Whitney's suggestion made to this committee some days ago, that those to compose such a body might be selected as representing, possibly, one from the New York Stock Exchange and possibly one representing the local exchanges throughout the country.

Senator ADAMS How do you mean to have them selected?

Mr. THOMPSON To have them designated by the exchanges.

Senator ADAMS Then you would propose to have the exchanges designate the membership of a Government commission?

Mr. THOMPSON No, sir. We do not suggest that at all. But we do think there should be on such a commission those who are acquainted with the intricate details of the business, and that the members, as usual in the case of any Government commission, would be selected by the President of the United States.

Senator ADAMS. Then you are not in favor of any regulations of stock exchanges, are you?

Mr. THOMPSON. I am in favor of some regulation if we may have some voice in it.

Senator ADAMS. I take it on the theory that you would furnish the voice and when that voice would come forward with a statement the rest of them would follow.

Mr. THOMPSON. Oh, no.

Senator COUZENS. I suppose the utilities would desire the same sort of regulation.

Senator ADAMS. That, it seems to me, would be worse than no regulation at all.

Mr. THOMPSON. I would not go that far. If a majority of the members of the commission are others than members of stock-exchanges, there would certainly be regulation.

The CHAIRMAN. In other words, if you could regulate the regulators you would be satisfied, is that it?

Mr. THOMPSON. No; I do not even ask that. If we had 1 voice out of 7, let us say, I would not say that that 1 voice would regulate the 7.

Senator BARKLEY. Well, in case of a tie vote of the other six members that voice would have the deciding vote.

Mr. THOMPSON. That would be true, too.

Senator MCADOO. Under the Constitution the President is the appointing power of all commissions and bodies representing the general public interest. Now, you wouldn't advocate the giving of that power to any private organization or body, would you?

Mr. THOMPSON. Not altogether, no. But when some one is selected who is familiar with stock exchanges that would give assurance of some knowledge within the board of the intricate workings of this business. Even though the exchanges themselves could not nominate some one, if there were some one selected who is familiar with stock exchange practices it would go a long way toward assuring a general knowledge of the business.

Senator ADAMS. I suppose the membership of the United States Senate should have the opportunity to select, then, 1 out of the 7, inasmuch as they are passing the legislation and dealing with it.

Mr. THOMPSON. Well, the Senate passes the legislation to create such a body, and they usually have the opportunity of confirming those who are nominated by the President to serve on such a body.

Senator GORE. Does the Federal Reserve Act require that men having knowledge of banking shall be placed on the Federal Reserve Board?

Mr. THOMPSON. I am not familiar with the act, but I know it has been done.

Senator ADAMS. Oh, yes, but the banks do not select the members.

Senator COUZENS. There is nothing to prevent the President from putting some stock exchange man on the proposed board if he wants to do it.

Senator MCADOO. The President has the power to select a member or members of the proposed board from your organization if he sees fit. He has a perfect right to take some one who is qualified. Don't you think there is just as much protection there in the make-up of such a body so far as you are concerned as any other interest has in the Interstate Commerce Commission or any other governmental commission?

Mr. THOMPSON. Senator McAdoo, I might say it is my recollection that even in the case of some commissions that have been provided for by law, there has been provision made by the Congress that the men selected for such positions should have a knowledge of and general acquaintance with the work to which they were to be assigned. I cannot point out at the moment what they are, but I think there are some nevertheless.

Senator GORE. I think the Federal Reserve Act requires that some one having a knowledge of agriculture shall be placed on the Board. But there are a lot of farmers who vote, of course.

Senator MCADOO. Business organizations might select a business man, and bankers might select some banking man, whose names would be presented to the President for consideration.

Senator GORE. Mr. Thompson, don't you think your statement is a sort of impeachment of the brain trust?

Mr. THOMPSON. Well, it might be so coneidered, but it was not intended as that.

Senator GORE. It would seem that way to me.

Senator ADAMS. Mr. Thompson, in the opening part of your statement you referred to the decline in value of stock exchange seats. What bearing does that have on the bill we are considering here?

Mr. THOMPSON. Well, I think the decline in stock exchange seats has been brought about by the fear that the exchanges will be so handicapped it will be difficult for them to do business as it has been done in the past, and that there will not be the usual demand for seats on stock exchanges.

Senator ADAMS. Isn't that begging the question? For instance, if there is any illegitimate business being profitably conducted, necessarily the shutting off of that business, or such portion of it as may be illegitimately conducted, will have an effect upon those engaged therein. Let us take Monte Carlo: If the Prince of Monaco should change the dice on the game, the franchise there would be worth considerably less.

Mr. THOMPSON. I agree with you, Senator Adams, so far as illegitimate things may be concerned. And we do not stand for those any more than you or anyone else. Certainly those whom I represent would not attempt to condone such things.

Senator ADAMS. Well, if the bill merely eliminated illegitimate practices and that resulted in reducing the price of stock exchange seats, that is no argument to be offered against the passage of this bill.

Mr. THOMPSON. I think it goes further than eliminating illegitimate practices. The bill as now drawn hinders legitimate practices.

Senator ADAMS. Well, that is the thing we are interested in knowing about.

Senator BARKLEY. What decline in stock exchange seats are you talking about?

Mr. THOMPSON. I am referring more particularly now to the newspaper accounts of the New York Stock Exchange and the New York Curb Exchange seats.

Senator BARKLEY. Well, before this bill was ever prepared, yes, long before the matter came up seriously at all, I might say, seats on the New York Stock Exchange declined from a price over $600,000 to less than $200,000.

Mr. THOMPSON. Well, whenever there is anything that will scare the people into the belief there will be a reduced amount of business you will find a decline in stock exchange membership.

Senator BARKLEY. But it was not a Government scare that brought about that decline. It was the debacle on the stock exchange and the general situation.

Mr. THOMPSON. That is true, but we have a worse decline in the last month or two as it affects seats on stock exchanges since this scare here.

Senator BARKLEY. Well——

Senator MCADOO (interposing). Well, Mr. Thompson—but pardon me, Senator Barkley. I did not mean to interrupt you.

Senator BARKLEY. Go ahead.

Senator MCADOO. I can ask my question later.

Senator BARKLEY. Well, never mind. I am through sometimes when I don't know it. [Laughter.]

Mr. THOMPSON. That might be better for some of us, Senator Barkley, outside of the Senate, too.

Senator MCADOO. I am the same way. I just wanted to ask a question along the line that I started out on a moment ago.

Senator BARKLEY. Go ahead, Senator McAdoo. I am through.

Senator MCADOO. Mr. Thompson, you do not mean seriously to argue that we should not perform a public duty here in the enactment of necessary legislation to correct abuses because the proposal to do so might result, even if it did, in a reduction in the value of stock-exchange seats, do you?

Mr. THOMPSON. Not at all. But are you stopping there?

Senator ADAMS. You realize that throughout the country right now there is some lack of confidence in the stock exchanges, some apprehension of manipulation, don't you?

Mr. THOMPSON. There is no doubt about that, but——

Senator ADAMS (continuing). Might it not result in reinstating your values if the public could be reassured, could feel that they were going to get a square deal if they went into the market to invest?

Mr. THOMPSON. When you speak of the public being assured of getting a square deal, that is true. That is what we want them to have. That is what we try to give them. But on the other side of the question, we representing stock exchanges feel that we should bring forward to you the things we see in the proposed legislation which would hinder stock exchanges in the conduct of legitimate business; in fact, which may drive many of them out of business. I am just as serious as I can be when I say that we do not come to you with a threat, but simply to draw to your attention the fact that local stock exchanges—and I can only speak for them—cannot live under this bill. It is impossible for members of local stock exchanges to conduct a profitable business if they are restricted as section 10 alone of this bill would restrict them.

Senator GORE. That has to do with the dealer-broker aspects of the matter.

Mr. THOMPSON. Yes, sir.

The CHAIRMAN. We have opened that door already by this amendment.

Mr. THOMPSON. Only partially. It still closes the door to us in many things we are doing, as we think legitimately and properly and to the satisfaction of the public.

Senator COUZENS. Mr. Chairman, have we any more witnesses this morning?

The CHAIRMAN. Representing these local exchanges, Mr. Thompson, do you concede that there is a real need for Federal regulation of stock exchanges?

Mr. THOMPSON. I think, Senator Fletcher, that some kind of regulation would be welcomed by the exchanges, but you must remember that——

Senator BARKLEY (interposing). It is not so much a question whether they would welcome regulation or not, but it is a question whether such regulation is wise or necessary.

Mr. THOMPSON. Do you mean, do I feel that there is any real need for it?

Senator BARKLEY. Yes.

Mr. THOMPSON. No, sir; I do not. But I think when you consider the frame of mind the public has gotten into, it is necessary to have it.

Senator GORE. Mr. Thompson, do you think that some of the abuses which characterize the New York Stock Exchange characterize other exchanges?

Mr. THOMPSON. No, sir; I do not.

Senator BARKLEY. Mr. Thompson, assuming that the big bad wolf up in New York needs regulation, what would you do toward minimizing the restrictive influences of any regulatory bill that would cover them as it might apply to local stock exchanges?

Mr. THOMPSON. Well, I would say that in general the business as conducted in local stock exchanges is practically the same as conducted on the New York Stock Exchange, but there are so many things done in New York that are not done on local exchanges by reason of the fact that the New York Stock Exchange is primarily a large national market, upon which there is, quite naturally, a great deal more speculation than there is upon the local markets, which are more semi-investment markets, or I might say perhaps three fourths of the business done is semi-investment to one fourth speculation. Yes; I should say that three fourths of the business done on all exchanges outside of New York is a cash business

Senator GORE. Did you say three fourths of the business?

Mr. THOMPSON. Yes, sir.

Senator BARKLEY. I suppose it is a recognized fact that the evils which brought about, to the extent to which they did bring about the collapse in the market, the nefarious practices that a lot of so-called financially respectable men engaged in, do not to any large extent attach to the small local stock exchanges, and that in large measure they were not responsible for the evils that brought about this whole pestiferous situation.

Mr. THOMPSON. I think that is quite a fair statement.

Senator BARKLEY. But I do not know how we are going to reach the general practices of the big one without in some way including the smaller ones.

Senator ADAMS. Mr. Thompson, have you prepared or can you prepare amendments to the bill which will permit the regulation

of the big exchange, of the evils which you confess are there, and at the same time not destroy the local exchanges?

Mr. THOMPSON. Mr. Whitney yesterday stated that he would confer with the associated stock exchanges, and so forth, in preparation of the amendments they were bringing in. May I say to you that one of the most difficult sections to whip into shape, and the one that will perhaps be delegated more to the exchanges to whip into shape will be section 10, and that is the big one that involves so much on the local exchanges, which are not comparable with New York.

Senator ADAMS. You recognize that the committee probably does not want to release the big exchange from proper regulation in order to protect the little exchanges.

Mr. THOMPSON. I quite agree with you. That is what I am speaking to you about. I think section 10 applies more to our local exchanges than it does to New York. I think in trying to correct the large evil, if I may so call it, that is apparent in New York, consideration has not been given to the damage that is going to occur to the local exchanges.

Senator GORE. You think that in killing the big bad wolf we are going to kill some of the lambs.

Mr. THOMPSON. I am positive of it.

Senator GORE. The problem is to know where to draw the line.

Senator MCADOO. As a matter of fact, the listed securities on the Washington Exchange are very few in number, are they not?

Mr. THOMPSON. Relatively few in Washington, because we have not an industrial market here.

Senator ADAMS. You have a good many gamblers here.

Mr. THOMPSON. Not on the Washington Stock Exchange.

Senator GORE. Let us pass a law to stop that.

The CHAIRMAN. Have you any figures or statistics sustaining your view that three fourths of the business on the local exchanges is cash?

Mr. THOMPSON. No. I am merely giving that as my opinion, based upon knowledge of the business only. I think it is a fair statement, and I believe an inquiry made of the local exchanges would show that I am a little under, rather than over. It may run as much as 80 or 85 percent cash.

Senator GORE. Do you think it would be better to let the exchanges initiate rules and regulations in the first instance, subject to revision and approval by the National Commission, or to vest the Commission itself with the power to initiate, prescribe, and fix rules and regulations.

Mr. THOMPSON. I would not want to say that, Senator, for I have not given that as careful study as I would like to in order to answer you intelligently. It is a very broad and serious question.

Senator GORE. That seems to me to be the real question that is running through and dividing the two schools of thought on this whole business.

Mr. THOMPSON. I do want to say, Mr. Chairman, that we will cooperate with Mr. Whitney in bringing in to you the suggested amendments and those amendments that we particularly have in mind. I mean those that will deal particularly with the local exchanges. They will be embodied and will be so indicated to the committee.

The CHAIRMAN. Mr. Whitney, you remember, discussed section 10 quite fully and proposed certain amendments to it.

Mr. THOMPSON. Yes, sir. We are in accord with those, but we feel that they should go even a little further than mentioned there

Senator GORE. Insofar as stock market transactions affect and react upon credit, do you not think control of those activities ought to be vested largely in the Federal Reserve Board?

Mr. THOMPSON. I should think so, Senator, yes. I think that is the proper place for them to be.

Senator GORE. Theoretically that is undoubtedly true, but in practice I do not know whether they have made sufficient use of the powers they have or not.

Mr. THOMPSON. Is there anything else, Mr. Chairman?

The CHAIRMAN That is all, I believe, if there are no further questions.

Mr. THOMPSON. Mr. Chairman, may I say that I understood that Mr. Ladd of Pittsburgh was unable to get here?

Senator BARKLEY. Have you extra copies of your statement?

Mr. THOMPSON. They are on the way up here. I will see that you get one.

The CHAIRMAN. Is there anyone present who wishes to make a statement now?

Senator GOLDSBOROUGH. May I inquire if the Assistant Secretary of Commerce, Mr. John Dickinson, was asked to appear before the committee?

The CHAIRMAN. He will come down later and appear before the committee.

Senator TOWNSEND. I move we adjourn.

The CHAIRMAN. We will meet Monday at 10:30.

Senator COUZENS. Will the hearing on Monday be an open hearing?

The CHAIRMAN. So far as I know. There are some doubts as to whether Mr. Whitney would be ready Monday.

Senator GORE. I have a notion Secretary Dickinson will want to appear in executive session.

(Whereupon, at 11:20 a.m., Saturday, March 24, 1934, an adjournment was taken until Tuesday, Mar. 27, 1934, at 10:30 a.m.)

STOCK-EXCHANGE PRACTICES

TUESDAY, MARCH 27, 1934

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

The committee met at 10:30 a.m., pursuant to adjournment on Saturday, March 24, 1934, in room 301 of the Senate Office Building, Senator Duncan U. Fletcher (presiding).

Present: Senators Fletcher (chairman), Glass, Barkley, Gore, Costigan, McAdoo, Adams, Goldsborough, Townsend, Walcott, Carey, Couzens, and Kean.

Present also: Ferdinand Pecora, counsel to the committee; Julius Silver and David Saperstein, associate counsel to the committee; Frank J. Meehan, chief statistician to the committee; Roland L. Redmond, counsel to the New York Stock Exchange; William A. Lockwood, counsel to the New York Curb Exchange; and Eugene E. Thompson, president of the Associated Stock Exchanges.

The CHAIRMAN. The committee will come to order, please. Mr. Whitney, you were to submit a further statement this morning by way of suggested amendments to the bill. We will be very glad to have you proceed.

STATEMENT OF RICHARD WHITNEY, PRESIDENT OF THE NEW YORK STOCK EXCHANGE—Resumed

Mr. WHITNEY. Mr. Chairman and gentlemen of the committee: First of all I should like to submit to the committee some additional documents with regard to the aviation stocks. They are supplemental lists, giving addresses missing in our original reports of transactions in aviation securities, as well as corrections covering errors which we have found. If I may merely submit them as exhibits as has been previously done, I will now be glad to do so.

The CHAIRMAN. They will be received and marked for identification.

(A document entitled "Supplementary List of Addresses Not Shown in Original Reports", was marked "Whitney Exhibit No. 40 for Identification, March 27, 1934", and will be retained in the files of the committee.)

(Another paper entitled "Curtiss-Wright Corporation, First Supplementary Report", was marked "Whitney Exhibit No. 41 for Identification, March 27, 1934", and will be retained in the committee's files.)

(Another document entitled "Wright Aeronautical Corporation Capital Stock, First Supplementary Report", was marked "Whitney Exhibit No. 42 for Identification, March 27, 1934", and will be retained in the committee's files.)

(Another document entitled "Aviation Corporation of Delaware, First Supplementary Report", was marked "Whitney Exhibit No. 43 for Identification, March 27, 1934", and will be retained in the committee's files.)

(A document entitled "Curtiss-Wright Corporation Class 'A', First Supplementary Report", was marked "Whitney Exhibit No. 44 for Identification, March 27, 1934", and will be retained in the committee's files.)

(Another document entitled "Douglas Aircraft Co., Inc., First Supplementary Report", was marked "Whitney Exhibit No. 45 for identification, March 27, 1934", and will be retained in the committee's files.)

The CHAIRMAN. You may proceed with your statement, Mr. Whitney.

Mr. WHITNEY. Mr. Chairman, I should like to read a very brief statement first, if I may.

The CHAIRMAN. You may do so.

Mr. WHITNEY. I am entirely in accord with the thought that great speculative excesses are an economic evil and that they can and should be prevented.

I am not in accord with the thought that the speculative excesses of 1929 and preceding years were to a material extent caused by or due to our stock exchanges or the way in which they were operated. I am not in accord with the thought that the stock-market panic of 1929 was the cause instead of one of the earlier results of the industrial depression.

I do not believe that the use of credit in connection with forward commitments, whether in the purchase of securities, of commodities, or of homes, or in the sowing of crops in the expectation of harvest can be otherwise than beneficial when wisely and reasonably employed.

I am not in accord with the provisions of this bill which seem designed to punish stock exchanges for imaginary offenses, nor am I in accord with those provisions which would throttle industry, contract credit, diminish the liquidity of securities, and postpone the return of prosperity.

I believe that H.R. 8720, in its present form, would prevent excessive speculation but only by seriously interfering with that great system of industry, commerce, and finance without which there can be neither speculation nor prosperity.

I believe that the evils which this proposed legislation seeks to remedy can be cured without risking the dangers inherent in this bill of delaying the return of prosperity.

From this standpoint I have caused to be prepared, within the framework of this bill, certain amendments which will eliminate its most dangerous features while increasing its effectiveness in the promotion of those objects which are vital in the public interest. I submit these amendments as a matter of practical expediency and solely because the stock exchanges of this country—and I am speak-

ing on behalf of substantially all of them—feel that every possible effort should be made to preserve for the benefit of investors and the public our organized security markets.

The CHAIRMAN. Mr. Whitney, is this memorandum of proposed amendments to H.R. 8720 in addition to those you proposed here the other day?

Mr. WHITNEY. These amendments contain all amendments as suggested by us to H.R. 8720, and contain the amendments submitted to you the other day as well.

The CHAIRMAN. All right. We are very glad to have them.

Mr. WHITNEY. Now, Mr. Chairman, it is our desire to go over these amendments with you in detail. There are certain points with respect to various sections that in our opinion would be defective in their operation if allowed to exist as now in bill H.R. 8720. Therefore we should like to go over these with you in detail, either now in public hearing or later, after you have had an opportunity to discuss them among yourselves; as I say, either in public hearing or in executive session as you may desire. But we do wish to have the opportunity to go over them with you, and particularly do I wish Mr. Redmond to sit with us and take up, section by section, the legal, technical, and defective parts of the present bill; and to explain also, Mr. Chairman, the reasons for our proposed amendments.

The CHAIRMAN. If it is agreeable to the committee I think we might proceed to hear you just as we are sitting here now. I think, perhaps, we would make better progress in that way.

Mr. WHITNEY. All right, Mr. Chairman, just as you may wish.

The CHAIRMAN. These amendments cover pretty nearly all portions of the bill, do they not?

Mr. WHITNEY. Very nearly so; yes.

The CHAIRMAN. I think you may proceed.

Mr. WHITNEY Then may I ask that Mr. Redmond be permitted to come up to the committee table?

The CHAIRMAN. Certainly.

Senator CAREY. I will move over so you may sit next to Mr. Whitney, Mr. Redmond.

Mr. REDMOND. I thank you.

Mr. WHITNEY. I think if Mr. Redmond will go along with the various sections in our proposed amendments we will make better progress, and I will interpolate occasionally if I may.

The CHAIRMAN. Very well.

STATEMENT OF ROLAND L. REDMOND, ATTORNEY FOR THE NEW YORK STOCK EXCHANGE

The CHAIRMAN. Mr. Redmond, I see in your memorandum that you propose no change to sections 1 and 2 of the bill.

Mr. REDMOND. No, Mr. Chairman, we are offering no amendments to sections 1 and 2 of H.R. 8720.

The CHAIRMAN. Then you may go to the next section.

Mr REDMOND. As to section 3 of the bill, subsection (6) paragraph (a)——

The CHAIRMAN. On what page of the bill does that appear?

Mr. REDMOND. That appears on page 6 of H.R. 8720.

The CHAIRMAN. I think we might mark the bill as we go along. Sections 1 and 2 are agreed to, subject to any change heretofore agreed to be made or which may hereafter be thought desirable.

Senator COUZENS. Mr. Redmond, may we understand that when you make no comment on other sections of H.R. 8720 that you approve of them?

Mr. REDMOND. Or that such section then falls entirely without the scope of our criticism.

Senator COUZENS. All right.

Mr. REDMOND. We propose an amendment of the definition of the term "bank" so as to clearly cover private banks, of which there are a good many in New York, Massachusetts, Pennsylvania, and the Western States, which are not necessarily in corporate form, although they are banks subject to State supervision. They are likewise banks which are subject to Federal supervision but which are not members of the Federal Reserve System, and which were not heretofore covered. So we have inserted as paragraph (b) a provision reading:

A person engaged in the business of banking pursuant to the laws of any State, who is subject to examination or regulation by Federal or State banking authorities

We have likewise included as paragraph (c):

A banking institution organized under the laws of a foreign country, or any agency or branch thereof, authorized to engage in business in a State and which his subject to the supervision of State banking authorities.

That refers to foreign banks, many of which have been established in this country and are operating here subject to State supervision. That is particularly true of many Canadian banks that have branches not only in New York but also along the Canadian border.

We have stricken out old paragraph (b):

A member bank of the Federal Reserve System

Inasmuch as it was clearly redundant, all members of the Federal Reserve System being either banking institutions organized under the laws of the United States or banking institutions organized under State laws.

Senator ADAMS. Then your proposed amendment would be in addition to and not in any way a subtraction from that section of the bill?

Mr. REDMOND. It is an addition, so as to take care of unincorported State banks and branches of foreign banks

The CHAIRMAN. All right. You may proceed.

Mr. REDMOND. Next, on page 8 of the bill, subsection (12) of section 3——

Senator MCADOO (interposing). Mr. Chairman, may I ask if it is your purpose to pass on these suggestions as we hear them made to us here?

Senator BARKLEY. I don't think we should do that.

The CHAIRMAN. No; I think we better hear the explanation offered, and then consider the matter later.

Mr. WHITNEY. May I interpolate that we would, quite naturally, like to have the members of the committee ask any questions as these proposed amendments are presented?

The CHAIRMAN. Oh, certainly. That will be quite in order if any member of the committee desires to ask any questions.

Mr. REDMOND. We here suggest an addition to the definition of the term "equity security."

Senator BARKLEY. On what page of the bill do we find this?

Mr. REDMOND. On page 8 of the committee print.

Senator BARKLEY. All right.

Mr. REDMOND. By inserting in line 9 after the words "similar security" the following:

Other than a preferred or guaranteed stock which is entitled to receive only a fixed or limited dividend

In other words, this definition of equity securities is intended to cover those stocks which may be rather free from speculation. In other words, we have a great many preferred stocks and some guaranteed stocks which are not only nonspeculative but actually are less speculative than bonds. There seems to be no good reason why such preferred and guaranteed stocks should not be exempted from the term "equity security."

Senator CAREY. That is to go in where in the bill?

Mr. REDMOND. Line 9 after the words "similar security." I have read what we suggest be inserted.

Senator CAREY. I should like to get that clear in my mind.

Mr. REDMOND. The memorandum furnished to you, Senator Carey, shows our proposed amendment of the entire section. But the only change we have made is the insertion of preferred and guaranteed stocks, among the classes of stocks which are not to be considered as equity securities.

Senator MCADOO. In other words, this is a substitute which you offer for subsection (12) of the bill, but it is in fact merely an amendment of the section?

Mr. REDMOND. Yes.

Senator MCADOO. And you have rephrased the entire subsection (12) in order to cover your proposed amendment?

Mr. REDMOND. Yes.

Senator BARKLEY. That would, of course, include the exempting of many preferred stocks which draw specified dividends, we will say 6 percent or less. That would not be included within your definition, as I take it.

Mr. REDMOND. Precisely. As long as the right to a dividend is fixed and limited we can see no difference between a preferred or guaranteed stock with a fixed and limited dividend and the obligation or a bond which may bear a fixed rate of interest.

Senator BARKLEY. But there is more speculation, or perhaps I should say a greater number of transactions in guaranteed and preferred stocks, or certainly in the case of one with no fixed rate of dividend, than there would be in the case of a bond.

Mr. REDMOND. I think on the contrary, Senator Barkley, it is the other way round. But Mr. Whitney can answer that as a practical question.

Mr. WHITNEY. Certainly not on the stock exchange, Senator Barkley.

Senator BARKLEY. I notice on lists of stock-exchange transactions as carried by the daily papers certain preferred stocks that are

bought and sold on the New York Stock Exchange, some of which have fixed dividends and some do not; and some have fixed dividends that have not been paid but they are nevertheless cumulative.

Mr. WHITNEY. That is true.

Senator BARKLEY. And frequently one reads of action taken by boards of directors ordering payment of 2 or 3 years' of accumulated dividends on preferred stocks, all of which has to come before the common stockholders get anything.

Mr. REDMOND. That is true.

Senator BARKLEY. Why should they be exempted from this definition, then.

Mr. REDMOND. Because they fall into the same category as bonds. There are many bonds that are in default in payment of interest but which have accumulated interest to become payable.

Senator MCADOO. Like income bonds, for instance?

Mr. REDMOND. Exactly.

Senator BARKLEY. They are only technically in the same category. There are many preferred stocks of that sort where the company has no bonds outstanding. They are a part of the original capital set up. But bonds are obligations or notes, that have been issued from time to time after the business has been started. The capital stock, either preferred or common, has already been sold and distributed. I do not see exactly an analogy between a preferred stock that has a fixed income and a bond in the form of a note bearing a certain rate of interest payable over a period of years.

Mr. REDMOND. It depends upon the type of stock or bonds, Senator Barkley. But if it is felt proper to exempt all bonds from this definition of "equity security" then logically preferred stocks, and more particularly guaranteed stocks bearing a fixed dividend, should be exempted.

Senator ADAMS. Your preferred stock in that case doesn't have the speculative range, so that speculation does not run wild in such a case, is that it?

Mr. REDMOND. They are not subject to anything like the speculation in common stocks. And in many instances I think bonds are more speculative than preferred stocks, particularly bonds of a company in the hands of a receiver, for they then often have very large fluctuations.

Senator MCADOO. I take it that you have in mind particularly those guaranteed stocks, preferred or common, of railroad corporations, let us say, that are guaranteed under the lease of one railroad by another. I am now just thinking of one type of corporation in order to illustrate the point.

Mr. REDMOND. I see, and——

Senator MCADOO (continuing). Which are generally dealt in in over-the-counter transactions and which are not very frequent. They are looked upon as prime investments.

Mr. REDMOND. They are.

Senator MCADOO. In fact, they are better investments than many bonds sold on the exchanges.

Mr. REDMOND. I agree entirely with that.

Senator MCADOO. And with respect to such securities I think it is clear an exemption should be made if you are going to exempt bonds.

Senator BARKLEY. Well, I merely wanted to inquire about it so as to understand what is proposed.

Mr. WHITNEY. And, you will remember, they are not capable of receiving any more than the fixed dividend, whereas an equity stock is capable of receiving anything over and above the fixed charges.

Senator BARKLEY. After the preferred stock has got its portion.

Mr. WHITNEY. Or the bonds; any fixed charges.

Senator WALCOTT. Would it include prior preference stock?

Mr. REDMOND. Only if it carried a fixed and limited dividend. We have not sought to include any preferred stock that is entitled to participate.

Senator WALCOTT. I think you make that clear in this provision here, that it must be a fixed and limited dividend.

Mr. REDMOND. All right, if that is now clearly understood?

The CHAIRMAN. The language now is quite broad, it seems to me. It means any stock or similar security or any security convertible, with or without consideration, into such a security, and so forth.

Mr. REDMOND. That is very broad, Mr. Chairman, in defining the term "equity security." That is really the difficulty with the definition, because it takes in these guaranteed stocks, which, as Senator McAdoo has well said, sometimes are very much better than bonds. It takes that class of stocks and throws them into the same category, as though they were a speculative security.

The CHAIRMAN. Very well. We will consider that suggestion.

Senator MCADOO. As I recall it I think the Pittsburgh, Chartiers & Youghiogheny Railroad, or some name of that sort——

Mr. REDMOND (interposing). The Pittsburgh, Fort Wayne & Chicago is the great one.

Senator MCADOO. Those are guaranteed stocks under leases by the Pennsylvania Railroad, and with strictly limited dividends. They are looked upon with greater favor by investors than the bonds of many railroads.

Mr. REDMOND. That particular company owns the main line of the Pennsylvania Railroad from Pittsburgh into Chicago, and has no bonds ahead of it, and the stock is guaranteed under lease by the Pennsylvania Railroad. It is a little better than practically all of the Pennsylvania Railroad Co.'s own bonds, and yet because technically a stock it would have been treated as an equity security not available for loans by banks under this bill, except on very heavy margin restrictions.

The CHAIRMAN. Very well. We will consider that suggestion.

Mr. REDMOND. We will now take up subsection (13) which deals with the definition of "exempted security", and we have included in that a provision exempting obligations of States and all political subdivisions of States or any agency or instrumentality of a State or any political subdivision thereof, as follows:

(13) The term "exempted security" or "exempted securities" shall include securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, such securities issued or guaranteed by corporations in which the United States has a direct or indirect interest as shall be designated for exemption by the Secretary of the Treasury, securities which are direct obligations of or obligations guaranteed as to principal or interest by a State or any political subdivision thereof or any agency or instrumentality of a State or any political subdivision thereof, and such other

securities and instruments as the Commission may by such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors, either unconditionally or upon specified terms and conditions or for stated periods exempt from the operation of any one or more of the provisions of this act, which by their terms are inapplicable to an "exempted security" or to "exempted securities".

That we put in simply because of the expressed sentiment of the committee the other day that State and municipal obligations ought to be treated as exempted securities. We express no personal opinion on the merits of that idea.

The CHAIRMAN. Your amendment would include State and municipal bonds, or bonds of subdivisions of cities.

Mr. REDMOND. Precisely.

Senator WALCOTT. You do not use in your suggested amendment the word "municipal." You say "subdivisions thereof." Do you think that is inclusive enough?

Mr. REDMOND. We thought it would include them.

Senator MCADOO. All municipal or political subdivisions thereof would cover it.

Mr. WHITNEY. That is the accepted phraseology.

Senator WALCOTT. Well, a city or a county is certainly a political subdivision of a State.

Mr. WHITNEY. Yes; and so as to a school district.

Senator ADAMS. And you follow the language: "State or any political subdivision thereof", with this language: "or any agency or instrumentality of a State or any political subdivision thereof."

Senator WALCOTT. I think that is satisfactory.

Senator MCADOO. I do not see any objection to putting the word "municipal" in there. It might be considered more satisfactory if you say "any municipality or other political subdivision thereof."

Senator BARKLEY. Of course there is no city now in existence except as the result of the passage of a law of the State authorizing it to become such subdivision.

Mr. WHITNEY. Yes. There are also included in that category, for instance, school districts, or lighting districts, or water districts, which are political subdivisions as we understand the accepted phrase.

Senator WALCOTT. Well, they would be a subdivision of a city in some cases. The question is whether we should use the word "municipal."

Mr. WHITNEY. It might possibly be a borough, too. It might be almost any other subdivision.

Senator WALCOTT. That is true.

The CHAIRMAN. Very well, Mr. Redmond, you may resume your explanation.

Mr. REDMOND. We propose to omit subsection (c) of section 3 in toto, which appears on page 10 of the print. That purports to give the Commission the power to define accounting, technical, and trade terms used in the act. And it says that such definitions shall have the force of law. Under amendments we suggest later on there would be no necessity for any such defining of technical terms.

Senator MCADOO. Well, now, do you say that is covered by what you have to offer later on by way of suggestions?

Mr. REDMOND. Yes.

Senator McAdoo. I should like to make a note of that here on my copy of the bill.

Mr. Redmond. That will be shown when we come to sections 10 and 11——

Senator McAdoo (interposing). One minute. Do you say sections 10 and 11?

Mr. Redmond. Or I mean sections 11 and 12 of the committee print. They are sections 10 and 11 of our suggestions.

Senator McAdoo. All right. I will make a notation of that on my copy of the bill here.

Mr. Redmond. As to section 4 of the bill we suggest no change.

As to section 5 of the bill we have redrafted it in toto so as to simplify it. That section purports to require national securities exchanges to file a registration statement with the Commission and allows the Commission, after examining the conditions of the exchange, to either grant registration or not grant registration. It seemed to us to be an unduly complicated section, and we have redrafted it purely with the idea of simplification and the carrying out of the fundamental idea that there should be an application by the exchange with right of examination by the Commission, and then for a granting or refusal of registration.

Mr. Pecora. There is no change in the substance?

Mr. Redmond. There is a change in substance as to some of these provisions. For instance, subdivision (1), on page 11 of the bill, requires an exchange to file an undertaking to comply and to enforce. If by that language it was intended that a penal bond should be required of exchanges, why, then we feel it is an entirely unfair provision. On the other hand, exchanges would be bound to comply with and to enforce the rules and regulations of the Commission without any such provision. Our proposal is:

Sec 5. (a) Any exchange may be registered as a national securities exchange by filing with the Commission an application in such form as the Commission may prescribe, containing all relevant information in regard to the history, organization, membership, and the rules and regulations of such exchange and a list of the securities in which dealings are permitted on such exchange

(b) Unless such application shall be withdrawn by such exchange, the Commission shall within thirty days after the filing thereof or within such further period as may be agreed upon, either register such exchange as a national securities exchange hereunder if the Commission shall be satisfied that the rules and regulations of such exchange are adequate to insure fair dealing and to protect investors, or enter an order, after appropriate notice and opportunity for hearing, denying such registration and stating the reasons therefor. Any order denying such registration may be reviewed as hereinafter provided in section 22 hereof

(c) Any national securities exchange may by appropriate notice to the Commission withdraw its registration

The Chairman. Your proposed amendment is set out in section 5 (a)?

Mr. Redmond. In section 5 in the paper which we have submitted to the committee.

The Chairman. All right. We will consider it. You may proceed.

Mr. Redmond. Section 6, dealing with margins, we make the same suggestion we made the other day, and that is, that unlimited power

be given to the Federal Reserve Board to determine the margin requirements and to change them at will.

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

If such broad power is not acceptable to the committee, I should like to take a minute or two to point out the holes or errors in the presnt draft of the committee bill, because there are some very fundamental difficulties with the draft of section 6 as it exists today. I do not know whether the committee would want me to go into that now or to continue going through with our suggested amendments.

The CHAIRMAN. I think you might go on through with them.

Mr. REDMOND. Very well. I will go right through with them, then.

Senator BARKLEY This section 6 as you have it written here, comprising only 6 or 8 lines of typewriting, is to take the place of all the subdivisions of section 6 of the bill?

Mr. REDMOND. Precisely.

Senator MCADOO. Then you cut out several pages of the bill.

Mr. REDMOND. Yes, sir. We jump from there over to page 19 of the committee print.

Mr. WHITNEY. It would leave the entire control of the matter to the Federal Reserve Board.

Senator MCADOO. You want to reduce the range of senatorial oratory, do you?

Mr. REDMOND. I am afraid that was not our desire. We wanted to see flexibility in the control of these margin and credit conditions.

The CHAIRMAN. How do you leave it now? Do you leave the whole subject of margins and credit control to the Federal Reserve Board?

Mr. REDMOND. Precisely.

The CHAIRMAN. Without any limitations at all?

Mr. REDMOND. Without any limitations at all.

Mr. WHITNEY. Except as they may put them in force.

Mr. PECORA. There is no limitation on the exercise of their discretion; is that it?

Mr. REDMOND. Exactly, Mr. Pecora. And if at this point——

Senator BARKLEY (interposing). In view of the fact that this bill puts the enforcement of this act in the hands of the Federal Trade Commission, why do you divide the authority by turning over to the Federal Reserve Board the question of margins?

Mr. REDMOND Well, margins, you see, affect the credit control rather than the control of exchanges or practices on exchanges. And it seemed to us that the Federal Reserve Board, which today under the law is charged with the control of the credit of the country, ought to exercise this control if any administrative body is going to do so.

Senator MCADOO. Well, you did not draw the bill as it appears now to leave that matter to the Federal Reserve Board, did you?

Mr. REDMOND. We have had no handing in the drafting of the present print.

Mr. PECORA. Mr. Redmond, in your proposed revision of section 6 of the bill you did not give any consideration at all to existing margin accounts, did you?

Mr. REDMOND. No. We felt that——

Mr. PECORA (continuing). And the preservation of your present status.

Mr. REDMOND. We felt that the Federal Reserve Board would give due consideration to existing accounts when it came to framing its rules and regulations.

Mr. PECORA. Don't you think that ought to be specifically set forth in the statute?

Mr. REDMOND. I do not think you could do it.

Mr. PECORA. I mean that some declaration ought to be made in the statute concerning present margin accounts.

Mr. REDMOND. A declaration might be made, but there is no provision I know of that you could draft that would actually preserve existing margin accounts, or loans held by banks against security collateral.

Mr. PECORA. How about the provision as now written into section 6, subsection (f)?

Mr. REDMOND. Well, quite frankly, they just won't operate in that way. In the first place, take your, roughly speaking, $1,400,000,000 of customers' debit balances which are carried today by brokers who are members of the New York Stock Exchange. Those brokers in turn are borrowing from banks, and 80 or 90 percent of such balances are made on demand rather than on time loans. Now, a bank, when it needs to bring up its reserves, the first thing it does is to call some of those demand loans. Upon the calling of such a loan the broker has got to pay off that loan, and while he can nearly always immediately secure credit from another bank, if that change in the loan would mean a new loan it would have to be brought up to the new margin requirements, as between the bank and the broker. Therefore, the broker in turn would have to call upon his customers to put up additional margins, so that those customers would not get the benefit of the theoretical 5-year extension.

Senator MCADOO. I think it is clear that to put this power in the Federal Reserve Board is much the better disposition of it. It gives the necessary flexibility, and, besides, here is the governmental agency dealing with credit and thoroughly competent to handle the matter and to meet all the mutations and intricacies that undoubtedly will surround the general transitions that this bill will necessitate.

Mr. REDMOND. And, Senator McAdoo, I might say in that regard we are very conscious of the fact that a rule which might be applicable to certain financial centers would certainly not be applicable to other financial centers; and this rule which purports to give a 5-year extension is overgenerous possibly in the case of conditions that might exist, let us say, in New York, but not overgenerous to conditions that might exist in the smaller financial centers throughout the country. We believe that flexibility as between centers is another thing that you gain by giving the power to the Federal Reserve Board.

Mr. PECORA. This section 6 is one of the fundamental provisions of the entire bill.

Mr. REDMOND. Yes; and——

Mr. PECORA (continuing). Because dealing with margin means dealing directly with the question of limitation of speculation.

Mr. REDMOND Yes; and——

Mr. PECORA (continuing). Have you considered, in drafting your proposed revision of section 6 of the bill, the question of whether or not the Congress might not, in this very broad function that you propose, be giving to the Federal Reserve Board a power that might be regarded as power to legislate?

Mr. REDMOND. Well, I do not think it is any broader than the power vested today in the Federal Reserve Board.

Mr. PECORA. But did you consider that question at all?

Mr. REDMOND. Yes; and you will notice that there is stated an indication of the legislative intent. I think you will see it if you will read the section as we have drafted it. There is stated the congressional purpose in granting the power to regulate the Federal Reserve Board.

Senator MCADOO. I presume, Mr. Redmond, that you have noticed in the bill there is given the affirmative power to the Federal Reserve Board to make such regulations?

Mr. REDMOND. There is such a provision, but I have forgotten the exact section. I think it is in section 23 or 24 of the bill.

Mr. PECORA. Do you think that section 6 as you have drafted it will meet the constitutionality question?

Mr. REDMOND. Well, it will do it as well as section 6 as it exists today.

Senator COSTIGAN. Speaking as a member of the bar, do you regard that as giving undue power under the Constitution?

Mr. REDMOND. I do not; or certainly any more so than you have it there.

Mr. WHITNEY. Mr. Chairman, for fear of repetition, with regard to subsection (f) of the present bill, under section 6, that says that those various types of loans, renewals, or extensions thereof, may be so treated, but it cannot, or does not, at least, enforce or make mandatory that they shall be so treated. That power rests entirely with banks that have made the loans, and with brokers who have made loans to their customers. The law does not pretend to say, nor does it say, that banks or brokers must so treat those loans. It merely says they may. As we know the practice is, and it should be the practice, that banks must protect the money of their depositors in a way that they believe is safe. So, unless they so believe, or unless the brokers so believe, in regard to the credit they are extending, then this subsection (f) will mean nothing, because it is permissive.

Mr. PECORA. Mr. Whitney, are you quite sure of that? The language of subsection (f) of section 6 specifically is:

> The provisions of this section shall not apply on or before January 31, 1939

That is mandatory.

Mr. WHITNEY. I am just as clear as I can be, Mr. Pecora, that it is mandatory by means of the use of the word, but that it is only

permissive in relation to the actual fact as it may exist in the case of a particular loan, extension of it, or renewal. And it is entirely up to the bank and to the broker as to whether they will follow what is allowed under this particular clause.

Mr. PECORA. I doubt if any court would interpret this provision that it shall not apply to a permissive loan.

Mr. WHITNEY. Supposing I am the customer, do you believe I could get recourse from a court by way of insisting on a bank carrying my particular account?

Mr. PECORA. That is a matter of private agreement between broker and customer.

Mr. WHITNEY. I do not believe it is a matter of private agreement. I think it is at the discretion of the broker and of the bank, only at their discretion.

Mr. PECORA. That is a matter of agreement between them. But this provision as now worded would continue in force the present margin accounts up until the 31st of January 1939, if the interested parties were willing to have it so continue.

Mr. WHITNEY. That is true, but, as I say, the banks and brokers are those who have control, and they would not so continue them if they thought it detrimental to their interests.

Mr. PECORA. That would be simply a case of the wishes of the parties interested but not because of the language of the act.

Mr. WHITNEY. I understand.

Senator BARKLEY. Regardless of subsection (f) and regardless of any other provision of this bill, any broker or any bank can refuse arbitrarily to extend any credit to anybody if they do not want to extend it.

Mr. WHITNEY. Exactly so, or to continue extending an existing credit.

Senator GORE. Is it your point that you cannot freeze these existing loans and put them on cold storage for 5 years?

Mr. WHITNEY. That cannot be done because that is at the discretion of the banks only as I see it.

Senator BARKLEY. You make it unlawful for a broker or a dealer to extend credit in violation of any rules made by the Federal Reserve Board, for instance, and how do you propose to enforce it? Suppose somebody does that, how will you handle it?

Mr. REDMOND. Well, a rule or regulation can be evaded, but——

Senator BARKLEY (continuing). Is there any penalty provided in this provision?

Mr. REDMOND. We have not attached a criminal penalty to that provision, but we feel if a member of an exchange violated such a rule under the set-up as we have it the Commission could require the expulsion or the disciplining of that member, and your effective control would be through the exchanges.

I might say in that connection that this section as drafted, particularly where it fixes the maintenance of ratios for loans, attaches to a violation of them a criminal penalty that runs, to force any person to comply. And there is no leeway granted. If a loan once got below the required ratio it is an extremely complicated thing to figure; in any event the broker would be liable to go to jail. The result of that is going to be the liquidation of a great many customers'

accounts long before you reach the lower ratios referred to in the act.

Senator BARKLEY. In other words, the broker would rather stay out of jail than to keep his customer out of bankruptcy?

Mr. REDMOND. I think he would. If the committee wishes, as I say, I will discuss the technical problems involved, with the committee's draft, of which there are many, and the effect of some of them is quite surprising and quite contrary, I think, to what was intended.

Senator WALCOTT. I think it would be useful to the committee if you did give us briefly your objections to this paragraph.

Mr. REDMOND. Well, in subsection (a) there is a prohibition against advancing any credit without collateral——

Senator GORE (interposing). What section is that?

Mr. REDMOND. Section 6, subsection (a).

Senator GORE. All right.

Mr. REDMOND. Now, almost——

Senator MCADOO (interposing). What page and what line?

Mr. REDMOND. Page 13. Almost every transaction may involve the use of credit temporarily, even a cash transaction, because the broker is, we will say, directed to buy 100 shares of stock for cash. He has a customer who he knows is sending him a check, but that check may not arrive in time so as to be banked and collected before the broker in turn—and that is the practice on the exchange—has got to take up and pay for the stock he has been directed to purchase. Therefore, in that interval of time, which is very common, in a cash purchase there is a technical advancing of credit without collateral. You have it in what are known as "delayed deliveries", where by reason of the fact that a man cannot physically deliver the securities at 2:15 p.m. on the date of delivery it goes over for 24 or 48 hours. And you have it almost always in out-of-town transactions where the securities being sold are in transit to New York, or where checks drawn on out-of-town banks cannot be collected until the lapse of 2 or 3 days. So that with that clause as it now stands almost every cash transaction would be stopped, and your out-of-town transactions would be greatly lowered. It certainly needs some clarification.

On page 14 of the bill, the clauses dealing with extension of credit initially, it is provided that you shall not extend credit unless a certain ratio is maintained. Now, in the case of any brokerage account at the end of each month interest is charged and added to the existing debit balance. Are these interest charges a further extension of credit within the meaning of the act? If so a purchase of securities strictly in accordance with the provisions of this act would immediately become open to question at the end of one or more months as interest charges accrue.

Next, subsection (2) deals with the lowest price at which a security is sold during a period of 36 months. But there is no definition as to what constitutes lowest price. Even in case of well-known securities dealt in on the New York Stock Exchange, they are also dealt in on other exchanges, and sometimes the lowest price may be on an exchange in California, or on an exchange in Cleveland, rather than on the New York Stock Exchange. If it goes further than that and lowest price means actually the lowest price that has been paid, you

might have to have recourse to transactions over the counter, emergency transactions, and cash transactions, which normally sell at a lower differential than regular transactions. But there is no definition as to what constitutes lowest price, which would mean, if this is to be the formula, that it becomes one of the critical facts in determining exension of credit.

Senator GORE. Well, would you fix it so that the lowest price on the New York Stock Exchange would be the standard?

Mr. REDMOND. Quite frankly, Senator Gore, I think the whole idea of tying things into the lowest price is so fundamentally unsound that I haven't attempted to draft even in my own mind a definition of what would be lowest price.

Senator GORE. Well, any definition would be better than none if you are going to have it in there.

Mr. REDMOND. I think it should be defined if it is going to stay in the bill.

Senator COUZENS. In other words, you feel that the Federal Reserve Board could draft this better than the Congress can?

Mr. REDMOND. I think they could make and apply rules and regulations in a particular situation in order to meet the need for flexibility.

Senator COUZENS. In other words, you would have a regulation promulgated by the Federal Reserve Board that would be different in one State from that in another State.

Mr. REDMOND. Very probably so.

Senator MCADOO. Where conditions might justify it.

Mr. REDMOND. That condition exists today. Many banks in smaller communities carry securities on quite different ratios as to collateral than is the case in the more active centers.

Senator MCADOO. I think often, or as a rule, it is much better not to provide in a statute an inflexible provision of this character, which may be most difficult of administration anyway because of the difficulties involved, but to leave it to a public body, like the Federal Reserve Board, to from time regulate it and to prescribe rules and regulations under which these transactions may be conducted.

Senator COUZENS. Senator McAdoo, the only difference between you and me is that I want Congress to set a limitation or give the scope within which they can operate rather than to leave all of that to a commission.

Senator MCADOO. I am speaking of the details of these loans. That is all.

Mr. REDMOND. In connection with this provision dealing with lowest price, I assume that the intention was to prevent appreciating securities having as large a value for credit purposes as stable securities.

Senator GORE. Will you state that again?

Mr. REDMOND. I assume the intention was to give securities which were appreciating a lower value for credit purposes than would be given to stable securities. But this provision would not necessarily operate in that way. For instance, suppose a stock which had been appreciating steadily and had got down to where the 40 percent was applicable, that stock could immediately be thrown into the

75-percent class by the declaration of a stock dividend, because the stock dividend would mean that the stock would sell then at a less price, within 36 months, and the 75-percent clause would apply.

Senator GORE. That is on this 3-year business?

Mr. REDMOND. That is on this 3-year business, Senator Gore.

Senator GORE. Is there not a provision in here which says 3 years, and then it says it does not mean that? It seemed to me like a contradiction in terms.

Mr. REDMOND. There is such a provision, Senator, and I assume that it was inserted because it was realized that a 3-year period would carry back to the low prices of 1932.

Senator GORE. That is why I wondered why they did not fix July of last year as the datum line or date from which to figure and let it go at that.

Mr. REDMOND. The second paragraph on page 14 allows transfers of accounts between brokers. It does not, apparently, allow transfers of accounts between brokers and banks, or vice versa. If such transfers are permissible as between brokers, it would seem natural to allow them also between banks and brokers or brokers and banks.

The same general comment could be made in regard to subsection (c) on page 15 that I have made in regard to subsection (b), because that again involves the use of arbitrary ratios tied down to the lowest price arrived at within 3 years.

Page 16, subsection 2: There is a provision there which says that no credit initially extended shall be increased by reason of any payment to or withdrawal by the borrower. The obvious purpose of that section was to prevent credit that was initially extended being immediately brought down to the more easy ratios which are allowed for maintenance. But that section will not prevent that practice. For instance, if I directed my broker to buy 100 shares of stock subject to the 40-percent ratio, the most that he could advance me would be $4,000. I may the next day, however, go to him and say, "Give me 25 shares out of my 100 shares." There would still be the advance of $4,000; he would not increase the credit extended to me, and yet the remaining 75 shares would comply with the maintenance ratio of 60 percent.

So the clause is obviously defective, if it is intended to prevent a customer making use of the more lenient maintenance ratios instead of the initial ratios. Quite frankly we want to call the attention of this committee to every error. We do not want to see a bill with "jokers" in it any more than anybody else.

Senator MCADOO. With reference to these margin requirements, assuming that the bill should be reported with specific provisions of this kind, I have a letter this morning from a gentleman whom I have known for many years and who is quite familiar with stock-exchange practices in New York, and his suggestion strikes me as having some merit. Since we are going into these details, I would like to ask a question after reading the letter, which is very brief. He says:

> Would it not be worth consideration to place a margin on a sliding scale governed by the total amount of secured loans outstanding? As you know, loans today are approximately $700,000,000, the highest being some $8,000,000,000 in the year 1929.

He says, further:

Today and ever since I have been in the street, the percentage of margin has been operating by the relation of the equity to the debit balance on loans For instances, securities cost $15,000. The amount furnished by the customer is, say $5,000. The loan is $10 000 An equity of $5,000 divided by the loan, $10,000 equals a 50 percent margin.

He says, further:

With our loans at $700,000,000, would it not be reasonable and practical to hold the present requirement of the New York Stock Exchange at the minimum when the total loans reach $900,000,000, to raise the requirement by 5 percent, and so on in steps of $200,000,000, or something on that order? I feel sure that if a formula of this character had been exercised in the years 1926 to 1929 much of the present suffering would have been avoided.

I submit that thought, not as a suggestion of mine, but as having been presented to me, and I was wondering what your view of that would be.

Mr. REDMOND. I think, Senator, our view would simply be this, that there are many banks that go into the determination of what is a proper margin, and a pure percentage of market value is not really sufficient. Let me cite an instance of what I have in mind. There are periods in which certain types of securities are apt to appreciate more rapidly than at others. Quite recently you had a very large speculation in brewery stocks because beer was legal before wines and other alcoholic liquors. Obviously, those securities for margin purposes ought to have been put into a quite separate category. Normally, banks handle that by writing down the market values of what they call volatile or quickly appreciating securities and maintain the same percentage ratio on all other securities.

Furthermore, margain accounts contain in large part sometimes bonds as well as stocks, and it is obvious that if you want to stimulate the purchase of bonds it is better to allow them to go into margin accounts at a lower margin ratio than you would apply to equity stocks. There are dozens of factors of that kind which really ought to be given consideration, and we have no doubt that the Federal Reserve Board will give consideration to all those factors and will make use of its power to prevent any excessive use of credit.

The CHAIRMAN. The point is that in case these brokers' loans increase whether you could not then increase the margins.

Senator MCADOO. It is a general formula for increasing margin requirements that is proposed. Under your suggestion of permitting the Federal Reserve Board to deal with this by rules and regulations to be prescribed by it, violations of which would be penalized under the law, the Federal Reserve Board could consider such a formula as this?

Mr. REDMOND. Or any other such formula which seemed to be in the public interest.

Senator BARKLEY. Would it be effective with reference to loans by others than banks?

Mr. REDMOND. That question is covered, Senator Barkley, in the next section; but it would, of course, to a certain degree have an effect, because loans for the account of others normally are not made through banks that are subject to be controlled by the Federal Re-

serve System or through brokers who would become subject to the rules of the Federal Reserve Board under this proposed bill.

Mr. WHITNEY. Both of them are now prohibited.

Senator GORE. By your amendment is it contemplated that the rules and regulations be approved by the Board or that the Federal Reserve Board shall take the initiative and prescribe rules and regulations?

Mr. REDMOND. It would allow the Federal Reserve Board to take action whenever it saw fit.

Senator ADAMS. I think section 6 ought to be mandatory on the Federal Reserve Board, that it shall adopt rules rather than that it may adopt rules.

Mr. REDMOND. We made it as broad as possible, because at present the amount of credit employed in speculation, i.e., brokers' loans, is less than 2 percent of the value of listed securities. It is at least an open question as to whether that is an excessive use of credit. If it is not, the Federal Reserve Board might well feel that it could allow the existing condition to go along, and after that, if it felt it was excessive, it would have the power to act.

Senator ADAMS. But it seems to me that it should be directed to provide rules which they could change from time to time, under your draft, rather than to make it merely permissive.

Mr. REDMOND. We would personally, I think, have no objection to that.

Senator GORE. But under your plan the exchange can initiate rules and submit them to the Board, and the Board can approve or reject them or revise them? Is not that the point?

Mr. REDMOND. Yes; absolutely.

Senator BARKLEY. Under that language, of course, the board could go along and the stock exchange could go along for 5 or 10 years without any regulation at all, and then, if the conditions seemed to justify it, in the opinion of the Federal Reserve Board, it could initiate some margin requirements. But do you think, in view of the fact that margin requirements have had a part in creating the situation which calls for any legislation at all, it would be wise to drift along for years without any rules at all if the Federal Reserve Board saw fit not to make them?

Senator MCADOO. I understood, from the question I asked you some time back when you read this substitute of yours, that there was a mandatory provision that the Federal Reserve Board shall provide rules and regulations?

Mr. REDMOND. It is a grant of power to it.

Answering your question, Senator Barkley, I would hope that the Federal Reserve Board would not immediately have to adopt any rules, but that by going to the exchanges and saying, "It is our idea that your margins ought to be raised", the exchanges would voluntarily raise the margins at the request of the Federal Reserve Board, thereby avoiding the necessity of the Federal Reserve Board's issuing a rule or regulation. But they have the power to do so if they feel it is necessary.

Senator BARKLEY. But I understand you to say a moment ago that you were quite willing to have a mandatory provision and I can see no objection to that.

Mr. REDMOND. We have no objection to that whatsoever.

Senator BARKLEY. That they must prescribe rules and regulations?

Mr. REDMOND Yes.

Senator GLASS. How many members of the Federal Reserve Board would have any information whatever about stock-market transactions?

Mr. REDMOND. That is rather a difficult question for me to answer, Senator; but having read this bill which the Federal Reserve Board has approved, my guess would be that very few of them know anything about stock-market transactions.

Senator MCADOO. We have got to educate them at some time, have we not?

Senator GLASS. Why would it be desirable to mix the Federal Reserve Board and the Federal Reserve System up in this matter, anyhow? When we enacted the Federal Reserve law we took care to exclude the system from stock-market transactions, and although the language is as plain as English could make it, the Federal Reserve Board and the Federal Reserve banks ignored the prohibition and furnished nearly a billion dollars of Federal Reserve facilities to stock-market transactions within a period of 6 months. I do not see why the Federal Reserve Board should be mixed up with it at all; and it is my judgment that there is not a single member of that board of eight members who knows anything on earth about stock-market transactions.

Senator GORE. Do you make any point of that, Senator Glass?

Senator GLASS. Well, I just make that bald statement, that it is my judgment they do not know anything about it, and I do not think they ought to be allowed to know anything about it.

Senator BARKLEY. Senator, the question was raised a while ago based upon the fact that all credit facilities ultimately have to come through the banks, anyway

The CHAIRMAN. The board has control of credit.

Senator GLASS. They ought not to have it. The Board was not set up for that purpose. It was set up to respond to the requirements of credit, not to control credit. It was not set up to control the stock market, and certainly it was not set up to be controlled by the stock market, which it has been for a long time.

Senator TOWNSEND. Do you feel that the Federal Trade Commission should have control?

Senator GLASS. I do not think they know anything more about it than the Federal Reserve Board.

Mr. WHITNEY. We are very glad to leave ourselves in the hands of the Federal Reserve Board. We believe they can acquire that knowledge because of their present connection with credit conditions.

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

Mr. WHITNEY. No, sir; I don't mean that at all. I have never told them anything.

Senator COUZENS. That is the reason that I disagree with Senator McAdoo.

Senator McADOO. I do not know what our disagreement is. I am simply speaking of the placing of a flexible power in the hands of some governmental body instead of leaving it to the stock exchanges themselves.

Senator GLASS. You do not think it was ever intended by the proponents of the Federal Reserve System to have them either control or be controlled by the stock market, do you?

Senator McADOO. No; certainly not. I agree with you It was not intended that the Federal Trade Commission should do it, either, but the draftsmen have incorporated certain powers in the bill for them to exercise.

Senator GORE. I think this matter of who shall initiate the rules and regulations is the fundamental point underlying this and gives rise to the two schools of philosophy in this whole regulation. I want the stock exchange to initiate the rules and regulations, subject to approval, so that if they fail the primary responsibility would be on the stock exchange. I do not want Congress or any agency of Congress to take the initiative in originating these rules and regulations so that the responsibility will be on them. I do not want to get into that position.

Mr. WHITNEY. As the bill is written, the responsibility is clearly on Congress.

Senator GORE. Yes; and if it results in a crash, we get the blame for it.

Senator BARKLEY. Is it because of the fundamental wisdom of it or just from a desire to get out from under?

Senator GORE. Congress passed a law like this once and repealed it in 14 days.

Senator KEAN. Germany and England tried it.

Mr. REDMOND. Subdivision (e) on page 17 is simply a minor matter, Mr. Pecora, but the way it reads at present, the transaction referred to on page 18, that is, a loan made by any person other than in the ordinary course of business, loans on exempted securities, loans to dealers to aid in financing the distribution of securities, and any loan by a banker on security other than an equity security is not subject to any control whatsoever, even by the Federal Reserve Board.

The CHAIRMAN. What page is that?

Mr. REDMOND. Page 18.

Senator GLASS. Loans by a bank may not be subject to control in this bill that we are considering, but they are very decidedly subject to control under the Banking Act of 1933.

Mr. REDMOND. They are, Senator Glass. But loans upon equity securities are likewise subject, even when made by banks, to the provisions of this bill, so that even a bank cannot extend credit against equity securities as defined in the bill except on the same terms that a broker can extend it. It ties the banks and the brokers together in one bundle.

Senator GLASS. I just want to untie them. I do not think they have any business being tied together. We have in the Banking Act of 1933, with regard to bank loans for speculative purposes, given the Federal Reserve Board almost unlimited power. We require the Federal Reserve banks to acquaint themselves in detail with the ac-

tivities of all member banks, National and State, and to report their transactions to the Federal Reserve Board; and the Federal Reserve Board is authorized to put a stop to any and all excessive loans for speculative purposes. We prohibit underwriting; we have separated the affiliates from the national banks, and on 15-day paper we provide the severest sort of penalty for the continuation of loans by banks to brokers for speculative purposes. We authorize the Board to deny them rediscount facilities for as long as 12 months or more. I do not think tha this bill ought to treat of bank loans that would conflict with the provisions of the act of 1933, which were so severe that all of you Wall Street people opposed the bill for 16 months and liked to have worn the life out of us who had it in charge.

Mr. REDMOND. I, for one, was not a party to opposing that bill. We are fully conversant with the very broad powers which the Banking Act of 1933 gives to the Federal Reserve Board. This bill, however, seems to go much further, and as originally drafted purported to place a part of the power to control credit in the hands of the Federal Trade Commission with power to raise or lower margins, the margins so raised or lowered to become applicable to the banking system——

Mr. PECORA. That was all changed in the revised draft.

Mr. REDMOND. The revised draft has substituted the Federal Reserve Board, and that is when it came into this draft and why our suggestion includes the Federal Reserve Board. But it seemed to us to be fundamentally unsound that another administrative department of the Government, other than the Federal Reserve Board, should be given the control of margins which in turn became pledged to banks, because that might bring a conflict of action between two administrative departments in carrying out any control——

Senator GLASS. That is the point I am making. I do not want anything in the bill which we are now considering to conflict with the very severe restrictions provided.

I would like to ask you, Mr. Pecora, if you have acquainted yourself with the provisions of the Banking Act of 1933.

Mr. PECORA. Yes, sir; we have had them in mind, sir.

The CHAIRMAN. It seems to me that it is in accord.

Mr. PECORA. It was a desire to supplement that and coordinate this power with the power of the Federal Reserve Board given to it under the Banking Act of 1933.

Mr. WHITNEY. We have suggested an amendment along the same lines, except simplified, and giving the Federal Reserve Board more discretionary power than is in the bill as now written.

Mr. REDMOND. I think we have discussed section 6.

Section 7, which deals with the restrictions on members borrowing, we believe was intended to supplement the power of the Federal Reserve Board to prevent corporations and others lending money for speculation in the securities market. That is the apparent purpose of subsection (*a*), and indeed we feel that a broad grant of power to the Federal Reserve Board, if it does supplement the powers they already have, cannot be amiss.

The other subsections of section 7—I am referring now to page 20 of the committee print. Subdivision (*b*) purports to require that the capital of a broker shall not be less than 10 times his aggregate

indebtedness to all other persons, including customers' credit balances——

Senator GORE. You mean 10 times or one tenth?

Mr. REDMOND. One tenth; I beg your pardon. Excluding indebtedness on exempted securities. Quite frankly that formula completely disregards the fact of brokerage accounts being affected by open contracts much more than by ordinary assets and liabilities, and as a basis for determining the necessary capital for the brokerage business subsection (*b*) quite frankly has no meaning. Under it a bucket shop could operate perfectly satisfactorily, whereas a brokerage house with ample capital to conduct its business might find itself technically under the restriction of this section.

Finally, let me point out that the exclusion of indebtedness on exempted securities illustrates the absurdity of the provision. Suppose you had a broker whose capital was slightly insufficient to meet the required ratio to his liability. If he could persuade one of his customers to give him $100,000 of Government bonds instead of $100,000 of stock as margin in that customer's account, the broker might then pledge his customer's exempted securities at a bank, get $100,000, pay off $100,000 of the loans that figure in his ratio, and then his capital conceivably would comply with this provision, although obviously that transaction would not have increased or decreased the broker's capital by 1 cent.

Mr. PECORA. What is the rule now on the stock exchange, if it has any, regarding the ratio between indebtedness and capital?

Mr. REDMOND. The existing rule is as follows, that the net working capital, that is, cash working capital, shall be sufficient to margin any securities by 30 percent, any securities that are carried for the account of the firm or for any partner in the firm and, in addition, have enough to margin all of the customers' debit balances, gross, by 5 percent.

That formula in many instances works out to more than one tenth of the liabilities that are referred to in this subsection; but you cannot reduce our rules to a formula because of the determination of what constitutes net working capital that may affect judgment as to the liquidity of the assets of the firm. For instance, if you have a customer's account that may have, let us say, on current market values, 20 percent or 25 percent margin, not up to the required standard, you have got to examine those securities to see whether they are sufficiently active to make sure that the broker would be able to count that debit balance as one of his assets. We very often throw out securities and say we will not treat them as of any value. We place no value on stock exchange memberships or furniture and fixtures or assets of that kind. It is an application, in each case, of judgment rather than of a fixed formula. I might say that we have in the past on different occasions changed our requirements as conditions seemed to warrant.

Senator GORE. Is this the point where that phrase "a thousand percent" occurs?

Mr. REDMOND. Exactly, Senator Gore.

Senator GORE. Would it not be better, as a mere matter of phraseology, to say 10 times instead of a thousand percent?

Mr. REDMOND. I think probably you are right, Senator Gore. I had not thought of that, as a matter of draftsmanship; but I think

probably 10 times would be more easily understood than a thousand percent.

Senator GORE. Some say there is no such thing as a thousand percent. I don't know about that.

Mr. REDMOND. Subsection (c) on page 20. We are doubtful as to the meaning of that. It can be interpreted so as to mean that a broker would have to carry only one loan at each bank and not have any other liabilities at that bank. The clause reads as follows [reading]:

To hypothecate or arrange for the hypothecation of securities carried for customers' accounts except free and clear from the liens of other creditors.

And so forth. A bank, when it has a loan, of course has its general banker's lien on any equity in that loan for any other liability of the maker of the loan. Therefore when a brokerage firm carries 3, 5, or 10 loans in a bank the equity in one loan is applicable to the other; and as I see it here, you might have a situation in which the pledging of one such loan would be subject to the liabilities of the other creditor. That would be particularly true where the broker was using his principal bank for what is known as "day-loan accommodation."

In regard to section 8 we make no suggestion in regard to subsection 1. This is the section of the bill dealing with the prohibition of manipulative transactions.

In regard to section 2, which Mr. Corcoran, when he appeared before the committee, said was to cover match orders, we believe that the section as drafted does not cover technically matched orders, and we have redrafted it so as to clearly cover that.

Senator GORE. Subsection 2?

Mr. REDMOND. Subsection 2 of section 8 (a).

Subsection 3 of section 8, which appears on page 22, Mr. Corcoran said was intended to prevent pools and manipulative transactions of that character. We believe it could be more clearly expressed so as to show its intent, and we suggest, therefore, that it be amended to read [reading]:

To effect, either alone or in conjunction with one or more other persons, a series of transactions for the purchase and sale of any security, for the purpose of creating a false or misleading appearance of the volume of trading in such security or of establishing price quotations therefor which do not truly reflect the market value of such security

This suggestion tends to make perfectly clear the intent of that provision.

Subsections 4, 5, 6, and 7, which deal——

Senator ADAMS. At that point: You have a qualification at the close of the section. You suggest that these transactions, these cross-transactions, would not be forbidden if they did properly reflect the market value. Ought they to be permitted even if they do truly reflect actual market conditions at the time?

Mr. REDMOND. Senator Adams, what is prohibited is a series of transactions made for the purpose of showing price quotations which are not properly reflected——

Senator ADAMS. But it is also, beyond that, "for the purpose of creating a false or misleading appearance of the volume of trading in such security."

Mr. REDMOND. Either one.

Senator ADAMS. We might add to it the actual true market figure. You could under this section have a very large volume of transactions without violating the section if they truly reflected the market value. That last qualification might well be stricken out——

Mr. REDMOND. But, Senator, I think possibly you have misread the section. What we intended to cover was either one of those transactions—if a man made a series of transactions either for the purpose of creating a false or misleading appearance of the volume of trading or for the purpose of establishing price quotations.

Senator ADAMS. Then the last clause does not relate back to the earlier part?

Mr. REDMOND. No; but it has sufficient affiliation so that a man, under the example you gave, could be considered subject to this clause.

Sections 4, 5, 6, and 7, dealing with the circulation of rumors and false information are intended, I believe, also to cover tipster sheets. We have redrafted two sections. I will read only the first one. The second one dealing with tipster sheets is highly technical, Mr. Pecora, but I invite your attention to it because I think it will be more effective against that type of unfair practice than what is in the bill today.

Senator GORE. It relates to tips, you say?

Mr. REDMOND. Tipster sheets, Senator—newspapers that are published for the purpose of leading people to buy and sell securities.

Senator GORE. Is there any way in which we can make that retroactive? [Laughter.]

Mr. REDMOND. I am afraid it is beyond even the power of Congress, Senator Gore.

In regard to the circulation of rumors we provide as follows:

> To circulate or disseminate, with intent to deceive, any false or misleading information in regard to any security, for the purpose of inducing the purchase or sale of such security

As we read and interpreted some of these sections, particularly 4 or 5, it seemed to us that even fair comment by people engaged in the security business might subject them to criminal liability. We did not believe that that was the intention of this act; but many organizations, like some of our statistical organizations, which might be considered as dealers or brokers because they use facilities, are daily expressing opinions as to the value of securities, and we thought they should not be considered criminal unless they did it purposely with the intent to deceive.

Section 8, which we have in our draft renumbered, deals with transactions for pegging, fixing, or stabilizing the price of a security in contravention of rules and regulations as the Commission may prescribe—this being in the alternative—or without having prior to such transactions reported the same.

It seemed to us that a mandatory provision that you would have to report might place an enormous burden on the Federal Trade Commission; and if it felt that such reports were necessary it could cover them by its rules and regulations.

So we have limited that section to read:

> 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 for the purpose of pegging, fixing, or stabilizing the price of such security in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to pevent unfair practices

Section 9 appearing at the top of page 25 refers to the guaranteeing of puts and calls by members of an exchange. It was not clear that that provision was subject to the limiting language contained in the opening part of section 9, that is, that these put and call transactions should not be executed or guaranteed in contravention of such rules and regulations as the Commission might prescribe; so we clarified that by making it clear that the power of the Commission to make rules applied also to the guaranteeing of puts, calls, and straddles.

Subsection (b) deals with the civil liability of any person who violates any of the subsections contained under subdivision (a) of this section.

It reads now. [Reading:]

(b) Any person who willfully participates in any act or transaction—

"Willfully participates" did not seem to us to be the test, but it was the question as to whether a person willfully violated any such provision, and to make that clear we redrafted it to read. [Reading:]

(b) Any person who willfully violates any provisions of subsection (a) of this section and any person who knowingly participates in any such violation shall be liable to any person who shall purchase or sell any security, the price of which was affected by such violation, and the person so injured may sue in law or in equity in any court of competent jurisdiction to recover the damages sustained as a result of such violation

Then the proviso which appears in the last part of that subsection, we believe, can be omitted.

Subsection (d), which appears on page 26, limits the period in which actions can be brought under this section to 2 years after the cause of action occurs. If it was intended to mean 2 years after the violation, we then suggest that that provision be specifically put in, but if it was intended that the action could be brought 2 years, let us say, after discovery, then we believe there should be some limited period beyond which no action could be brought. There was, I believe, discussion before the committee some weeks ago, and general agreement that there should be some maximum limitation beyond which no action could be brought.

Mr. PECORA. There was such discussion, as I recall it. The suggestion was that action must be brought within 2 years after the discovery of the violation, but in no event could it be brought after 6 years from the commission of the violation.

Mr. REDMOND. There was discussion of that. This "cause of action" language, we felt, was not quite clear, and we were fearful that it might bring about an absurd condition, in that the laws of some States might allow an action at a much later date than other laws, and even if the action were brought in the Federal courts, following the local practices with regard to limitations might result in varied rules of law as to the liability. We feel that it should be made definite or certain one way or the other.

We suggest that section 9 be omitted entirely. As to subdivisions (a) and (b), you will find them incorporated in our redraft of section 18.

As to subsection (c), which seemed to be a general grant of power to the Commission to define as a crime any practice which they thought was manipulative, it seemed to us to be an altogether too broad grant of power to any administrative body. It is a criminal provision there, which the Federal Trade Commission might, by rule or regulation, interpret in common practice, and suddenly announce that it was a violation of that, subjecting the violator to 10 years in jail. It seemed to us to be going a little far, and we suggest its omission in toto.

Section 10 deals with the segregation and limitation of the functions of broker, specialist, and dealer. We have simply recommended, as Mr. Whitney did the other day, that subdivisions (a) and (b) be combined into subsection (a), and subsections (c) and (d) into subsection (b). There is one slight change in language, Mr. Pecora, simply so as to make it clear that a member of the exchange, under subsection (b), who has not been granted the privilege of acting as a dealer and a broker, cannot do so without violating this provision.

Senator GORE. A specialist, you say?

Mr. REDMOND. The specialist provisions are left to such rules——

Senator GORE. I did not catch the first part of that last sentence.

Mr. REDMOND. Under subsection (b) provision is made for the granting of the privilege to brokers to engage in business as dealers and brokers off the floor of the exchange, on certain terms and conditions. We simply put in the provision that it would be unlawful for a man to engage in such business until he had been granted the privilege, which was not in our original draft.

Senator BARKLEY. My attention was called yesterday by some gentleman to the provisions of this bill as applicable to the members of the exchange who deal in bonds, somewhat after the fashion of the specialist.

Mr. REDMOND. That is true, Senator.

Senator BARKLEY. Have you dealt with that situation in your suggested amendments?

Mr. REDMOND. We would leave full power to the Federal Trade Commission to prescribe rules and regulations as to the way that business is carried on. Our subsection (a) simply says [reading]:

SEC 9 (a) It shall be unlawful for an individual 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

Senator BARKLEY. You have changed the number. You have eliminated one section.

Mr. REDMOND. We have eliminated one section.

Mr. PECORA. He has eliminated section 9, and section 10 becomes section 9.

Mr. REDMOND. Section 11 deals with the registration requirements for securities. We suggest that these two sections, 11 and 12 of the committee print, which are quite long and quite detailed, be very substantially changed, so that the listing requirements of the exchanges shall be subject to the control of the Federal Trade Commission, but that the securities of those corporations that comply with those listing requirements shall be considered as registered securities

under the act. In other words, that insofar as the corporations are concerned, the regulation of listing by the Federal Trade Commission would be through the exchanges rather than by a direct control over the corporations.

Also, in the interest of preserving a market upon the effective date of this bill, we have provided that securities which are listed at the time that the exchange itself registers with the Federal Trade Commission shall be deemed to be registered securities under this act, subject, however, to the full right of the Commission to suspend dealing, or to require their delisting if that should become necessary.

We also provide that securities admitted to dealing on April 1 of this year should have the same status when an exchange which has admitted securities only to dealing, and not listing, makes its application for registration, but again with the full right of the Commission to remove those securities if it is necessary.

Senator GORE. That is the Curb.

Mr. REDMOND. That would cover the existing situation in the Curb. We give power to the Federal Trade Commission to permit dealings in securities that are not technically listed, so as to take care of situations which we know will exist in the future where, for instance, let us say, you will have a split-up, and a "when issued" security of large moment. Our experience in the past has indicated that where that security is listed on an exchange, unless the exchange is willing to deal in the "when issued" a large market will develop for the "when issued" stock over the counter, which will have a very detrimental effect on the market of the exchange; whereas, if the "when issued" is brought on to the exchange, so that the two are traded in, one alongside the other, then the market will be very close and very orderly. The same thing applies to rights to subscribe, which are often "when issued", and to other similar securities.

Senator BARKLEY. At the bottom of page 32 of the bill, subsection 9, among other things which may be required to be filed, specifies material contracts not made in the ordinary course of business, and material patents. Of course, we all know that patents are a matter of public record in the Patent Office here in Washington. I am wondering whether that language might be construed to authorize the Federal Trade Commission to require the filing of contracts of such a nature as to reveal secret processes and trade secrets that any concern might not wish to reveal to its competitors. For instance, a chemical company that manufactures some commodity by a secret process of its own that it has worked out would not want to divulge it, especially to foreign competitors. Have you given any thought to the possibility—and I am directing the same question to Mr. Pecora—whether that language might not be construed, if the Federal Trade Commission saw fit, to require the filing of secret information with reference to formulas, processes, and contracts—contracts between the company and some person, some inventor, or some expert, or some company that was manufacturing a certain thing that the company needed for the manufacture of its chemical processes, or any other? Have you thought anything about that?

Mr. REDMOND. We feel that it is a very dangerous provision, largely because of the doubt as to what is included in it. In the same way, if you look at subdivision 7, which includes management

and service contracts, it is rather difficult to say precisely what might be included in your service contracts. You might, for instance, retain a very well-known engineer, if those services mean personal services, but you might retain him to manage a particular plant, with some description as to what purposes he was going to aim at. If the publication of that was necessary, the whole value of the attempt to get a better process might be thrown away.

Senator BARKLEY. I do not quite understand what the language means there "material contracts" and "material patents." I do not see the necessity for putting in there any requirement as to material patents, or any kind of patents, all of which are a matter of public record in the Patent Office in Washington.

Mr. PECORA. The Federal Trade Commission, as I understand it, has required considerable information of the secret nature to which you have referred. So far as I know there has been no public disclosure of it made. This bill imposes upon the Federal Trade Commission the duty of making such requirements only, as the language of the bill says, where it may be necessary or appropriate in the public interest, or for the protection of investors. In view of the experience of the Federal Trade Commission in dealing with such secret information, I do not think any apprehension need reasonably be felt as to their laying down requirements that would not be consistent with the public interest or with the protection of investors.

Senator BARKLEY. There is a theory which is entertained by a good many people, that all records in Governmental offices are public records, and that any interested party may have a right to go in and demand that he be allowed to see them It is difficult for that to be done unless the Commission or the officer in charge is willing. But I am wondering whether, under that section, we are authorizing the compiling of records that might be deemed public, so that things like this, that have been worked out for years and years as a secret process of manufacture, might be divulged to some competitor who might like to take advantage of it.

Mr. PECORA. They have not heretofore been divulged by the Federal Trade Commission, so far as I know, and yet they have required such information in the discharge of their duties. I think that they can be trusted to exercise the kind of judgment this bill calls upon them to exercise, that is, make such rules and requirements with respect to furnishing such information as may be necessary or appropriate in the public interest or for the protection of investors.

Senator BULKLEY. Where do you find secret processes involved?

Senator BARKLEY. Not by language, but take material contracts. I do not know what is meant by that, unless it is contracts for material. That might include anything. That might include——

Mr. PECORA. I think that would mean contracts considered material.

Senator BULKLEY. Considered important.

Senator BARKLEY. I do not know whether that is the interpretation to be placed upon that or not.

Mr. WHITNEY. As applied to material patents, that would signify that they would be of importance.

Mr. PECORA. Patents, as the Senator has remarked, are a matter of public record anyway. There is no concealment about those.

Senator BULKLEY. This is different. This requires them to set forth which ones they regard as important. That adds something to the public record in the Patent Office.

Mr. REDMOND. Is it not true that every corporation, to be on the safe side, will have to submit every patent they have? How can they tell, looking at it in retrospect, that any particular patent is not an important one? They would not dare take the risk.

Mr. WHITNEY. I think the American Telephone & Telegraph Co. has 5,000 or more.

Senator CAREY. Why have it anyway? Cannot the Commission demand anything like that if they are passing upon securities?

Mr. REDMOND. We have omitted any specific provision in our suggestions, because we felt that there was some danger in the disclosure of secret information, but, much more, that you would collect a great mass of information of no practical value to investors. There is no point in having a great list of contracts, management, service, and material contracts of one kind and another, compiled in some place, because investors are not going to read them. It will be the competitor who will go and read them, the very fellow who ought not to get the information.

Mr. PECORA. He probably has the information anyway, through the system of espionage.

Mr. REDMOND. I do not think that exists. I know that statement was made before the House by Mr. Pressley, and, quite frankly, I do not believe it. Having looked over the financial results of Mr. Pressley's management of his own companies, if there is such a system then he certainly did not make good use of it.

Senator GORE. The management contract would include a situation where one concern buys another concern, a public utility, for example, and enters into a contract to manage it as a large stipulated price and really does nothing on earth, just covering up a charge of that sort.

Mr. REDMOND. I think that was the intention, Senator Gore, to cover both that type of management contract and possibly another type, where a corporation is actually hired for a stipulated fee to operate or manage some other company.

Senator GORE. It seems to me that is one of the abuses, the "bug under the chip." They make these contracts for management or service, or advice, and charge a large fee for it, and do nothing in return.

The CHAIRMAN. You propose an amendment for that?

Mr. REDMOND. We do.

Senator GORE. And yet they drain the local concern they buy, and it results in high rates to the consumers of the service.

Mr. REDMOND. I will not discuss the technicalities unless the committee wishes me to, of the listing requirements. That is a highly specialized field.

Section 13 appears on page 37 of the committee print, and our references appear on page 18 of our print. That deals with the granting of proxies, and makes it a crime for a person to solicit a proxy without filing information with the Federal Trade Commission, and including in the application, or the solicitation, such part of the information as the Federal Trade Commission may require by

rules and regulations. I am aware of the fact that this provision was put in with the idea that it would facilitate minority stockholders getting in touch with each other in a possible contest for control, but, quite frankly, I think it is going to operate almost the other way around, because under this provision the first thing that a minority stockholder would have to do before he could solicit the other stockholders would be to get a complete list from the company and file it with the Federal Trade Commission, and the expense that would be imposed upon the minority stockholders by that provision might be so great as to prevent the soliciting of any proxies. Quite frankly, we feel that this provision has no part in a stock-exchange bill.

We do suggest, however, in the line that we have taken right straight through of making these provisions flexible, that if any provision is retained it should be made simply to the effect that it shall be unlawful to solicit or permit the use of his name to solicit any proxy in contravention of such rules and regulations as the Commission may adopt for the protection of investors. That, at least, would allow the Federal Trade Commission to study the problem and to adopt rules and regulations, if it becomes necessary.

In like manner we have changed subdivision (b) so as to give the Federal Trade Commission power to make regulations in regard to brokers granting proxies on securities held by them. A prohibition of that practice would, I am afraid, in many instances prevent corporations from securing a quorum for stockholders' meetings. That, in effect, would result in the perpetuation of existing management, which might be quite contrary to the interests of stockholders. It is a very considerable problem, one which we have wrestled with, because we have a provision in the rules of the New York Stock Exchange in regard to the granting of proxies, and even that, which is much less restrictive than the one proposed in the bill, has in many instances caused grave difficulty.

Section 14, which appears on page 38, deals with the over-the-counter markets. We believe this section will, as a practical matter, be unenforceable. In any event, we think it should be restricted so as not to apply to commercial paper or bankers' acceptances, or commercial bills, even though they might have a longer maturity than 9 months, and other similar obligations incident to commercial and industrial activities, all of which are included in the very broad definition of the term "security" which now appears in the bill.

Senator GORE. This is what section?

Mr. REDMOND. Section 14, dealing with over-the-counter markets. As a practical matter, if it were possible to arrive at another definition that would include simply what are normally considered to be the securities which would be traded in on an exchange, that, I take it, is what ought to be regulated in the over-the-counter market. It is primarily your stocks and bonds rather than these very sweeping definitions of securities which it was necessary to include in the drafting of the act.

With respect to section 15—we make a comment at the end in regard to certain of these sections which seem to fall outside the scope of our particular criticism, but we would like to point out that the 5 percent provision in regard to stockholders, as drafted today,

might prevent arbitrage transactions, because it is very common, in arbitrage, for a man to buy one security and at the same time sell against it an equivalent security. While that process of the arbitrage is going on he might conceivably accumulate more than 5 percent of this security, and he would be the beneficial owner of that 5 percent. He would, of course, have off-setting contracts or obligations against it, but they are not reflected in the definition, which imposes penalties upon a stockholder owning 5 percent or more of a registered security.

Senator GORE. You mean in that sort of transaction he might be buying one security and selling another?

Mr. REDMOND. Very often, Senator Gore, he actually buys and pays for a security, and then sells, let us say, an equivalent security for future delivery, or "when issued", as in the case of rights to subscribe.

Senator GORE. Of some other concern?

Mr. REDMOND. Sometimes of the same concern, and sometimes of another concern. Arbitrage is possible when securities, if not presently equal to each other, will become presently equal to each other. In cases of merger and consolidation it is very common to have an arbitrage between the securities of the consolidating corporations, and we suggest, therefore, the addition of a small subsection at the end, which would allow the Federal Trade Commission to adopt rules and regulations to prevent the abuse of arbitrage transactions, but otherwise would permit both foreign and domestic arbitrage.

The CHAIRMAN. Are you talking now of section 15?

Mr. REDMOND. Section 15, Mr. Chairman.

The CHAIRMAN. You propose a substitute for that section?

Mr. REDMOND We propose simply the addition of a short final paragraph.

Mr. PECORA. It excludes arbitrage transactions of the operations of the section, except in accordance with rules and regulations to be adopted by the Federal Trade Commission.

Mr. REDMOND. Precisely.

The CHAIRMAN. Did you have a substitute for section 14?

Mr REDMOND. We simply expressed our feeling that it probably was an unenforceable section, and suggested the possibility of its being limited in scope, but we did not attempt to redraft it.

Mr. PECORA. Limited so as to exclude bankers' acceptances, commercial bills, and so forth.

Mr. REDMOND. And even further, if possible, so as to get down to what are commonly known as stocks and bonds.

We suggest that section 16 be omitted entirely, the substance of the right of the Commission to investigate the books and records being included in our proposed draft of section 18.

Mr. PECORA. You will come to section 18?

Mr. REDMOND. Yes, sir.

Section 17 covers the liability for misleading statements. We feel that that should be redrafted so as to make it perfectly clear that it is a liability for a misstatement in regard to a material fact, and not for a misstatement or a false or misleading statement in regard to a matter sufficiently important to influence the judgment of an

average investor. Quite frankly, we feel that this imaginary creature known as the average investor is not a standard which ought to be used in legislation to determine the liability of anybody. Nobody can tell precisely——

Senator KEAN. I would like to ask you a question in regard to that section. Do you think that a director of a corporation would be liable under these circumstances? Suppose a man walked up to him in the street and said "Are you going to vote for a 6-percent dividend today on your stock?" Suppose he said, "Well, I do not know", and he did know all the time that he was going to, but he had no call on him, and the man had no business to ask him the question. Under this section would he be liable?

Mr. REDMOND. No, Senator Kean. This section is limited, as I see it, to a person who shall make, or be responsible for making, any statement in any application, report, or document filed pursuant to this act.

Senator KEAN. Only a document? No verbal statement?

Mr. REDMOND. This apparently is limited. That is correct, is it not, Mr. Pecora?

Mr. PECORA. Yes.

Senator KEAN. He would not be liable for any oral statement?

Mr. REDMOND. It would not apply to an oral statement.

Senator KEAN. People come and ask you questions about your companies very often, which you do not care to answer, and there is no reason why you should answer.

The CHAIRMAN. You would not be liable under this section.

Senator WALCOTT. It says here "any statement in any application." What would an application cover?

Mr. PECORA. Any application, report, or document filed pursuant to this act. That refers to written statements, reports, and so forth

Senator KEAN. Everybody who is a director in any corporation knows that people come and ask him questions which they have no right to ask. They are not even stockholders in the company They just come and ask him some question in regard to the company, which they think he might tell them, and they have no business to ask it.

Senator BARKLEY. That would not apply here.

Senator WALCOTT. That might be a written request, and the reply might be in writing.

Mr. PECORA. It must be a statement or report required to be filed

Senator CAREY. Filed with the Federal Trade Commission.

Mr. PECORA. With the Federal Trade Commission.

Mr. REDMOND. In section 18 we suggest no changes to the first four subdivisions, which appear on pages 43 and 44. We suggest, in the manner, and I think in almost the exact detail suggested by Mr. Whitney the other day, the amendment of subsection 5. I think there may be some small changes in language. If there are, they were made to clarify and make more certain the provisions, but not with any attempt to change the substance of what Mr. Whitney said. I take it the committee is familiar with that section.

Senator BARKLEY. You offer a substitute for subsection 5?

Mr. REDMOND Precisely.

Mr. WHITNEY Adding to this general section various subsections from other prior sections, Senator Barkley.

Mr. REDMOND. It includes also the matters from section 9 and section 16.

With respect to section 19, we refer to our comment, which I will read in a moment. We suggest no changes in sections 20, 21, and 22; no change in section 23, but it is subject to comment.

With respect to section 24, we suggest that subsection (a) of that be amended, as that deals with the right of persons to review by court proceedings the orders of the Commission. It is limited, however, in its present draft, to "any person aggrieved by an order issued by the Commission in a proceeding under this act to which such person is a party." It is very possible that a person might be aggrieved by an order of general application to which he would not expressly be a party. We felt that if he were so aggrieved, he should be given the right of review, so we have redrafted the clause for that purpose.

Mr. PECORA. You say in your redraft [reading]:

> Any person aggrieved by an order issued by the Commission in a proceeding under this act to which such person is a party and any person aggrieved by any rules or regulations of general applications made effective as prescribed in section 20 may obtain a review of such order

Do you intend by that to subject the rules and regulations which may be adopted under the act by the Federal Trade Commission to court review?

Mr. REDMOND. Where a person is aggrieved.

Mr. PECORA. Then you are not giving the Federal Trade Commission the discretionary power that you maintain is being given to it.

Mr. REDMOND. Yes; I think we are, Mr. Pecora.

Mr. PECORA. If you make its rules and regulations subject to court review——

Mr. REDMOND. But these rules and regulations——

Mr. PECORA (continuing). You will put the Federal Trade Commission, then, in the position of making rules and regulations for which a court may provide a substitute. You are giving the court, then, the power to make the rules and regulations in the final analysis, are you not?

Mr. REDMOND. No; I do not think so, because the term "rules and regulations" is used throughout the bill, that the exchange might, by rules and regulations, do thus and so. Let us take an example: We referred a moment ago to the question of foreign and domestic arbitrage. Suppose the Commission should adopt rules and regulations which literally prohibited that. Do you not think a person engaged in the business of being an arbitrageur should have the right to review the question of whether those rules and regulations were necessary to carry out the provisions of section 15?

Mr. PECORA. If you are going to do that by what you designate as section 22 (a), the clause you have in there, now, I am afraid you are going to make all the rules and regulations which the Federal Trade Commission is presumably empowered to make, subject to court review. You are going to make the court, in the final analysis, the arbiter of the rules and regulations which the Federal Trade Commission is required to make.

Mr. REDMOND. But, Mr. Pecora, you are using the words "rules and regulations." The only necessity for putting that in is that through-

out this draft of the bill we have not attempted to redraft all the language of the bill. The term "rules and regulations" is used precisely as if they were orders of the Commission. In other words, the Commission, by rule and regulation, says the bill can accomplish the same thing that they could by an order.

Mr. PECORA. At the same time, the Commission is empowered to make rules and regulations with regard to many, many things. As a matter of fact, you are entrusting to the Federal Trade Commission powers in addition to those that were entrusted to it in the printed draft of the bill.

Mr. REDMOND. True.

Mr. PECORA. Now you say "We propose that the Federal Trade Commission be given that much broader power than was originally contemplated," but by this clause you are virtually saying "The Federal Trade Commission's rules and regulations, however, are subject to review by some tribunal."

Mr. REDMOND. But was not this section intended to allow citizens who were aggrieved by the action of the Commission——

Mr. PECORA By an order, which is different from a rule or regulation.

Mr. REDMOND. Quite frankly, I thought the intent of the section was to allow to citizens who would be affected by the action of the Federal Trade Commission the normal right, which is the right of citizens to review the action of an administrative body in the courts.

Mr. PECORA. If the Federal Trade Commission should, by order, determine that an individual has violated a rule or regulation, the right to review is given, but not the right to review the making of the rule or regulation.

Mr. REDMOND. But if, Mr. Pecora, the making of the rule or regulation would have the same effect—it does under this bill—as an order, should the Federal Trade Commission be able to escape a court review by making a general rule or regulation rather than a specific order? I know of no administrative proceeding which is not subject to some form of court review, and, quite frankly, it never occurred to me that this bill was intended to establish an administrative authority that would not be subject to court review. In fact, I think Mr. Corcoran——

Mr. PECORA. There is not any such purpose revealed in the printed bill.

Mr. REDMOND. It is limited here——

Senator TOWNSEND. What page?

Mr. REDMOND. Page 50. It says [reading]:

> Any person aggrieved by an order issued by the Commission in a proceeding under this act to which such person is a party——

Mr PECORA. Yes.

Mr. REDMOND. That is the only type of act of the Federal Trade Commission which, under this bill, would be subject to court review. Take the case——

Mr. PECORA. You propose to extend that by giving the court the power to review rules and regulations which the Federal Trade Commission is authorized by other provisions of this act to formulate and prescribe from time to time for the purpose of carrying out the provisions of the act, so that are you not virtually making the

court the final arbiter of what rules and regulations are to be made, and not the Federal Trade Commission?

Mr. REDMOND. Only insofar as the rules and regulations directly and adversely affect the rights of a citizen. It is because the form of this bill has used the term "rules and regulations" for all sorts of things, which are not really rules and regulations at all.

Take the incident I gave you, of the man engaged in foreign or domestic arbitrage. The Commission could adopt what it might say was a rule or regulation, prohibiting foreign arbitrage. Those men would be put out of business, and would have no right to review in the courts the order of the Federal Trade Commission, because the Federal Trade Commission would not have entered an order. It would have adopted a rule or regulation.

Senator BARKLEY. You have two classes of people here, one who are parties to any proceeding——

Mr. REDMOND. True.

Senator BARKLEY. In that case there is no question under either language. They can go into court.

Mr. REDMOND. Correct.

Senator BARKLEY. Your language, however, makes it possible for anybody to go into court and make a general attack.

Mr. REDMOND. Anybody who is aggrieved.

Senator BARKLEY. Anybody who thinks he is going to be aggrieved. If he has been aggrieved, he can easily become a party to a proceeding that would enable him to appeal to a court.

Mr. REDMOND. But there are no proceedings here.

Senator BARKLEY. This language is broad enough to enable anybody who thinks he is liable to be aggrieved by the specific application of the regulations to go into court and attack the whole body of regulations.

Mr. REDMOND. If my language is so broad as to allow that interpretation, clearly it should be limited. But I was trying to cover the point that because of the way the bill is drafted, the term "rules and regulations" was made of general application, and effectively destroyed the rights of citizens, and no opportunity would be given them to review that action in the courts.

Senator BARKLEY. Of course, it is easy for any person to become a party to a proceeding by violating any of the rules or regulations, and then having proceedings instituted against him so that he may come within the language of the bill as written. Then he can get an appeal to the circuit court.

Mr. REDMOND. I beg your pardon, Senator. The purpose of this provision, and it is the same type of provision that is in all of our administrative acts, is to allow a person who is affected by the administrative commission's action to have an orderly review of that proceeding before he has got to subject himself to criminal proceedings.

Senator BARKLEY. It seems to me you have subjected the language to the danger of involving some attack on the general body of rules and regulations made without regard to the possibility of them affecting him in all their ramifications. He might undertake to relieve a lot of others besides himself of the binding effect of the regulations by some proceeding of his own.

Mr. REDMOND. That is not my intention, and if the language is capable of that construction, I will be the first to amend it so as to limit it to what I really had in mind, and that is that a person who was aggrieved could have a right to review.

Senator BARKLEY. I do not know just what the proceedings will be under this bill. It is like a new court of appeals being established. It has to work out its own rules over a period of time. Anybody who is aggrieved by any regulation or rule of the Commission can go before the Commission in a proceeding to have that rule or regulation modified or abandoned entirely. In such a proceeding, if the decision is adverse to him, he can then go into court, so that, as I said a moment ago, it is easy for anybody to make himself a party to a proceeding under which he can go into court and attack it.

Mr. REDMOND. I think I am right in stating—Mr. Pecora will correct me if I am wrong—that this bill allows the Federal Trade Commission to adopt rules and regulations without any proceeding whatsoever. It can just adopt them and promulgate them.

Senator BARKLEY. I understand.

Mr. REDMOND. Then there is no way in which that can be reviewed.

Mr. PECORA. How about invoking the injunctive power of the court to prevent the enforcement of a rule or regulation?

Mr. REDMOND. Then, Mr. Pecora, we might drop the entire section 24. The same argument would apply.

Mr. PECORA. We are giving a person aggrieved by an order the right to review that order. You propose to give not only that right but also the right to any person who claims to be aggrieved by a rule or regulation adopted by the Commission, to go to court and have the court review that rule or regulation; and at the same time you are entrusting to the Federal Trade Commission the power to make rules and regulations for the purpose of administering the entire act. You, yourself, propose, for instance, with regard to the provisions of section 10, having to do with segregation of dealers and brokers, that that whole question be left to the discretion of the Federal Trade Commission through the adoption of rules and regulations.

Mr. REDMOND True

Mr PECORA. Now, you say that any person aggrieved by a rule or regulation may go to court and obtain a review or regulation. In other words, you are giving the power to the Federal Trade Commission in one breath, and in the next breath you are transferring that power, in the final analysis, to a court.

The CHAIRMAN. I think we can take that up later.

Mr. REDMOND Section 25 deals with the criminal liabilities. We firmly believe that the criminal penalties of the bill ought to be restricted to what are really in their nature crimes, and not violations of rules and regulations or other provisions of the act where a man literally might violate them through no affirmative act of his own. For example, under the bill as drawn the maintenance of credit, unless certain rules are complied with, is declared to be unlawful, and therefore the maintenance of such credit would be a violation of the act. Take a broker, or even a banker; he may have a loan to a customer amply collateralled according to the requirements of the bill, but on a certain day that stock or security may drop rapidly, and

it may get below the fixed limits of this law. The net result is that through no action on the part of the lender he has become a criminal. We do not feel that that is a proper criminal provision. We feel that strict criminal provisions——

Mr. PECORA. Is not that going to be covered by rules and regulations adopted by the Federal Trade Commission prescribing the manner and method of closing out margin accounts?

Mr. REDMOND. I know of no such provision. Under the present draft there is no provision, so far as I know, allowing the closing of margin accounts in any particular manner

Senator GORE. You figure, under that, that if a stock were to take a sudden drop and then rally and break through this limitation, that would be a crime.

Mr. WHITNEY. It could be so construed.

Mr. PECORA. If you will turn to page 17 of the printed bill, section 6, beginning with line 15——

Mr. REDMOND Mr. Pecora, would you read the whole sentence. I know that power exists in the Federal Reserve Board, but it is limited to a certain particular type of condition It may be a mistake in draftsmanship.

Mr. PECORA. It would cover the very situation you have assumed.

Mr. REDMOND. I do not think so Suppose we read the section. It says. [Reading:]

Although the limitations of this section 6 upon the extension and maintenance of credit shall, except in the extraordinary circumstances hereinafter referred to, be strictly adhered to by the Federal Reserve Board as the considered policy of Congress, the Federal Reserve Board may, notwithstanding the other provisions of this section 6, in situations where it deems such action vitally essential to the accommodation of commerce and industry and with regard to its bearing on the general credit situation of the country, by rules and regulations permit lower margin requirements for particular securities or transactions or classes of securities or transactions and for particular periods

They cannot adopt any rules and regulations lowering the margin requirements unless they are in situations where the Federal Reserve Board deems such action vitally essential to the accommodation of commerce and industry, and with regard to its bearing on the general credit situation of the country.

The CHAIRMAN You propose a substitute?

Mr. REDMOND. We were discussing the criminal provisions. I do not feel that a man should be made a criminal for something which happens really through inaction, or by reason of somebody else's action, and yet that is the effect of many of the provisions of this bill.

Mr. PECORA. Mr. Redmond, the provisions on page 17 of the printed bill, commencing in line 15 and continuing down to and including line 21, may easily be clarified so as to require the Federal Reserve Board to make rules and regulations, or empower the Federal Reserve Board to make rules and regulations covering the carrying and closing out of margin accounts.

Mr. REDMOND. But even so, Mr. Pecora, that does not cure my fundamental objection.

Mr. PECORA. They certainly would take care of a supposititious case such as the one you referred to.

Mr. REDMOND. It simply means that you are going to make it possible for a man to be a criminal and be faced with a jail sentence of 10 years, although he has done nothing.

Mr. PECORA. Oh, no.

Mr. REDMOND. It is the fact that he fails to take action to liquidate a loan that will make him a criminal.

Mr. PECORA. Only willful violations may be dealt with.

Senator GORE. As a matter of draftsmanship, do you think the word "vital" adds anything to it in the way of certainty or clarity?

Mr. REDMOND. I really do not, Senator Gore. We make our suggestion here for consideration.

The CHAIRMAN. On your page 25, have you any suggestion to make as to the amounts there?

Mr. REDMOND. No, Senator. We frankly feel that the present amounts proposed in the bill are excessive, but we leave it to the discretion of the committee to determine what would be more appropriate and lower amounts.

Mr. PECORA. You must remember, Mr Redmond, that the penalty provisions of the bill are the teeth.

Mr. REDMOND. I am not unaccustomed to seeing teeth in a bill, Mr. Pecora.

Senator BARKLEY. You do not want them to have false teeth.

Mr. REDMOND. No; I do not want them to be false teeth at all. I want them to apply to what is really a crime, but I do not want to see innocent people made liable as criminals.

The CHAIRMAN. I am just wondering whether you had in mind what the fine should be, and what the term of imprisonment should be.

Mr. REDMOND. No, Senator. I think those matters should be fixed with relation to the other Federal statutes determining what is a proper penalty for different types of offenses.

Mr. PECORA. You think there should be something more than a slap on the wrist for a violation, do you not?

Mr. REDMOND. Absolutely; and I would expect substantial penalties, Mr. Pecora, but not these provisions of 10 years and $25,000, which, so far as I know, exceed the Federal penalties for many felonies.

Mr. PECORA. You talk of 10 years as if that were the only penalty the court could impose. That is the maximum.

Mr. REDMOND. I know; but is it not true, in the criminal law, that very few penalties are mandatory? A man may be sent to prison for 10 years for forgery, and that is the maximum

Mr. PECORA. That is the maximum There are very few maximum terms of imprisonment imposed by the courts anyway.

Mr. REDMOND. If you are trying to give me comfort, Mr. Pecora, that I will not languish in jail as long as I might otherwise, I am afraid it is cold comfort [Laughter]

The CHAIRMAN. Very well.

Mr. REDMOND. Section 30 deals with the registration fee. We suggest its omission because of our feeling that it is merely a further tax.

With respect to section 31 we have no suggestions.

Section 32 deals with the members and employees of the Federal Trade Commission. We renew our statement that we feel that the

authority in charge of regulation of exchanges should be a separate body, thoroughly familiar with the operation of stock exchanges and the security business.

With respect to section 34 we would like to point out that the effective dates suggested by the bill will make it absolutely impossible, as a practical matter, for the machinery which the bill itself proposes to be put into effect There are approximately 900 corporations listed on the New York Stock Exchange Even with the best wish in the world to comply with the registration requirements of the bill it would be physically impossible for them to do so.

Of course, if our amendments were accepted to sections 11 and 12, that matter would be cured automatically, because those corporations which are now listed would be allowed to continue listed, at least temporarily.

There is a comment here in regard to certain sections of the bill which do not directly affect the work of stock exchanges. There is one thing——

Senator TOWNSEND. Do you want that inserted in the record?

Mr. REDMOND. Suppose I read it. It is very brief. [Reading:]

A number of sections deal with subjects which do not directly affect the work of stock exchanges We have refrained from making any comment on such sections but this fact must not be considered as indicating approval by stock exchanges of the substance of these sections This is particularly true of section 15 insofar as it deals with the liability of principal stockholders, of section 19 which deals with the liability of controlling persons, and of section 23 which deals with the public character of information

Senator GORE. What was the first section? I did not get it.

Mr. REDMOND. Section 15, Senator Gore. [Continuing reading:]

The first two of these sections will impose liability upon persons merely because they are the owners of property and will almost certainly interfere with the free flow of capital into industry The last will require corporations whose securities are dealt in on exchanges to disclose highly confidential information which will be of value only to competitors, both foreign and domestic

There is one other. It came in late, and is therefore an addendum, showing that even persons like ourselves, who think we have some knowledge of stock exchanges, do not always remember all the details. Counsel for the San Francisco exchanges, who came on from the coast, has pointed out to us that under their rules they have today certain banks which are literally members of the exchange. Therefore they would be swept in under the definition of a member of the exchange under many provisions of this bill which would not normally be considered applicable to banks For this reason he suggests that there be added to paragraph 3 (a) 3, at the beginning, the following:

Subject to paragraph 7

That is to be added to the definition of members of the exchange. Also the following language in subsection 7. [Reading:]

(7) The term "broker" or "dealer" shall not include a bank, except as hereinafter set forth, or any person insofar as he buys or sells securities for his own account and not as a part of a regular business, the term "member" shall include a bank member of a national securities exchange but only to the extent that it shall act as broker or dealer

Thereby putting a bank, when it acts as a broker or dealer, subject to the same restrictions as members of the exchange, but otherwise exempting them from the provisions of the act and putting them in the category with banks.

The CHAIRMAN. Is that all? Are there any questions?

Mr. WHITNEY. Mr. Chairman, I would like to add this one word: That these amendments have been approved—if I state anything that is inaccurate, the gentlemen are here, so that they can contradict me if they wish. These amendments have been approved by the representatives of the Boston Stock Exchange, the Chicago Stock Exchange, the New York Curb Exchange; by Mr. Thompson, president of the Associated Stock Exchanges, as members of which there are 18 exchanges, and he has been authorized as well to represent the Louisville Stock Exchange, of Louisville, Ky.; the Seattle Exchange, of Seattle, Wash.: and the Richmond Exchange, of Richmond, Va

Separately we have been instructed to represent, by members in the Associated Stock Exchanges, the Baltimore Stock Exchange and the Philadelphia Stock Exchange.

There are present here representatives of the four California stock exchanges, in Los Angeles and San Francisco. They also approve these amendments as suggested, with the one reservation made by San Francisco which Mr. Redmond has just referred to.

That covers, by and large, almost all the exchanges of this country with the exception of some of the smaller ones or exchanges on which particular securities are dealt in.

Senator GORE. Mr. Redmond, did you say that the changes which you have suggested cover the case of transactions and dealings in bonds, which are not speculative, and that they would not be involved in these regulations? Somebody was talking to me a day or two ago, and said there ought to be a differentiation between transactions or dealings in bonds and dealings in stocks. Do your amendments cover that point?

Mr. WHITNEY. The matter in section 6, Senator Gore, leaving it to the Federal Reserve Board as to rules and regulations would enable them to accommodate that situation. Also section 10, which is section 9 in our amendments.

Senator GORE. What section do you leave out?

Mr. WHITNEY. We leave out section 9, and section 10 deals with segregation. Again, that is left to the Commission to determine the function of dealer and broker. Under that come bond brokers as well as all other types of brokers.

Senator GORE. You kept section 2 in there?

Mr. WHITNEY. Yes, sir.

Senator WALCOTT. There is no change in section 2.

The CHAIRMAN. Is there anything else?

Senator WALCOTT. Mr. Chairman, just one question. With regard to section 6, Mr. Redmond, in presenting that, on the matter of exempted securities, in which he now includes Federal and State securities and securities of subdivisions thereof, made the remark, I think, that he did not object to that change. It was a half-hearted, rather lukewarm advocacy of that, as I recall it. How do you feel about that?

Mr. REDMOND. I think our feeling is that it is not a subject really on which the exchanges ought to express a very definite position. Very few of the municipal bonds are actually listed and dealt in. The committee has heard, of course, from the representatives of the bond traders who deal in such securities over the counter, and I believe also from persons representing municipal interests.

Senator WALCOTT. Do you not feel that there are a great many that are really vitally interested in dealing in municipal securities and securities of other State subdivisions who would be very seriously hurt if they were not included in the exemptions?

Mr. REDMOND. I think there is no question about that.

Senator WALCOTT. I would like to make that clear, because I thought, from the fact that you were rather lukewarm, you merely meant by what you said that the stock exchanges are not particularly interested in this particular thing.

Mr. WHITNEY. It is merely outside their province, as such, although of great and most vital interest to many of their members.

Mr. PECORA. But insofar as you would permit yourself an expression of opinion on that, you think exemption could be provided for in the bill for all issues of States and political subdivisions of States.

Mr. WHITNEY. I certainly do.

Senator GORE. Under your suggested amendments, could a person who does not know a thing on earth about securities or stock exchanges make money every time he ventures in?

Mr. WHITNEY I wish it were true, sir.

Senator GORE If it is not I am against it. [Laughter.]

The CHAIRMAN. Is there anything else, gentlemen. (No response.) If that is all, then you may be excused, Mr. Whitney We are very much obliged to you We will take up these matters and consider them carefully.

I want to submit for the record a communication and have it read. Mr. Pecora will read it, and let it go into the record.

Mr. PECORA (reading):

THE WHITE HOUSE,
Washington, March 26, 1934.

Hon DUNCAN U FLETCHER,
Chairman Banking and Currency Committee,
United States Senate, Washington D C

MY DEAR MR CHAIRMAN Before I leave Washington for a few days holiday, I want to write you about a matter which gives me some concern

On February 9 1934, I sent to the Congress a special message asking for Federal supervision of national traffic in securities

It has come to my attention that a more definite and more highly organized drive is being made against effective legislation to this end than against any similar recommendation made by me during the past year Letters and telegrams bearing all the earmarks of origin at some common source are pouring in to the White House and the Congress

The people of this country are, in overwhelming majority, fully aware of the fact that unregulated speculation in securities and in commodities was one of the most important contributing factors in the artificial and unwarranted "boom" which had so much to do with the terrible conditions of the years following 1929

I have been definitely committed to definite regulation of exchanges which deal in securities and commodities In my message I stated, "It should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations"

I am certain that the country as a whole will not be satisfied with legislation unless such legislation has teeth in it. The two principal objections are, as I see it—

First, the requirement of what is known as "margins" so high that speculation, even as it exists today, will of necessity be drastically curtailed; and

Second, that the Government be given such definite powers of supervision over exchanges that the Government itself will be able to correct abuses which may arise in the future

We must, of course, prevent insofar as possible manipulation of prices to the detriment of actual investors, but at the same time we must eliminate unnecessary, unwise, and destructive speculation.

The bill, as shown to me this afternoon by you seems to meet the minimum requirements I do not see how any of us could afford to have it weakened in any shape, manner, or form.

Very sincerely,

FRANKLIN D. ROOSEVELT.

The CHAIRMAN. The bill to which the President refers is the redraft we have been considering in this committee for some time past.

Senator GOLDSBOROUGH. I would like to submit for the record a letter from Mr. George A. Lambell of New York City, chairman of the committee of put and call brokers and dealers in the city of New York; also a telegram from Mr. Jacob France, chairman of the board of the Equitable Trust Co., of Baltimore.

The CHAIRMAN. They may be entered in the record.

(The communications referred to will be printed at the conclusion of today's proceedings.)

The CHAIRMAN. If there is nothing further, this closes the open hearings. We will not adjourn until 2:30 this afternoon, to meet in executive session.

(Whereupon, at 1 p.m., Tuesday, Mar. 27, 1934, the committee recessed until 2:30 p.m. of the same day, to meet in executive session.)

[Telegram]

BALTIMORE, MD, *March 24, 1934*

Hon PHILLIPS LEE GOLDSBOROUGH,
United States Senate

As chairman of board of one of Maryland's largest State banks I earnestly request your full cooperation and support in opposing paragraph A, section 7, National Securities Exchange Act, 1934, because of its unfair discrimination against nonmember State banks I feel I am likewise voicing the sentiment of Maryland's 119 nonmember State banks whose total deposits are approximately $147,000,000

JACOB FRANCE,
Chairman of Board, Equitable Trust Co

NEW YORK, N Y, *March 23, 1934*

Hon PHILLIPS LEE GOLDSBOROUGH,
United States Senate, Washington, D C

DEAR SIR On March 7, 1934, we submitted to the committee of the United States Senate a brief in regard to the National Securities Exchange Act of 1934

The committee of put-and-call brokers at that time pointed out and tried to make plain the economic importance of puts and calls and endeavored to show the difference between the so-called "manipulative options" and those dealt in openly by the put-and-call brokers and dealers in this country

We were then, and are now, of the opinion that section 8, paragraph 9, as it appears in the proposed law, as well as in its revised form, only applies to such options which are acquired in conjunction with the actual purchase or

sale of stock Such puts, calls, and straddles are clearly manipulative options

It seems to us that for the sake of clarity and sharper distinction that this paragraph should be drawn so as to leave no doubt as to the intention of allowing dealings in and the guarantee of legitimate puts, calls, straddles, etc, eliminating puts, calls, straddles, etc, used for manipulative purposes

We also call your attention to the last part of section 8, paragraph 9, third subdivision, reading as follows:

"Or if a member, directly or indirectly, to indorse or guarantee the performance of any put, call, straddle, option, or privilege in relation to any security registered on a national securities exchange The terms put, call, straddle, option, or privilege as used in this paragraph shall not include any registered warrant, right, or convertible security"

We submit that this wording should be clarified so that there can be no doubt that the foregoing subdivision was meant to refer to manipulative options only.

We further recommend that the National Securities Exchange Act of 1934 shall provide that the Federal Trade Commission will have the power to require, after an appropriate hearing, that all put-and-call dealers and brokers conform with rules and regulations adopted by the Commission, and that the effective date of section 8, paragraph 9, be changed from August 1, 1934, to some later date.

We therefore respectfully request that such changes be made

Very truly yours,

THE COMMITTEE OF PUT AND CALL BROKERS AND DEALERS IN THE CITY OF NEW YORK.
GEO A LAMBELL, *Chairman*

MEMORANDUM OF PROPOSED AMENDMENTS TO H R 8720

Section 1. No change.

Section 2: No change.

Section 3: Amend subsection (a) (6) to read:

"(6) The term 'bank' means (a) a banking institution organized under the laws of the United States, (b) a person engaged in the business of banking pursuant to the laws of any State, who is subject to examination or regulation by Federal or State banking authorities, (c) a banking institution organized under the laws of a foreign country or any agency or branch thereof authorized to engage in business in a State and which is subject to the supervision of State banking authorities, or (d) a receiver, conservator, or other liquidating agent of any institution included in clause (a), (b), or (c) of this paragraph"

Amend subsection (a) (12) so as to read

"(12 The term 'equity security' means any stock or similar security, other than a preferred or guaranteed stock which is entitled to receive only a fixed or limited dividend; or any security convertible with or without consideration into such a security and any warrant or right to subscribe to or purchase such a security, or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate by rules and regulations to treat as an equity security"

Amend subsection (a) (13) to read

"(13) The term 'exempted security' or 'exempted securities' shall include securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, such securities issued or guaranteed by corporations in which the United States has a direct or indirect interest as shall be designated for exemption by the Secretary of the Treasury, securities which are direct obligations of or obligations guaranteed as to principal or interest by a State or any political subdivision thereof or any agency or instrumentality of a State or any political subdivision thereof, and such other securities and instruments as the Commission may by such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors, either unconditionally or upon specified terms and conditions or for stated periods exempt from the operation of any one or more of the provisions of this Act, which by their terms are inapplicable to an 'exempted security' or to 'exempted securities'"

Omit subsection (c) of section 3 in toto

Section 4 No change

Section 5 Amend section 5 so as to read

"SEC 5 (a) Any exchange may be registered as a national securities exchange by filing with the Commission an application in such form as the Commission may prescribe, containing all relevant information in regard to the history, organization, membership, and the rules and regulations of such exchange and a list of the securities in which dealings are permitted on such exchange

"(b) Unless such application shall be withdrawn by such exchange, the Commission shall within thirty days after the filing thereof or within such further period as may be agreed upon, either register such exchange as a national securities exchange hereunder if the Commission shall be satisfied that the rules and regulations of such exchange are adequate to insure fair dealing and to protect investors, or enter an order, after appropriate notice and opportunity for hearing, denying such registration and stating the reasons therefor Any order denying such registration may be reviewed as hereinafter provided in section 22 hereof

"(c) Any national securities exchange may by appropriate notice to the Commission withdraw its registration"

Amend section 6 so as to read

"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"

Amend section 7 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 borrow any money, the repayment of which is secured by the pledge or hypothecation of any security (other than an exempted security) registered on a national securities exchange, 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"

Section 8 (a) (1) No change

Amend section 8 (a) (2) to read as follows

"(2) To enter orders by prearrangement with any other person or persons, for the purchase and sale of any security at substantially the same time at substantially the same price for the purpose of creating a false or misleading appearance of the volume of trading in such security or of establishing price quotations therefor which do not truly reflect the market value of such security"

Amend section 8 (a) (3) to read as follows:

"(3) To effect, either alone or in conjunction with one or more other persons, a series of transactions for the purchase and sale of any security, for the purpose of creating a false or misleading appearance of the volume of trading in such security or of establishing price quotations therefor which do not truly reflect the market value of such security"

Amend section 8 (a) (4), (5), (6), and (7) to read as follows

"(4) To circulate or disseminate, with intent to deceive, any false or misleading information in regard to any security, for the purpose of inducing the purchase or sale of such security"

"(5) To pay or cause to be paid, in connection with any attempt to purchase or sell, at prices which do not truly reflect the market value, any security in which the person making such payment or causing the same to be made is directly or indirectly interested, any consideration to any person to circulate or disseminate, as news or disinterested opinion, any information intended or likely to induce the purchase or sale of such security at such prices, or to receive knowingly any consideration for such circulation or dissemination"

Amend section 8 (a) (8) to read as follows:

"(6) 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 for the purpose of pegging, fixing, or stabilizing the price of such security in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent unfair practices"

Section 8 (a) (9). Amend last six lines to read as follows

"Or if a member, directly, or indirectly, to endorse or guarantee in contravention of any such rules or regulations the performance of any put, call, straddle, option, or privilege in relation to any security registered on a national securities exchange The terms "put", "call", "straddle", "option", or "privilege" as used in this paragraph shall not include any warrant, right or convertible security registered on a national securities exchange"

Amend section 8 (b) so as to read:

"(b) Any person who willfully violates any provisions of subsection (a) of this section and any person who knowingly participates in any such violation shall be liable to any person who shall purchase or sell any security, the price of which was affected by such violation, and the person so injured may sue in law or in equity in any court of competent jurisdiction to recover the damages sustained as a result of such violation"

Section 8 (c) No change

Amend section 8 (d) to read as follows

"(d) No action shall be maintained to enforce any liability created under this section unless brought within 2 years after the violation upon which it is based."

Omit subsection 8 (e)

Section 9. Omit entire section The substance of subsections (a) and (b) will be included in section 16, formerly section 18

Amend section 10 to read as follows:

"SEC 9 (a) It shall be unlawful for an individual 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 ensure 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 without such privilege to act as a broker and as a dealer or for a member with such privilege who acts as a broker to act as a dealer 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 six months prior to such transaction or (2) unless, if the transaction is with a customer, he discloses to such customer in writing at or before the completion of the transaction whether he is acting as broker for such customer or is acting as a dealer for his own account or as broker for some other person"

Amend section 11 so as to read

"SEC 10 (a) It shall be unlawful for any person to effect any transaction on a national securities exchange in any security, other than an exempted security, unless a registration is effective as to such security in accordance with the provisions of this Act and the rules and regulations thereunder

(b) A security may be registered with a national securities exchange upon application by the issuer, by filing with such exchange and with the Commission——

(I) A listing application in such form as the exchange, with the approval or upon the order of the Commission, may require as necessary or appropriate for the protection of investors,

(II) Such information as to the issuer and affiliates as the exchange, with the approval or upon the order of the Commission, may require as necessary or appropriate for the protection of investors in respect of—

(1) The organization financial structure, nature, and operation of the business,

(2) The terms, position, rights, and privileges of the different classes of securities outstanding;

(3) Terms on which securities have been or are to be offered to the public,

(4) The names of directors, principal officers and underwriters and the remuneration paid or to be paid underwriters in connection with the issuance of the security to be registered and a statement of any contracts, other than contracts of employment, between directors or officers on the one hand and the issuer or its affiliates on the other,

(5) A statement of the terms and provisions of all bonus and profit-sharing plans and the aggregate amount of payments made thereunder during the last three fiscal years of the issuer,

(6) Options in respect of securities existing or to be created,

(7) Balance sheets for the three preceding fiscal years or for such portion of that period as the issuer shall have been in existence, certified, if required by the exchange or by order of the Commission, by independent public accountants If the balance sheets for preceding fiscal years have not been certified by independent public accountants, only the balance sheet for the last preceding fiscal year shall be so certified;

(8) Profit and loss statements for the three preceding fiscal years or for such portion of that period as the issuer shall have been in existence, certified, if required by the exchange or by order of the Commission, by independent public accountants If the profit and loss statements for preceding fiscal years have not been certified by independent public accountants, only the statement for the last preceding fiscal year shall be so certified;

(9) Any further financial statements which the exchange, with the approval or upon the order of the Commission, may deem necessary or appropriate for the protection of investors.

(III) Copies of articles of incorporation, bylaws, trust indentures, or corresponding documents, whatever the names, underwriting arrangements, and other documents of the issuer and affiliates which the exchange, with the approval or upon the order of the Commission, may require as necessary or appropriate for the protection of investors

(c) If the exchange shall determine that any report or reports required under subsection (b) are inapplicable to any specified issuer or class of issuers or unnecessary for the protection of investors, it may require, in lieu thereof, the submission of such reports, if any, as it may deem appropriate The exchange may receive and act upon listing applications, subject to the right of the Commission to enter an order requiring such additional statement or information from the issuer as the Commissioner shall determine is necessary or appropriate for the protection of investors

(d) If the exchange shall certify to the Commission that the security has been approved for listing, the registration shall become effective upon the filing with the Commission of such certification The Commission may, however, suspend dealing in such security or after appropriate notice and opportunity for hearing, enter an order revoking the registration thereof if it shall determine that such security is not suitable for registration, or if the issuer shall have failed to comply with the registration requirements of this Act Securities representing an interest in registered securities or growing out of registered securities may be listed by an exchange or admitted to dealing in advance of registration upon request in writing from the issuer accompanied by assurance that a listing application in form required by the exchange will be made within a reasonable time

(e) Notwithstanding the foregoing provisions of this section, all securities listed on a national securities exchange at the time the registration of such exchange as a national securities exchange becomes effective shall be considered securities "registered on a national securities exchange" within the meaning of all the sections of this Act, and all securities admitted to dealing on such national securities exchange prior to April 1, 1934, shall be considered securities "registered on a national securities exchange" within the meaning of all the sections of this Act, other than sections 10 and 11 The Commission may, however, require any national securities exchange to suspend dealing in any such security or securities, or may, after appropriate notice and opportunity for hearing, enter an order requiring any national securities exchange to remove the same from the list of securities listed or admitted to dealing thereon whenever it shall determine that such action is necessary or appropriate for the protection of investors

"(f) The Commission is directed to make a study of trading in unlisted securities upon exchanges and to report the results of its study and its recommendations to Congress on or before January 3, 1935 If the Commission deems such action necessary or appropriate for the protection of investors it

may by rules and regulations prescribe the terms and conditions on which a national securities exchange may admit to dealing unlisted securities. An unlisted security admitted to dealing pursuant to any such rules and regulations shall be considered a security registered on a national securities exchange within the meaning of all the sections of this Act, other than sections 10 and 11

"(g) Any national securities exchange may, and upon the order of the Commission shall, suspend dealing in or, after appropriate notice and opportunity for hearing, remove from the list of securities dealt in thereon, any registered security or any security admitted to dealing thereon"

Amend section 12 to read as follows

"SEC 11 (a) Any national securities exchange may require the issuer of a security registered thereon to file with the exchange, in such form and detail and at such times as may be prescribed by such exchange, with the approval or upon the order of the Commission:

"(1) Such information and documents as may be required to keep reasonably current the information filed pursuant to section 10,

"(2) Such annual reports, certified if required by the exchange or the Commission by independent public accountants, and such quarterly or other reports as may be necessary or appropriate for the protection of investors, and

"(3) Such separate and/or consolidated balance sheets or income accounts as shall be necessary to truly reflect the financial condition of the issuer

"(b) The methods to be followed in the preparation of accounts and financial statements to be filed pursuant to this section and sec 11 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 shall be in accordance with any principles of accounting which are generally accepted as proper by the accounting profession at the time of the preparation of such accounts or financial statements, and each issuer shall adopt and make binding upon its officers and employees the accounting and reporting methods to be employed by it in the preparation of its accounts and financial statements If any change is made in such methods the first accounts presented thereafter shall contain a statement of the nature of such change

"(c) If the issuer of any security registered on a national securities exchange fails to file information, documents, or reports as required by this section such exchange may, and upon the order of the Commission shall, after notice and opportunity for hearing, remove the securities of such issuer from the list of securities admitted to dealing on such exchange"

SEC 13 This section should be omitted It has no proper place in a stock exchange regulatory bill However, if it is decided that some provision with regard to the solicitation of proxies is necessary, we believe the section should be amended so as to read·

"SEC 12 (a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of any national securities exchange or otherwise to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered on any national securities exchange in contravention of such rules and regulations as the Commission may adopt for the protection of investors

"(b) It shall be unlawful for any member of a national securities exchange or any broker or dealer who transacts a business in securities through the medium of any such member to give a proxy, consent, or authorization in respect of any security registered on a national securities exchange and carried for the account of a customer in contravention of such rules and regulations as the Commission may adopt for the protection of investors."

Section 14 We believe this section will, as a practical matter, be unenforceable In any event, it should be restricted so as not to apply to commercial paper, or to bankers' acceptances, or commercial bills, although of a longer maturity than nine months, and other similar obligations incident to commercial or industrial activities, all of which are included in the very sweeping definition of the term "security", contained in section 3 (11) The number should be changed to section 13

Section 15· Subject to reservations contained in comment below No change except to amend section number to read "SEC 14" and to add the following·

"(d) The provisions of this section shall not apply to foreign or domestic arbitrage transactions unless made in contravention of such rules and regula-

tions as the Commission may adopt in order to carry out the purposes of this section."

Section 16. Omit entire section

The substance of this section will be included in section 16 formerly section 18

Amend section 17 so as to read:

"SEC 15 (a) Any person, including any director, officer, accountant, or other expert, who, with intent to deceive, shall make or be responsible for the making of any statement in any application, report, or document filed pursuant to this Act or any rule or regulation thereunder, which statement is false or misleading in respect of any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who shall have suffered loss by reason of having purchased or sold a security in reliance on such statement and the person so injured may sue in law or in equity in any court of competent jurisdiction for the damages caused by such false or misleading statement

"(b) (No change.)

"(c) No action shall be maintained to enforce any liability created under this section unless brought within two years after the violation upon which it is based"

Section 18 Subsections (1), (2), (3), and (4) no change, except to renumber section as "SEC 16"

Amend subsection (5) to read as follows

"(5) If after appropriate request in writing to a national securities exchange that such exchange effect on its own behalf specified changes in its rules and practices, and after appropriate notice and opportunity for hearing, the Commission determine 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, and to this end the Commission may require any national securities exchange to adopt rules and regulations with respect to:

"(*a*) Market letters, advertising, or other publicity 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 exchange,

"(*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 reports to be filed by the members of such 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"

Section 19 Subject to the reservation contained in comment below No change except to amend section number to read section 17

Section 20 No change except to amend section number to read section 18

Section 21 No change except to amend section number to read section 19

Section 22 No change except to amend section number to read section 20

Section 23 Subject to the reservation contained in comment below No change except to amend section number to read section 21

Section 24 Amend section number and first two sentences of (a) as follows:

SEC 22 (a) Any person aggrieved by an order issued by the Commission in a proceeding under this Act to which such person is a party and any person aggrieved by any rules or regulations of general application made effective as prescribed in section 20 may obtain a review of such order or of such rules and regulations in the Circuit Court of Appeals of the United States, within any circuit in which such person resides or has his principal place of business, or in the Court of Appeals of the District of Columbia, by filing in such court, within sixty days after the entry of such order, a written petition praying that such order or such rules and regulations of the Commission may be modified or set aside in whole or in part A copy of such petition shall be forthwith served upon the Commission and thereupon the Commission shall certify and file in the court a transcript of the record upon which such order was entered or such rules and regulations were adopted"

Section 25 Amend to read as follows

"SEC 23 Any person who with intent to deceive makes any false or misleading statement as to a material fact in any application, report, or document required to be filed under this act, or any rule or regulation adopted by the Commission thereunder, and any person, including a director, officer, or accountant, who willfully and knowingly is responsible for the making of any such statement, and any person who willfully violates any provision of section 8 (a), subsections (1) to (5), inclusive, shall upon conviction be fined not more than $———, or imprisoned not more than ——— years, or both, except that when such person is an exchange a fine not exceeding $——— may be imposed"

The penalties provided by the bill are manifestly excessive and should be made more reasonable

Section 26, section 27, section 28, and section 29 No change except to amend section numbers to read, respectively, section 24, section 25, section 26, and section 27

Section 30 Omit section entirely

Section 31 No change except to amend section number to read "SEC 28"

Section 32· Amend section number to read section 29 No other amendment is suggested although we believe that the commission or authority charged with the regulation of stock exchanges should be a separate body having no other function and composed at least in part of persons who are thoroughly familiar with the operation of stock exchanges and the security business

Section 33 No change except to amend section number to read section 30

Section 34· Amend section number to read section 31 The effective dates proposed by the act should be extended This is essential unless the amendments we propose in regard to sections 11 and 12 are adopted It will be practically impossible for the nearly 900 corporations listed on the New York Stock Exchange to prepare and file registration statements prior to August 1, 1934

A number of sections deal with subjects which do not directly affect the work of stock exchanges We have refrained from making any comment on such sections, but this fact must not be considered as indicating approval by stock exchanges of the substance of these sections This is particularly true of section 15, insofar as it deals with the liability of principal stockholders, of section 19, which deals with the liability of controlling persons, and of section 23, which deals with the public character of information The first two of these sections will impose liability upon persons merely because they are the owners of property and will almost certainly interfere with the free flow of capital into industry. The last will require corporations whose securities are dealt in on exchanges to disclose highly confidential information which will be of value only to competitors both foreign and domestic

ADDENDUM

The following is an addendum suggested to the proposed amendments by counsel for the San Francisco exchanges which is designed to make provision for banks which are members of exchanges The suggested addendum meets with the approval of all exchanges.

Add to paragraph 3 (a) 3 at beginning, "subject to paragraph 7"

Amend section 3 (a) (7) to read

"(7) The term 'broker' or 'dealer' shall not include a bank, except as hereinafter set forth, or any person insofar as he buys or sells securities for his own account and not as a part of a regular business; the term 'member' shall include a bank member of a national securities exchange, but only to the extent that it shall act as broker or dealer"

(The following is a telegram received by the chairman and submitted for the record:)

NEW YORK, N Y, *March 23, 1934.*

HON DUNCAN U FLETCHER,
Chairman Senate Committee on Banking and Currency,
Senate Office Building, Washington, D C.:

The new bill for the regulation of stock exchanges, introduced by Mr. Rayburn (H R 8720) on March 19 is a substantial improvement over the original bill (H R 7852)

The investment house group, of which the undersigned is chairman, being concerned primarily with the maintenance of the existing broker-dealer organization has directed its efforts mainly toward improving the broker-dealer provisions of the proposed stock-exchange legislation The original bill, by its drastic segregation clauses would have largely destroyed the long-established broker-dealer organization in the United States The new bill permits the continuation of this organization, and its provisions, relating to the broker-dealer, with some changes in phraseology designed primarily to clarify what seems to be their intent, would be satisfactory to this group

The amendment of section 10, suggested by Mr Richard Whitney on March 22, insofar as it relates to the broker-dealer, with some adjustment of phraseology, would also be satisfactory This group has not concerned itself with section 10 as it relates to floor traders, specialists, and odd-lot dealers

It seems to us unwise to make rigid margin requirements and certain other matters by statute, except to such extent as may be necessary to remedy existing evils which are to be prohibited by law

The margin requirements of the new bill while apparently better and more elastic than in the original bill have elements of inflexibility which are unavoidable if the margin requirements are to be embedded in statutory law. Furthermore, it is feared that these complicated requirements will prove impracticable in operation

We are, therefore, in accord with the viewpoint of Mr Whitney's statement of March 22 that margin requirements would be more wisely left to the Federal Reserve Board This course would provide the requisite flexibility and would insure that this margin problem, which is of great importance to our national economy and to the recovery program, would be dealt with by governmental authority in harmony with the broad banking and monetary policies of the country and without the embarrassment of the rigidity and inflexibility inherent in the fixation of margins by statute

Certain of the provisions of the new bill, very unwisely it seems to us, become effective on July 1 or August 1, 1934 This has an important bearing on section 14, which throws the whole over-the-counter market into the control of the Federal Trade Commission. The Commission may feel compelled to establish rules for the regulation of this large and important market for a huge mass of outstanding securities by August 1 of this year. It will be impossible properly to prepare these rules within so short a space of time The uncertainty as to what regulation may be established makes for unsatisfactory market conditions which would largely deprive holders of unlisted securities of their market, for people will not readily buy unlisted securities when the future market for these securities is clouded with uncertainty This uncertainty will in itself tend to occasion the liquidation of unlisted securities while a free over-the-counter market still exists It would seem wiser to postpone legislation as to the over-the-counter market until regulation can be considered in the light of operation under the new investment banking code which is about to be put into effect

Trowbridge Callaway, chairman of investment-house group consisting of the following: Chas D. Barney & Co, Callaway, Fish & Co Cassatt & Co, Clarke, Dodge & Co., Field, Glore & Co., Hallgarten & Co, Hemphill, Noyes & Co., A Iselin & Co, Kidder, Peabody & Co, Ladenburg Thalmann & Co, Laurence M. Marks & Co, G M P Murphy & Co, Riter & Co, L F Rothschild & Co, Edward B Smith & Co, Spencer, Trask & Co, Tucker, Anthony & Co, White, Weld & Co.

STOCK-EXCHANGE PRACTICES

MONDAY, APRIL 2, 1934

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

The committee met in executive session at 10:30 a.m., pursuant to adjournment on Thursday, March 29, 1934, in room 301 of the Senate Office Building, Senator Duncan U. Fletcher presiding.

Present: Senators Fletcher (chairman), Barkley, Costigan, Reynolds, McAdoo, Adams, Townsend, Walcott, Carey, Steiwer, and Kean.

Present also: Ferdinand Pecora, counsel to the committee; Julius Silver and David Saperstein, associate counsel to the committee; and Frank J. Meehan, chief statistician to the committee.

The CHAIRMAN. The committee will come to order, please. This is a resumption of our executive-session hearings, and we have asked Judge Healy, chief counsel of the Federal Trade Commission, to come down this morning to give his views about certain phases of H.R. 8720.

Judge Healy, will you give your name, connection with the Government, and residence?

Mr. HEALY. My name is Robert E. Healy I am chief counsel of the Federal Trade Commission.

STATEMENT OF HON. ROBERT E. HEALY, CHIEF COUNSEL OF THE FEDERAL TRADE COMMISSION, WASHINGTON, D.C.

The CHAIRMAN Judge Healy, how long have you held that position?

Mr. HEALY. I came to the Federal Trade Commission in February of 1928.

The CHAIRMAN. Judge Healy, as chief counsel of the Federal Trade Commission have you had to do a good deal with the handling of securities, accounting, and that sort of thing, particularly I might say with reference to sections 12 and 12 (b) of this bill?

Mr. HEALY. Yes; but I think I ought to say——

The CHAIRMAN (continuing). Your experience has been in connection with that sort of question, I suppose?

Mr. HEALY. I think I ought to say that since the Securities Act of 1933 was passed I have had very little to do with the administration of that act. But I have had charge of the public hearings on S.Res. 83, the resolution which authorized the investigation of utility companies and holding companies; and in connection with that investigation I have seen a great deal of the accounting methods of cor-

porations by which asset statements, income statements, and surplus statements are built up.

I do not pretend to be an expert about stock-exchange procedure. or even about accounting, but I have seen some things about accounting methods of various corporations which seem to me to support certain provisions of this bill.

Senator ADAMS Referring to your expression about accounting methods and how assets are "built up", that is quite an accurate statement, is it, Judge Healy?

Mr. HEALY. Yes, sir; that is also true of surplus statements and income statements of corporations. I do not know, Mr Chairman, how much the committee wants to hear from me, but I will go along and if you are not interested in something I say, if you will just tell me I will stop

The CHAIRMAN That is all right You may proceed with your statement.

Mr. HEALY. One of the most striking things we have come across in our utilities investigation, so far as it relates to market operations, was in the case of the Cities Service Co. The Cities Service Securities Co. staged a campaign for the selling of common stock of the Cities Service Co., and the securities company made contracts with various dealers, with distributors throughout the country, and it also made many of its own employees distributing agents, or salesmen. For example, there were 399 employees of the Cities Service Refining Co., including oil-station attendants, and so forth, in Massachusetts alone who were licensed to sell securities They had literally hundreds, perhaps thousands, of them all over the United States.

These salesmen or distributors sold the stock of the Cities Service Co by going into people's homes and into offices all around the country. The arrangement was that if a commission man sold the stock to an investor who resold his stock within a certain period of time the commission agent lost his commission. They were encouraged by means of literature put out by the company and by contract provisions not to sell in large lots but in small lots, and that is why we have been getting letters from people who write in pencil and who misspell words, people who bought 10 or 15 or 20 shares, and some of them put all the money they had into that stock because these salesmen and distributors solicited them. For instance, if a man anticipated his installment payments he could not get delivery of his stock until the time provided, the 10 months' period, was up So that I think our record indicates that every effort was made to keep the stock off the market.

Senator ADAMS In connection with that, Judge Healy, did you include within your investigations their campaign for selling stock to employees of the Cities Service Co. and its various subsidiaries?

Mr. HEALY. Just far enough to learn, as I believe the evidence showed, that the stock was peddled around by employees But you are talking about sales to employees, I believe?

Senator ADAMS. Yes.

Mr. HEALY. Yes. There is no doubt that employees were expected to invest a part of their earnings in Cities Service Co. securities We have had information to that effect. But one of the effects of this particular manner of selling securities, with this provision about com-

missions and the fact that purchasers could not get delivery of their stock until the time was up, and so forth, was to keep the stock off the market.

Now, at the same time that this was going on we should remember that the contracts provided that sales should be made at the preceding day's closing price on the New York Curb. Now, how was the price on the Curb made? I have told you of the methods employed by which the agents kept the stock from coming onto the market, or restricting it as much as possible from coming onto the market; and yet at the same time the Cities Service Securities Co. was buying immense quantities of stock on the market—yes; immense quantities of the stock, and I will give you those figures in just a minute. Now, in some years, or in some months, purchases by the Cities Service on the Curb accounted for over 95 percent of all the stock bought on the Curb. And for the stock-selling campaign period, I believe 3 years and 8 months, those purchases accounted for over 73 percent of all purchases made of the stock on the Curb. Therefore the law of supply and demand was not operating naturally in that stock. They were keeping the shares off the market on the one hand, and on the other hand they were making the demand for the stock, with the result that the stock had the appearance of great activity. And one of the very striking things about the campaign was that the money the people paid in on those various contracts was the very money which was used to make the market at which they bought their securities.

Senator ADAMS. How much did the Cities Service Co in the aggregate put into the market?

Mr. HEALY. Let me give you another figure first, and then I will give you that figure.

Senator ADAMS. All right.

Mr. HEALY. In the period from April 1, 1927, to the last day of December 1930 a subsidiary of the Cities Service Co., a wholly controlled subsidiary, known as the "Cities Service Securities Co.", which carried on those operations, took in from the people of this country $1,146,518,000, and something over.

Senator COSTIGAN. Quite a staggering figure in one stock.

Mr. HEALY Yes. Now, how much of that did they spend, and what did they do with it? In the first place, they spent $965,000,000 in market purchases of the stock. And that answers your question, Senator Adams. In addition, they paid out over $32,000,000 for the cost of shares issued in the exercise of warrants, including premiums that they paid in buying warrant-bearing debentures, warrants entitling the holder to subscribe to common stock at stated prices.

Now, these big figures I have given of the amount of money that they took in, of more than a billion of dollars, do not include anything for the money that they took in in selling debentures to other people. I allude to convertible debentures from the sale of which they took in many millions of dollars.

Senator KEAN. The result of that was that they sold to the public the stock and then bought it back from them; is that true?

Mr. HEALY. No, sir; I do not think so.

Senator KEAN. Well, then, what was it?

The CHAIRMAN. What was the reason that prompted them to go and sell to the public stock of an amount exceeding a billion dollars and then to buy their own stock to the extent of $965,000,000?

Mr. HEALY. The stock they were selling was being sold to individuals around in the cities and the country districts.

The CHAIRMAN. At what price?

Mr. HEALY. Oh, at prices that got to be as high as $60 and $65 a share.

Senator KEAN. What was the Curb market?

Mr. HEALY. Approximately that amount at the time when the sales were made and when the Cities Service Securities Co. helped to make the Curb market.

Senator KEAN. What I am getting at is this: They sold stock to the public exceeding a billion dollars, and then they bought back stock from the public at practically the same price, aggregating something like $965,000,000.

Mr. HEALY. No, sir. But the effect of their market purchases was to help to make the price at which they were selling the stock to the public. And you have not allowed me to finish my story.

Senator KEAN. All right. Go ahead.

Mr. HEALY. I was trying to tell you what they did with the $1,146,518,000. They took $965,000,000 and put it into market purchases, but that was not a buying back of the stock from the same people it was sold to. A lot of those people, out in the sticks, that bought this stock to the extent of more than a billion dollars still have it. The deal as planned, the whole plan, worked out in such a way that they restricted the amount of shares coming onto the market, and then they created a great big demand by buying this vast quantity of shares themselves.

Senator BARKLEY. But didn't they sell a lot of that stock by peddling it around, door-to-door, on the installment plan, and requiring the buyer to agree not to put it on the market for sale for a certain period of time?

Mr. HEALY. Yes, sir.

Senator BARKLEY. So that the stock could not be dumped back on the market after it had been purchased by the public.

Mr. HEALY. That is right. And if a fellow who purchased the stock resold it within a certain period of time the salesman was penalized by having to forfeit his commission.

Senator BARKLEY. I know that one of the salesmen came into my office in spite of the rule here against peddling in this building, and sold some of the stock to one of the young ladies in my office, on the installment plan, and she hasn't finished paying for it yet.

Mr. HEALY. Oh, yes. Now let me give you the next item, showing what they did with the $1,146,518,000 that they took in.

Senator BARKLEY. Excuse me right there for one minute.

Mr. HEALY. Certainly.

Senator BARKLEY. And this young lady——

Senator KEAN (interposing). Of course if the people had been a little market-wise they could have sold that stock short, couldn't they?

Senator BARKLEY. Well, if they had sold it short, they would have had to deliver the stock. They could not receive the stock until they finished paying for it, and how would they have delivered the stock in case of a short sale?

Mr. HEALY. That is it.

Senator CAREY. As I recall the situation at that time a great many people bought the stock on the installment plan and had to wait to get the stock, like the young lady in your office.

Senator BARKLEY. Oh, yes.

Mr. HEALY. Well, gentlemen, if you could see the letters that come in to us you would find an indication that they sold a great deal of the stock to illiterate people, to people who knew nothing about the market for securities. The local representatives of the Cities Service Securities Co. talked those people into buying the stock. And those representatives were expected to do it, were urged to do it.

The CHAIRMAN. What did those local representatives get for selling the stock?

Mr. HEALY. They got commissions, but I do not recall the amount.

The CHAIRMAN. All right.

Mr. HEALY. Now, the next item that I have referred to in telling you what they did with the $1,146,518,000, shows that they paid $20,500,000 of it to Henry L. Doherty to buy shares he had. When that campaign had reached a certain point they took the opportunity to market some of Mr. Doherty's shares Now, on those sales Mr. Doherty made a profit of $17,700,000. They paid $2,800,000 to a company known as the "Gas Securities Co", which was wholly owned by Mr. Doherty, on which transaction that company made a profit of about $2,000,000. So that Mr Doherty's personal profit exceeded $19,000,000.

Now, this may not be quite in point but you may be interested to know that after they did that he caused the Cities Service Co., or at least somebody caused the Cities Service Co. to create a new class of stock, of 1,000,000 shares of $1 a share; each share having full voting rights, and he bought back, or rather he bought those 1,000,000 shares, with the result that after he had sold certain of his shares and made profits of more than $19,000,000, he ended up with a bigger percentage of control of the Cities Service Co. than he had before he made the profit.

Now, in fairness to Mr. Doherty I must say that the whole arrangement was described in circulars and proxies sent out to the stockholders, and the stockholders voted the creation of that new class of stock. But they were not told anything about Mr. Doherty's selling of his own securities.

Now, I do not want to take up too much of your time in accounting for this sum of $1,146,518,000 that they took in. There were certain shares purchased from Harris-Forbes & Co., and Halsey, Stuart & Co. There was a cancelation of employees' subscriptions, and there were expenses and losses to the Cities Service Securities Co. in their market operations of more than $14,000,000. But, the Cities Service Co. itself received as new capital through the issuance of original shares that were fed into the market in this connection only about $77,000,000.

Looking at it from the point of view of whether this method of obtaining capital is economic and well advised, it is interesting to note that the average yield per share to the Cities Service Co. from the stock it put out during this period was something less than $25 a share. But many people paid much more than that.

Senator ADAMS. What is the present market for the Cities Service stock?

Mr. HEALY. The last time I noticed it the price was around $2 a share. And it has been lower than that. If some of those folks had purchased those securities direct from the company when this elaborate work was carried out on the New York Curb, the Cities Service Co. itself would have realized more capital and the purchasers would have had a very much smaller loss.

The CHAIRMAN. Under the laws of what State was the Cities Service Co. incorporated?

Mr. HEALY. I don't remember.

Senator KEAN In Delaware, I think

Mr. HEALY The point I would make in connection with this matter is that this bill now being considered by your committee I believe should be drawn and I think is drawn so that activities of this character on exchanges, the making of prices by this sort of process, would be ended.

Senator KEAN. I think that is right.

Mr. HEALY. I am informed that the Cities Service Co is a Delaware corporation.

The CHAIRMAN. All right.

Mr. HEALY. Now, I have here a mimeographed copy of the summary that accompanied our examiner's report when it was presented for our public utilities record, and I would be very glad to leave copies here if you would like to read it.

Senator ADAMS. I should like to have a copy of it.

Senator KEAN. And I would like to have one.

Senator MCADOO. Please give me one, if you will.

The CHAIRMAN. Let it go into and be made a part of our record.

(A paper entitled "Summary of the Report of the Federal Trade Commission Examiner, placed in the record of the Commission's investigation of power and gas utilities, Tuesday, Apr. 25, 1933," will be found at the end of the day's proceedings)

The CHAIRMAN. You may proceed with your statement, Judge Healy.

Mr. HEALY. The complete report, that is, Dr. Mitchell's report, and my examination of him, in which I tried to demonstrate, through him, what the report meant, has been printed in Senate Document No. 92, part 53, which is your print of our utilities investigation That report goes into the matter in a much more detailed manner than does this mimeographed statement, which is merely a summary.

The CHAIRMAN. You referred to Senate Document No 92?

Mr. HEALY. Yes.

Senator ADAMS. Is there contained in that report a copy of the contract with the employees who bought Cities Service Co stock?

Mr. HEALY. I do not remember.

Senator ADAMS. You see, an employee bought under a 5-year contract which tied up his stock for that length of time.

Mr. HEALY. Of course, the striking thing about it from my point of view is that those large dealings by the Cities Service Securities Co. on the market made the price, or at least helped to make the price, at which the stock was being sold to the public throughout the country.

Now, there is one other phase of this matter which I should like to talk about——

Senator KEAN (interposing). This was over what period of time?

Mr. HEALY. This period of time ran from the first of April 1927 to the last day of December of 1930, 3 years and 8 months if I have figured it correctly.

Senator KEAN. Because during that time the people were a little crazy.

Mr. HEALY. Yes. Of course, we cannot ascribe all of the rise in Cities Service Co stock to this activity. I presume the activity in the stock attracted speculators and also aroused the cupidity of many people. It may be that this campaign was calculated to do that.

Mr. PECORA. Judge Healy, did you come across any evidence as to the issuance of new securities by the Cities Service Co, not for the purpose of utilizing the proceeds in the business but to take advantage of high rates offered for the use of money in the call-loan market?

MI. HEALY. I cannot say that I did, Mr. Pecora.

Mr. PECORA. There was some reference to that made recently before this committee by an officer of the Cities Service Co., whom you will recall, Mr. Chairman, was subpenaed by us and who appeared here about a month or a month and a half ago.

The CHAIRMAN. Yes.

Mr. PECORA. That the Cities Service Co. made very extensive loans during the year 1929 in the call-money market of New York, and that they got the money from the sale of securities.

Mr HEALY. We have in process of preparation a detailed report on the Cities Service Co., which will be presented the latter part of this month, and in which we expect to analyze their fixed capital account, their earnings statements, and their surplus statements.

Mr PECORA. I will say while on the subject that when I first became counsel to the committee, a year ago in January, the very first inquiry I intended to make was into the operations of the Cities Service Co. Senator Norbeck, who then was chairman of the committee, entirely agreed to that; in fact, he was one of the gentlemen who originally suggested it to me. And I had just barely got started on it when it seemed quite apparent to everybody that an inquiry into the Cities Service Co. at that particular time might be attended with very, very serious consequences in the tottering stage of the economic structure, in January and February of 1933, and for that reason we withheld our comments. And I haven't really had the time to get back to it since.

The CHAIRMAN. Also it was along about that time understood that the Federal Trade Commission was making an investigation of the matter.

Mr. PECORA. Yes; that is true, too.

Mr. HEALY. Of course, gentlemen of the committee, I can only refer to just a few high spots of this situation There is much more of value in our record than I have the time to tell you about.

The CHAIRMAN Just go ahead with your statement, Judge Healy

Mr. HEALY. Now, I should next like to say that it is our observation, as a result of our work in these utilities investigations, that a balance sheet or an income statement of a corporation may be a very misleading thing; if not misleading intentionally it is at least not a proper disclosure. It often fails to show things that ought

to be shown. So that I very earnestly urge upon you gentlemen of the committee this point, that if you are going to enact such a bill as this, and if you are going to give the Federal Trade Commission jurisdiction, and if you are going to require a corporation whose securities are registered to make reports, then by all means give the Commission sufficient authority to the end that we may get reports that will really disclose the facts.

As proof of why you cannot depend entirely upon a balance-sheet statement I should like to tell you that in our investigation we have found a great many of these so-called "write-ups" of investments and in fixed capital accounts. It is not always done in as simple a form as that which I will try to describe for you, but in its simplest form it means that a corporation strikes out from its books the cost at which a particular security or property has been recorded and substitutes somebody's idea of value, which is always, or nearly always, far in excess of the book figures We have found up to date, according to the last compilation I saw, over $1,150,000,000 of write-ups.

Senator McADOO. Did you say $1,550,000,000?

Mr. HEALY. No; I said $1,150,000,000.

Senator McADOO. Well, that is a pretty big sum

Mr. HEALY. I should like to refer to a few specific instances I do not want to burden you by too much detail, but one of the most striking instances was in the case of the Appalachian Electric Power Co That was a subsidiary of the American Gas & Electric Co., and it operates in Virginia and West Virginia. The American Gas & Electric Power Co. at $139,000,000, or a write-up of $66,000,000, Appalachian Electric Power Co was organized by the American Gas & Electric Co. in March of 1926 Now, all of the constituent companies making up the Appalachian Electric Power Co were owned by the American Gas & Electric Co. at the time of their consolidation. A dummy intermediary was used. The American Gas & Electric Co. sold the properties to that dummy, or the securities were sold to him, and he sold them to the Appalachian Electric Power Co., the newly formed company.

Now, those properties had had a book value on the books of constituent companies of $72,621,000, but they were recorded on the books in the fixed capital account of the newly formed Appalachian Electric Power Co. at $139,000,000, or a write-up of $66,000,000, which did not represent a single additional dollar of investment by anybody in the Appalachian Electric Power Co. I inquired of one of their officials about it, and it appeared that a man rode over the property, and I don't know how long he took, but not very long, and he made some figures on the back of an envelop that expressed his idea of the value of the property being put together. It was never approved by any public service commission nor submitted to any public authority, but it was used to mark up the fixed capital account of those companies $66,000,000.

Now, the American Gas & Electric Co. in that process got all the common stock of the Appalachian Electric Power Co., and according to a computation made by our man, they owned that stock at $5,000,000 less than nothing. In other words, through the manner in which it was handled they got all the common stock plus a profit

of $5,000,000. According to their claims the common stock cost them about $2,000,000, or possibly $3,000,000, and the par value of the stock was $50,000,000.

Now, we have numerous items of that character

Senator KEAN. Now, in that case suppose they had written it down, would you have objected?

Mr. HEALY. My information is that conservative accountants, conservative business men regard a writing down as necessary and proper sometimes, but there doesn't seem to be very much support for writing up, especially when the write-up is carried over into a stated value of nonpar stock or in par value of par stock, or to create surplus accounts, or depreciation reserves, or other reserves, which under such circumstances are nothing but bookkeeping entries. What we want to say is that the actual cost of that company's capital was $66,000,000 less than those figures indicate.

That sort of thing is not confined to the Appalachian Electric Power Co.

Mr. PECORA. I think in the case of the Insull corporate structure it was shown where investment trusts and holding companies that were units of the Insull scheme, issued securities and transferred or sold them to one another at an inflated valuation, which created large paper profits on the books of the companies that issued and sold those securities to other units of the Insull system On the statements or balance sheets they were able to so reflect those large profits that they sold to the public millions of dollars of other securities, consisting principally of debentures, which speedily became worthless. That was another scheme of corporate financing that we were able to bring to the attention of this committee last year.

Mr HEALY. We saw an instance in the case of one of the Insull companies, the name of which escapes me for the moment but it was an operating subsidiary, which had an operating deficit. It had some securities in its treasury which it sold to another Insull company, and the second Insull company paid for those securities in its own stock. The first company took the stock of the second company onto its books at the par value thereof and that par value was large enough to wipe out the operating deficit and to create a surplus of about $700,000. Our records show instances in the Insull outfit where stock dividends were kited as people kite checks, where a company paid a stock dividend to a second company, which took it on into surplus, and paid a stock dividend, charged against surplus, back to the first one

Now, as to earnings statements which do not disclose the source of the earnings and do not give the Commission an opportunity to learn whether the earnings statements submitted are built up in such a fashion, or whether the fixed capital accounts are built up in such a fashion, if we do not have the proper authority the Commission will not accomplish what ought to be expected of it under this bill.

Senator STEIWER. Are you going to suggest an amendment?

Mr. HEALY. No; that is merely suggested to you as an important matter It seems to me that the authority will be given if the bill is passed in its present form

Senator STEIWER. You are, then, speaking in behalf of the bill as it is before us now?

Mr. HEALY. Yes, sir.

Senator ADAMS. What section or sections of the bill contain that authority?

Mr. HEALY I think sections 11 and 12 of the bill.

Mr. PECORA. That is page 35 of the bill H.R. 8720. In other words, you advocate that these corporations be required to file statements that not only tell the truth, but the whole truth.

Mr. HEALY. That is exactly it.

Senator CAREY. I presume the Commission would set up a form that they would have to follow.

Mr. PECORA. The Commission is empowered to do it under section 12 (b).

Senator STEIWER. In your opinion, Judge Healy, would there be any advantage in requiring two reports, that is to say, reports in two forms, one for the information of the Commission, and the other a simplified form to be published for the information of the public? Would there be any advantage in that?

Mr. HEALY. I would think there would be much advantage in this, in having the detailed statement, attaching to it a simple summary which should be informative. There would not necessarily have to be two separate statements.

Senator STEIWER. Is it not true that many of the corporate returns have been so complicated and difficult that the average layman would get no meaning out of them at all?

Mr. HEALY. Yes, sir; I can agree to that immediately.

Senator STEIWER. Can the Commission devise a way to obviate that, and to bring about a system of simplified reports from which the average business man would get at least some meager information?

Mr. HEALY. I should think that would be very desirable.

Senator ADAMS It is not merely the average layman that could not get anything out of it, but the expert could not get anything out of a good many of these balance sheets.

Mr. HEALY. I give you my word that in interpreting these accounting examinations that the expert accountants of the Commission turn in to me, I have sweat blood trying to understand some of them. Before I get through, if you want to hear it, I am going to show you some things connected with the Associated Gas & Electric Co. that I think will disclose the complicated nature of many of these transactions. A lot of it grows out of the fact that these groups can create corporations almost at will, and use them almost as they please. They have artificial beings that they create, that they can buy things from and sell things to, and by the time they get through I do not believe the men who started it can unravel it themselves. Take the Insull instance I do not believe that the human being has ever lived that could know enough to run that whole Insull outfit. To adopt an expression of Mr. Richberg's, it would require "double Napoleons."

Mr. PECORA. Mr. Owen D. Young testified before this committee a year ago about the Insull structure, that he was absolutely helpless in contemplation of it, to try to understand it; that it was a veritable labyrinth.

Senator ADAMS. I think we had one gentleman before the committee for a very few moments one day who said he was a director of some 300 companies.

Mr. PECORA. He said they had simplified the Associated Gas & Electric organization by reducing its units to some two hundred odd. That was the simplification.

Mr. HEALY. I think the Associated structure is extremely complex, and the dealings inside the system have been very complex.

Senator MCADOO. Referring to the very pertinent questions asked by Senator Steiwer and Senator Adams a moment ago, about this simplified statement, I think if we are going to give the investor any protection at all, there must be adequate provision in this bill to require some such simplified statement that will give the ordinary layman some sort of comprehension of the game he is getting into. You think sections 11 and 12 are sufficient for that purpose?

Mr. HEALY. It strikes me so, Senator. I confess that I had not thought particularly about this very point.

Senator MCADOO. I wish you would give some thought to that, because I realize that it is imperative. Take the ordinary layman who wants to buy stock or make an investment in any one of these corporations. I know that I, myself, am incapable of following these structures. I have tried to at times, and while I do not pretend to have any more intelligence than anybody else, I refer to it simply as showing that even where a man has been accustomed to examining statements and analyzing corporate structures, as you said a moment ago, it is almost impossible for any man to follow the meanderings and devious trails of many of these institutions.

Is it possible, in your opinion, under those sections, as I have said before, for the Commission, in the administration of this act, to compel such statements as will be informative and give the investor some idea of what it is that he is getting into?

Mr. HEALY. The Commission is empowered by sections 12 and 13 to prescribe the forms in which information shall be given, and it seems to me that if the Commission does well with the act, it will try to sum up, so to speak, what these reports show in such a way that the average business man can understand them. Of course, these securities have not been sold to the average business man. A great many of them have been sold to people who will rate much below the average business man

Senator MCADOO. It is those people that I am afraid very little can be done for, so far as analysis of these statements is concerned.

Mr. HEALY. You can do this for them. You can stop manipulations on the market that give an appearance of false activity and false values at a time when shares are being peddled from door to door around the country by employees, ex-ministers, and others. In getting up this simplified statement, however, I think care should be taken that you do not prevent the Commission from getting the complicated details that carry the truth.

Senator KEAN. Judge Healy, I would like to ask you this question. One of the great difficulties with forming any scheme for investment, or studying any of these companies, is that you cannot get any information that is not about 6 months old.

Mr. HEALY. The bill gives the Commission the authority to get reasonably current the information and documents filed. This is found in section 12 (a) 1.

Senator KEAN. That does not mean anything.

Mr. HEALY. But the corporations themselves have to have a little interim in which to compile this information.

Senator KEAN. The trouble is that every statement you get out of them is about 6 months old. A great deal may happen in 6 months.

Mr. HEALY. That is true.

The CHAIRMAN. That is better than having nothing.

Mr. PECORA. Subdivision 2 of section 12 specifically requires these corporations to file such annual, quarterly, monthly, and/or other reports, the annual reports to be certified by an independent public accountant or otherwise, as the Commission may prescribe. The fulfilment of that requirement by the corporations would necessarily cause them to file reports periodically which would enable the Commission to keep itself currently posted.

Senator KEAN. I am not as much worried about the commission as I am about the investor.

Mr. PECORA. These reports are to be made public.

Senator KEAN. My experience is that you never can find out until about 6 months afterwards, what has happened in a lot of these corporations.

Senator MCADOO. What are you going to do if the security is not registered?

Mr. HEALY We are going to try to handle it under the Securities Act of 1933

Mr. PECORA. I wonder if I may ask Judge Healy his opinion on this suggestion. The suggestion has been advanced here—I do not at the moment recall by whom—that section 12 (b), which is the provision that empowers the Federal Trade Commission to prescribe the form and content of these reports, be amended, in line 20 on page 36, by adding the words "or any State" after the words "United States", so that that section would read:

> But insofar as the accounts relate to any person whose accounting is subject to the provisions of any law of the United States or any State, or any rule or regulation made thereunder, the rules and regulations of the Commission with respect to accounts shall not be inconsistent therewith

The purpose of the provision in its original form, that is, without the inclusion of the words "or any State" was to make it unnecessary for railroad corporations, for instance, whose accounting is prescribed by the Interstate Commerce Commission, largely, to have to make reports inconsistent with the reports they are required to file under the Interstate Commerce Act. Do you think the addition of the words "or any State" would be helpful, or do you think it might tie the hands of the Federal Trade Commission in prescribing rules and regulations with respect to the form of these corporate reports, by such laws as any one of the 48 States might enact with regard to corporation accounting?

Mr. HEALY. I do not see offhand how the inclusion of that statement would affect the accounts of railroads, the form of which is prescribed by Federal law and by the Interstate Commerce Commission, and not by State law.

In answering your question as to the effect of the inclusion of a reference to State laws, I would omit any reference to railroads. The public-utility commissions, many of them, have a classification of accounts pursuant to which the operating companies are required to report. There is no such provision, generally speaking, for holding companies and sub-holding companies.

Senator KEAN. The law, if it is amended as suggested or spoken of by Mr. Pecora, would leave you free to regulate all these holding companies throughout, would it not?

Mr. HEALY. No, sir; not in my opinion. It would leave us free to require information from them, and to exercise the other authority in this act, but this act does not give the Commission authority to regulate holding companies, as I read it, at least.

Senator KEAN. You can make up the form of accounts that holding companies have to give you under the act.

Mr. HEALY. We can prescribe the forms on which they shall report to us, yes. I do not think that the Commission is undertaking or is authorized to undertake to tell them how they shall keep their books, although I have not any hesitation in saying—and I am quite willing to go on record to this effect—that it will not be long before business itself will be advocating the establishment of uniform accounting systems If you drop down to the N.R A., you will see the difficulty that they are having with the definition of cost, for example. Everybody has a different definition for cost, and Mr. Filene's committee this morning, the Twentieth Century Fund, advocates the establishment of uniform rules for accounting. This bill does not, as I understand it. But this bill does permit the Commission to prescribe the forms on which the information shall be furnished. I think that is a perfectly reasonable thing.

I have not answered Mr. Pecora's question.

Mr. PECORA. Before you proceed to do it, may I call to your attention the fact that the portion of the section that I have already read, while it is intended to obviate the necessity for railroad corporation to file one form of report with the Interstate Commerce Commission and another form of report with the Federal Trade Commission, is, nevertheless, applicable to all corporate reports, and if the phrase "or any State" were to be inserted here, I apprehend that the hands of the Federal Trade Commission, in its desire to require corporations to submit proper reports, might be tied by some State law, or laws, thus defeating the very purpose of this provision.

Mr. HEALY. There is no telling what the States will enact, or what the public-service commissions of the States will enact My own view is unfavorable to the inclusion of such a provision I would like to tell you why.

In the first place, I am suspicious that the uniform classification of accounts gotten out and now in use in the United States by many public-service corporations is more the product of the utility companies than of the commissions. In the next place, the New York Commission and the Wisconsin Commission have both found occasion to criticize the uniform classification, and one of our examiners, Mr. Dickerman, who came to us from M.I.T., and who is very skilled and very impartial, points out many defects in the uniform classification of accounts.

Take the case of the Appalachian. The Appalachian Electric Power Co. report to the public service commission will not disclose the facts regarding the write-up that I have just spoken of. While I think that the uniform classification of accounts in use by operating public-utility companies is quite informative, quite disclosive, I do not think it is the last word on the subject, and I think that if the commission, through experience, learns that additional information is required, it ought to be allowed to get it.

I would like to give you an illustration of how an account made according to the uniform classification may be misleading. The Public Service Co. of Colorado was a Doherty-owned company, and it undertook to build a new steam plant just outside of Denver, at a place called Valmont. It made a contract for the building of it with the Lakeside Contruction Co., which was not a Colorado corporation. Under the contract the Public Service Co. of Colorado was to pay $10,000,000 for the Valmont steam station, and it was to pay it in securities, and it did pay it in securities, and it entered the cost of the plant at $10,000,000. In a way, that was a perfectly truthful entry, but when you come to look at the books of the Lakeside Construction Co., which is also controlled by the Cities Service, what do you find? You find that the Lakeside Construction Co., through Doherty & Co., marketed the bonds that they got from the Public Service Co. of Colorado for $6,000,000 or thereabouts. You find that the actual cost of building the Valmont station by the Lakeside Construction Co. was about $4,000,000, so they sold the bonds and built the plant with a $2,000,000 profit, and in addition owned $4,000,000 of securities for nothing.

Very much the same thing happened in the Niagara Falls Power Co. at Niagara Falls, a plan that was put through many years ago with the assistance of Francis L. Stetson and his firm, where the Cascade Construction Co. undertook to build the property for a stated consideration, for a company which in effect it owned and controlled. When you examine the accounts of the Cascade Construction Co. you see that it got a large profit on the building. So, there is that type of inflation that is hidden, and that you will not find until you examine the construction company's books, especially if the construction company is an allied corporation, as it very often is. We have a number of instances of that character that make me feel that the State classification is not quite enough.

The CHAIRMAN. The point was made before the committee that these companies are required by State laws to make certain reports and returns and accounting, and upon those reports the rates are fixed in the States for the power and light companies. They are required by the commissions of the States to make certain forms of reports. Now, they raise the question, Should we require them to make another form of report to the Federal Trade Commission? They claim that their method of accounting in nearly all the States is in accordance with the accounting required by the Interstate Commerce Commission from the railroads, and on those reports and that finding by the commissions of the different States, their rates are fixed.

Mr. HEALY. So far as the railroads accounting to the Interstate Commerce Commission are concerned, I offer no suggestion; but

so far as the forms on which the operating utilities report to the State commissions are concerned, I think, for the reasons that I have just given at some length, that the Commission should be free to supplement that information with further information. In other words, the Commission should not be bound by those State forms. I will say that there is much to be said in favor of the State forms, but they are severely criticized in some quarters. The public utility companies themselves had a large hand in getting them up, and certain State commissions are changing them. You do not know what will be done in these State commissions and in the State legislatures.

Senator KEAN. Might not that be true of your Commission, too?

Mr. HEALY. Yes, sir.

The CHAIRMAN. Do you find that they are comparatively uniform throughout the country, or do they differ in different States?

Mr. HEALY. There is a uniform classification of accounts that the National Association of Public Utility Commissioners have pretty much agreed on, that is in quite general use. It is not in universal use. The New York State commission is changing it, and so is the Wisconsin commission. I understand the California commission is considering doing so, and I think our final report, when it comes to the Senate, in our public utilities investigation, will make some further suggestions about it.

Senator COSTIGAN. Judge Healy, in the bill as now before you, have you discovered any undesirable restrictions on the authority of the Commission to require reports?

Mr. HEALY. Nothing of that sort occurred to me as I read it through, Senator.

Senator COSTIGAN. Have you suggested any amendments to enlarge the authority of the Commission?

Mr. HEALY. No, sir.

Senator MCADOO. I was interested in your observations about the limitation which you say the insertion of the words in line 20, page 36, "or any State" after "United States" would bring out. I agree with you fully that that would put a decided limitation upon the powers of the Commission which ought not to be put there. Do you think that the language as it is in the bill now gives you ample authority, regardless of the laws of the States, to accomplish the desired object?

Mr. HEALY. I believe it does. I would like to say, though, that I did not help to write this bill, and I have studied it as much as I could in the time I have had.

Senator MCADOO. I just wanted your opinion, as to whether you think the omission of the words "or any State" leaves you in a position to get what you want.

The CHAIRMAN. Proceed, Judge Healy.

Mr. HEALY. I fear I shall weary the committee if I give you all the instances of write-ups that we have found, but if I am not taking too much time, I will call attention to a few more.

The CHAIRMAN. Go ahead.

Mr. HEALY. In the case of the Florida Power & Light Co., that company was the result of a consolidation of a number of companies

all owned by the same interests. Before the consolidation the property stood on their books at $28,000,000. After the consolidation the properties were recorded at $58,000,000, a write-up of $30,000,000, or 103 percent.

Senator KEAN. How did they write it up?

Mr. HEALEY. They entered the properties on the books——

Senator KEAN. I mean to say, did they have expert engineers, and so forth, to go over the property and revalue it, or how did they write it up?

Mr. HEALEY. My information is that they did not. It was not approved by any State commission.

Senator KEAN. Would you think it fair if they had competent engineers and competent bookkeepers to go over it and say that the value when they bought it was so much, and the present value, according to the estimate of the amount of money they had spent, and the amount of money they had put into the company, and the present-day value, was so much—would you think it fair, under those circumstances, to write it up?

Mr. HEALY. I should say it was unfair. I should think it was improper. I agree that in a rate case the rate base is the present fair value of the property, to be arrived at in some such manner as you have described. I do not agree that present values should be substituted on books in place of cost. The evil of it is that when these accounts are written up on books of account, the inflation is carrried over into the liabilities side of the balance sheet, to create surplus accounts, or false retirement reserves, or to balance new security issues.

The CHAIRMAN. Does that represent water?

Mr. HEALY. Nothing but water.

Senator KEAN. When they come to put down so much a year for obsolescence, that writes that off, does it not?

Mr. HEALY. If the company keeps its accounts properly, the annual depreciation charges tend—but only tend—to write out the written-up and inflated value from the records. I would like to say, however, that it has been our observation that a great many of these companies do not properly depreciate their properties. Many of them are so eager to pay dividends and keep the public buying their securities that they disregard depreciation to a great extent. One of the first things the Insull receivers had to do was to set up a big reserve on their books to take care of depreciation that never had been entered.

Senator KEAN. I think they all ought to write off depreciation.

Mr. HEALY. We have several instances in our records where these companies abandon property and then do not write it out of their books. They carry the property in fixed capital, which sometimes does not actually exist at all, or has been completely abandoned.

Mr. PECORA. You referred to a write-up of 103 percent a few minutes ago.

Mr. HEALY. Yes.

Mr. PECORA. There is evidence before this committee that in connection with the organization of the General Theatres Equipment Co. there was a write-up of its assets from $4,000,000-odd to some $24,000,000-odd, and that write-up was reflected in the balance sheet

submitted to the New York Stock Exchange when that company made application to list its shares on that exchange. Mr. Harley Clarke was the witness who was identified with the General Theatres Equipment and its creation, and who admitted that fact very blandly here.

Mr. HEALY. We showed in our report on Mr. Harley Clarke's company, the Utilities Power & Light Corporation, a few weeks ago, that he had something like $4,500,000 of write-up in the accounts of that company, but if you want a really big figure let me tell you that the Electric Bond & Share Co. wrote up its investment in American & Foreign Power Corporation $399,000,000.

Mr PECORA. That is another corporation whose officer admitted here recently that in 1928 and 1929 they had outstanding a daily average of $100,000,000 or more in call loans, and that they got much of that money through the issuance and sale of securities.

Senator WAGNER. What does the three hundred million-odd represent?

Mr. HEALY. The American & Foreign Power Corporation stock at that time was selling on the market at a very high figure, and Electric Bond & Share struck out the figures at which the investment in that stock was being carried on its books, which was approximately cost, and substituted a higher figure, which approached, but did not equal, the market value of the stock

Senator WAGNER Was that during the 1929 period?

Mr. HEALY. It was back about 1927. [After conferring with associates:] I am told by one of the men with me that it happened in March 1929. That was carried over into the surplus account, and, of course, the public seeing that surplus, the average man, even the average business man, thinks that surplus represents earnings We have learned down at the Commission that very often it does not represent earnings; it represents something else

Senator KEAN. And very seldom represents cash.

Senator MCADOO. Mostly deficits probably, we will say, transferred by some devious process.

Mr. HEALY. Deficits are concealed through such a device as I described in the case of the Insull Co The Central Public Service Corporation, which is now in bankruptcy and which sold securities all over the country, had a deficit in its earned surplus account during the very period—3-year period—when it was selling preferred stock to the public all over the country.

The Central Public Service Corporation followed another practice which is very interesting and which is one of the things that makes me believe that if the Commission is going to administer this act it ought to be allowed to get the real facts, and that is this: They followed the practice—so does the Associated Gas & Electric Co. and several others—of taking onto their books the earnings of their subsidiaries, which the subsidiaries do not distribute in any form, as dividend or credit to the parent company or anything else.

In the case of the Central Public Service Corporation it had over $8,000,000 of that kind of income on the books of that company which it never received. Then there was a reorganization, and bankruptcy; there were losses, and it never will receive them. In fact, the Central Public Service Corporation does not even own those subsidiaries any longer.

That is done too much. It may be proper to reflect earnings of subsidiaries in the consolidated statements, but I do not believe that it is proper to take those earnings without receiving them into a surplus account and then pay out cash dividends against them.

Mr. PECORA. And sell securities on the showing?

Mr. HEALY. Yes, sir; I think that is quite wrong. And they were selling securities to the public in a very intensive campaign. We have a lot of their literature in our record.

Here is the American Water Works and the Electric Co., Inc., which has recently filed a statement under our Securities Act. It shows a write-up of $51,000,000 in excess of the amount at which the same assets had been carried on the books of a predecessor company, controlled by the same interests, and one of its own directors made the valuation. I will not weary you by reciting the write-up in the case of the Oklahoma Gas & Electric Co. or the Carolina Power & Light Co.

Senator REYNOLDS. How much was it?

Mr. HEALY. Which one?

Senator REYNOLDS. The Carolina Power & Light Co.

Mr. HEALY. The present Carolina Power & Light Co. was created through an agreement adopted by the stockholders of Asheville Power & Light Co., Pidgeon River Power Co., Old Carolina Light & Power Co., Adkin River Power Co., and Carolina Power & Light Co.

In the process of the merger the assets were written up $19,100,-478 23. There is a report in our records that gives all of the detail. What I have said, means that the properties of the new Carolina Power & Light Co. were recorded on the books of that company at a figure $19,100,000 in excess of the figures at which they appeared on the books of the predecessor companies.

Senator REYNOLDS. That is before they were consolidated?

Mr. HEALY. Yes, sir.

Senator KEAN. Do you take into consideration whether a company has earned for a long period of years and put the money into the company?

Mr. HEALY. Yes, sir. If that occurs, it is not a write-up. If a company earns a million dollars and invests it in fixed capital, the million dollars will appear in the fixed-capital account. That is a legitimate figure.

I would like to say, however, that there have been a lot of fixed-capital accounts built up through some pretty big earnings, and it makes one wonder if the State public service commission laws had been enforced if any such earnings could have come about.

In the case of the Minnesota Power & Light Co. there was a write-up of something over 21 million dollars, 126 percent. And that company did an interesting thing that helps to show us how important it is that the accounting details should be known. It had certain lands that it was keeping for development purposes in its power business. The lands were not being used and were producing nothing. It was costing the company something to carry its investment in the property. It put that property into its fixed-capital account at a figure above cost. It wrote it up, and then computed interest on it and added the interest to the fixed-capital account, and

then carried that interest, which it never received, of course, which is just imputed interest, as the accountants call it, over into the income account and reported it to a trustee under a bond indenture under which the amount of bonds that it could take down was influenced by earnings, controlled by the earnings. In fairness to that company let me say that after our report was brought out at the Commission it abandoned doing that sort of thing.

We have a write-up in the case of the Oklahoma Gas & Electric Co. of about $2,300,000. The Public Service Co. of Oklahoma shows about $6,700,000 of inflation.

Senator WAGNER. Were the same methods employed in all of them that were used in these?

Mr. HEALY. No, sir; it is not always done the same way. Sometimes they just strike out cost and substitute this larger figure.

Senator WAGNER. Arbitrarily?

Mr. HEALY. I think, in many instances, arbitrarily. There are some instances where the write-up is passed upon and approved by a State commission.

This whole trouble, in my opinion, grows out of the decisions of the Supreme Court in which reproduction cost new is made one of the elements in determining present fair value in rate cases. What they have done in practice is to make that the only element in a rate case, or the controlling element. Even by the Supreme Court decisions it is only one of the elements that ought to be considered in fixing present fair value in a rate case.

But they do not confine themselves to determining reproduction-cost new for rate-making purposes. They will have an appraisal made and then put it on the books to balance security issues, or to create surplus accounts. Sometimes a surplus account so created has dividends charged against it, or you will find that the corporation having unamortized discount on bonds that it has sold, instead of amortizing the discount or, in other words, meeting its annual interest payments, will write the whole thing off against a surplus account which has been created out of just a matter of opinion and this has the effect of overstating the earnings, because over the life of the bonds there should be annual charges against earnings or earned surplus large enough to provide for the discount, which the courts say is merely deferred interest.

Senator WAGNER. What is it in the cases where the new construction falls below in value what they regard as the actual investment?

Mr. HEALY. There are many instances where they have written down their properties. They are in the minority, the amounts are small, and you must remember that most of this writing up was done during a period of high prices.

Senator WAGNER. Yes; that is right.

Mr. HEALY. We have found more write-ups than write-downs. I should say, having referred to the Electric Bond & Share Co., that since March 1929 when they reported that big write-up in American & Foreign Power Corporation, they have written that down. They have taken that out of their books by charge against surplus.

Mr. PECORA. Written down the full amount of the write-up 390 million dollars?

Mr. HEALY. Yes, sir; and something more besides.

Senator KEAN. In other words, the stock went down so that it was not worth that and they wrote it off?

Mr. HEALY. Yes. But I think it cannot be right to keep books on that basis.

Mr. PECORA. Books kept on that basis reflect a false book value?

Mr. HEALY. I think they have bad effects. I am not an accountant, but I think the proper function of accounting is to make a historical record of events as they happen.

The CHAIRMAN. This loss really fell on the people who bought their stock, didn't it?

Mr. HEALY. I cannot say yes to that. It is not an actual loss. They had an investment which had cost them a certain sum. They wrote it up and credited it, added it to surplus. On the basis of that showing it is probable that some people bought stock, and those that brought I presume have lost, or some of them have.

Senator KEAN. That was the market value at that time?

Mr. HEALY. It was an approach to the market value. It was actually less than the market value.

Senator KEAN. Then, the market has gone down and they have written it down?

Mr. HEALY. They have written it down again. But they never actually had in my opinion such a surplus as they reported after that write-up.

Now, we have a write-up of something over 5 million dollars in the case of the Arkansas National Gas Corporation.

Senator WAGNER. Judge, my last question is, That hardly would happen again?

Mr. HEALY. That is pretty hard to say. If proper legislation is enacted it cannot happen again without the security-purchasing public knowing it.

Senator WAGNER. That is what I was after.

Senator KEAN. They would know it long after it was done.

Senator REYNOLDS. How do you propose to get this information initially to the man who is in contemplation of making a purchase of stock on the exchange?

Mr. HEALY. That is by giving publicity to the statements to the extent permitted by this statute. Also it is hoped that the purchasing public will learn that this information is available and can be had.

Senator REYNOLDS. Do you really think that the people who contemplate making purchases of stock would write to the Commission prior to making an investment? Do you think enough publicity could be given to it? Do you think the press of the country would reveal to their respective readers information pertaining to the write-up of these various companies?

Mr. HEALY. Not now, no; but it is hoped—at least, I hope—that in time the purchasing public will come to learn to do that.

Senator REYNOLDS. The fundamental idea of this whole thing is to protect the investors?

Mr. HEALY. That is one idea. That is not the only idea.

Senator REYNOLDS. The question is whether you are going to get this information to the people who invest. Now, you made mention a moment ago to Senator Wagner of some three-hundred-and-some-

odd stock salesmen who were employees of a certain company going from house to house and making sales of these shares in blocks of 10 upward on the installment basis. Those people who make those purchases, there is sold to them what is known in the securities world as a "one-turkey call." They sell them there. They never go back the second time. They are the people who buy all these securities to make the millions for the people who write them up, as a matter of fact. The man who makes a purchase of that is not going to the trouble to ascertain as to the real value or worth of the stock, and I venture this, to say that in this matter here, if you will put that in language as simple as you can that man would never be able to understand it. You could not get it through his head what a write-up means.

Mr. HEALY. Senator, may I make a suggestion, if I am not interrupting you?

Senator REYNOLDS. Yes.

Mr. HEALY. Don't you think that some of the people who bought Cities Service Stock, for example, were shown by these stock salesmen the amount of sales and the prices on the curb?

Senator REYNOLDS. Surely; unquestionably; a great many of them.

Mr. HEALY. Don't you think that the activities of the Cities Service Security Co. had a direct effect on the price at which the shares sold on the curb?

Senator REYNOLDS. Yes; I do.

Mr. HEALY. And on the number that were sold?

Senator REYNOLDS. Yes.

Mr. HEALY. So in that way those people, those ignorant people that you refer to, were influenced by a thing that had been done on the curb exchange, and that may have been done for the very purpose of influencing them.

Senator REYNOLDS Yes. That is, the volume of shares traded in had its effect?

Mr. HEALY. Yes, sir.

Senator REYNOLDS. Compelling effect upon those who were thinking about the matter?

Mr. HEALY. Yes; and the price, too.

Senator REYNOLDS. And the price.

Mr. HEALY. Because you do not get a free operation of supply and demand when the company that is issuing the securities is buying them to the extent of 92 percent of all those that are offered, or when the company is spending, as the Cities Service Co. did, $965,000,000 in a 3½-year period on purchases in the market. In that respect there is some help here.

Senator REYNOLDS. One question, Mr. Chairman, I want to ask there in the presence of Mr. Pecora: Take, for instance, the Carolina Power & Light Co.; they have a write-up of $19,000,000. Take, for instance, the American & Foreign Power Co.; they have a write-up of $399,000,000.

When they have those various write-ups on their statements and they go out and deliberately sell stock upon those statements, which are false, in truth and in fact, are not those people violating the criminal law by obtaining money by false and fraudulent representations, and could they not be prosecuted under out present statutes?

Mr. PECORA. Yes; Senator, they undoubtedly could. At least that is my opinion. But the necessity of proving the falsity of the representation would present a genuine difficulty. If you compel these corporations to file the reports that are contemplated under this act your proof would be readily at hand; and those prosecutions would be calculated to be much more successful, and I think a few prosecutions successfully along that line would have a most salutary effect.

Senator REYNOLDS. In a sense, the burden of proof would somewhat shift in that case where they are required to make a report.

Mr. PECORA. I had something to do with prosecutions for a number of years in the city of New York, and we came to many instances where persons had undoubtedly been victimized by false representations and where, because of the inherent difficulty of obtaining the necessary legal proof to prove the falsity, prosecutions were unsuccessful.

Senator REYNOLDS. But in this I understand you have it in written form.

Mr. PECORA. Yes; and that would afford a great measure of protection to the investing public, and I think, as I remarked before, a few successful prosecutions along those lines would go a long ways toward cleansing the market of these practices.

The CHAIRMAN. It would have a very good effect on the issuing company.

Mr. PECORA. Oh, yes; it would have a determining effect on the company.

Senator WAGNER. A very important factor in all these manipulations is the publicity.

Mr. HEALY. That is apparently an important part of it. But of course the protection of the investor is not the only purpose of this bill, as I read the preamble.

Senator WAGNER. But I am speaking generally of all these manipulations and all that sort of thing; publicity plays a very important part.

Senator KEAN. What are the other purposes?

Mr. PECORA. Since publicity, I think, as Senator Reynolds has remarked, might not reach the eyes of the average investor.

Senator WAGNER. I don't say that is the only thing necessary, but I say that is a very important consideration.

Mr. PECORA. Yes, there is no question about it.

Mr. HEALY. The bill devotes nearly four pages to the preamble giving the reasons why the framers of it think such legislation is necessary. It speaks about the adverse effect on credit and interstate commerce and the general welfare from excessive speculation, and bad practices on exchanges. I number myself among those who think that the orgy of speculation that we came through is in part responsible for some of our present difficulties.

Senator KEAN. Well, now, Judge, I would like to ask you this: Suppose this bill passes as is; then you get these reports. Those reports will come to you. A report will be a month or 6 weeks late. That is reasonable, isn't it?

Mr. HEALY. Yes, sir; very reasonable.

Senator KEAN. Probably more than that?

Mr. HEALY. Probably a little more.

Senator KEAN. Then it will take you another 3 weeks to get it out, won't it?

Mr. HEALY. We have a 20-day period for examination under the Securities Act, and, as I said at the outset, I have had no contact with the administration of the Securities Act, but our accountants and examiners, by working day and night, have been able to keep up with that work.

Senator KEAN. We work day and night, too. But you cannot get that out possibly in a month. That would be 4 or 5 months. In 4 or 5 months a lot can happen. That is what I am talking about, as far as the investor goes. What I am talking about is that he cannot get any information for 4 or 5 months. Isn't that about right?

Mr. HEALY. I should think that that was something of an overestimate of the time required, Senator.

Senator KEAN. Not much.

Mr. HEALY. When a corporation closes its books at the end of the year it takes it some time to get out its statement, its annual statement, and it takes the Commission some time to analyze these statements that come to it. But I don't see any way of avoiding that. Necessary time has got to be taken.

Senator KEAN. The point that I am getting at is for the investor. He wants the information of what is happening when he buys the stock.

Mr. HEALY. All the investors are not going to buy the stock between the 1st of January and the 1st of March.

Senator KEAN. No; but he is 4 or 5 months behind when he does buy the stock, always 4 or 5 months behind. That is what I am getting at.

Mr. HEALY. Properly analyzed fixed capital or investment accounts, for example, will give him information that will always be good. That is, the first disclosive statement that one of our corporations gets up as to the content of its fixed capital account, will make a record which may be always referred to.

Senator KEAN. Of course that is true, but what has happened in the last 6 months you would not be able to find out.

Mr. HEALY. No, sir; I presume not, unless the Commission under the—well, let me amend what I have said. The Commission has authority to try to keep these accounts current.

Senator KEAN. I know.

Mr. HEALY. But of course the Commission cannot keep these corporations making reports and accounts all the time.

Senator KEAN. No.

Mr. HEALY. The Commission has got to be reasonable in what it exacts of them.

Mr. PECORA. But the investor today has no information available to him within a shorter period of time, and if he has records only on the kind of information that Judge Healy has alluded, being quite prevalent, he is going to get misleading information.

Senator KEAN. He has the annual reports.

Mr. PECORA. If he has the information called for by this act he will get reliable information.

Senator KEAN. What he will do, he can today take 5 years back, 10 years back, and he can compare or have compared those reports,

which is done, I think, by most people that are a little careful; they take a period of 5 years and they take their annual report and they just find out what the differences are between those annual reports, and then they try to find out where those differences originated and what they are.

Senator REYNOLDS. Under this act how many different concerns which file reports would have to make an audit of and an examination of, for instance on the New York Stock Exchange?

Mr. HEALY. I am informed that there are about 800 listed on the New York Stock Exchange.

Senator KEAN. That is very small.

Mr. HEALY. Let me suggest that these reports that are filed with the Commission will also be analyzed by the financial writers and the financial departments of the various newspapers and also by certain concerns such as Poor's and Moody's, and I think that they will have available more information than they have ever had before.

Senator REYNOLDS. In other words, that is where the majority of the publicity would come from relative to these securities initially?

Mr. HEALY. I am not sure that I understand you.

Senator REYNOLDS. In other words, Moody's and financial writers would make an analysis of the report rendered by the Federal Trade Commission. They would give considerable publicity as to the value of the securities in that way?

Mr. HEALY. Yes, sir.

Senator REYNOLDS. Isn't it a fact that the man who buys securities on the New York Stock Exchange in average intelligence is far beyond that of an individual who makes a purchase of stock from salesmen like you mentioned a moment ago?

Mr. HEALY. I would think so; yes, sir.

I would like to call the committee's attention to the case of the Nebraska Power Co because of one rather striking feature There was one corporation which succeeded another, and the new corporation became the Nebraska Power Co It was controlled by the same interests that controlled the old company. The transfer from the old company to the new company was made through an intermediary who had no financial interest of his own in the transaction. In the process of the transfer from one corporation to the other the plant and franchise accounts were written up. On the books of the predecessor company they stood at something like $6,400,000, and on the books of the new company are something like $13,500,000.

The holding company, which was the American Power & Light, one of the Bond and Share group, owned the common stock, and there were several years that the American Power & Light Co. owned the common stock of the Nebraska Power Co., when, as a result of these transactions, it owned that stock at no cost to itself; in fact, at something less than cost, if I may put it crudely.

Now, during the time that it owned that common-stock equity in the Nebraska Power Co., the Nebraska Power Co. was making earnings that were applicable to that common-stock equity, and our accountants, of course, under those conditions could compute no rate of return on the investment to the American Power & Light Co, because, although the American Power & Light Co. owned the stock and was receiving income from it, it owned it at no cost.

But by 1926 the accumulated earnings of the Nebraska Power Co. had gotten to such a point that by leaving those earnings on the books of the Nebraska Power Co. instead of taking them, the American Power & Light Co. then did have a cost of the investment. But the cost was not through putting any new money in but because it left in the Nebraska Co. the earnings which it might have taken out in dividends.

And the rate of return in 1926, which was the first year that we could compute it, was 338 percent. In 1927 it was 212, and in 1928, 175 percent. You see, it dropped every year, and I presume it will continue to drop as the surplus continues to accumulate.

The CHAIRMAN. What did you say was the write-up of that?

Mr. HEALY. The write-up of that company was $6,432,000.

Mr. PECORA. There was a write-up of a little over 100 percent.

Mr. HEALY. It was nearly $7,000,000.

I would like to spend a few minutes talking about what our records indicate as to Associated Gas & Electric Co. The corporate structure of that company is intricate, and it has been with great difficulty that we have been able to get some understanding of the accounting methods. They have a subsidiary corporation, among a great many others, known as "Associated Gas & Electric Securities Co., Inc.", which carried on the distribution of the securities of the Associated Gas & Electric Co.

They not only sold the securities of the Associated Gas & Electric Co. to the public, but when Associated paid dividends in stock the Securities company distributed the stock dividends. Then there were a great multitude of exchanges and conversions within the Associated system. That is, the Associated company would say, "If you will turn in such a security we will give you such a security in return", and a great many of those exchanges and conversions were made through the Securities Co.

The stock of the Associated Gas & Electric Co., which figured most frequently in those transactions, was the class A stock. That was nonpar stock. The directors assigned a stated value of $35 a share to that stock. When the stock was handed over to the Securities Co. to distribute to the public in stock dividends it was handed over at $20 a share. And thereupon the Associated Gas & Electric Co. carried $15 a share into an asset account which it styled "Cost of Acquiring Capital", and carried the same $15 over into a surplus account. In other words, the greater the discount on a sale of the stock the more their surplus grew to be. Parenthetically, I should add this practice has been abandoned.

Now, the Securities Co., having taken the stock at $20 a share, at the end of every month determines how many shares of class A stock it is carrying regardless of how they were acquired. That included securities delivered for exchange, stock delivered to be paid out as stock dividends. And when they came to the end of the month and determined that they had so many shares of class A on hand they wrote up the class A shares to the market value at that time and carried the amount of the write-up over into a surplus account on the books of the Securities Co.

So that in the case of the class A stock that was delivered to the Securities Co. to be distributed as stock dividend there was a write-up from $20 to a higher figure, often a good deal higher.

In the meantime, as I told you, the Associated Gas & Electric Co. had carried the difference between $20 and $35 into an asset account entitled "Cost of acquiring capital" and had carried it into a surplus account in its own books.

Certain of the class A stock that Associated Gas & Electric Co. carried over to the Securities Co. was turned over at $35 a share, during the period when the stock was being sold at $50 a share and sometimes higher.

When the Securities Co. sold that stock at $50 a share it counted a $15 profit on it, but the Securities Co. was just the alter ego of the Associated Gas & Electric Co. itself.

Thus I have tried to describe two kinds of profits that the Securities Co. counted on its books, due largely to the arbitrary valuation assigned to class A stock when it was issued by Associated Gas & Electric Co.

In the course of time the Securities Co. built up a large surplus in that way. I have forgotten the year, but I think it was in 1929—yes; it was in 1929—that this Securities Co. paid a $22,000,000 dividend to another Associated company which passed it through its surplus account and paid a $21,000,000 dividend to the Associated Gas & Electric Co., which went into the surplus account of the Associated Gas & Electric Co. When the Associated Gas & Electric Co. issued its stock, if it had sold its class A stock out to the public at $50 a share it could not have put any part of that $50 into surplus account, according to my understanding, but when it sold to the Securities Co. at $35 and the Securities Co. sold to the public at $50 per share and counted the difference as profit and carried it into surplus and paid a dividend out of it, then it came back to the Associated Gas & Electric Co. and went into its surplus account.

The Associated Gas & Electric Co. has followed the practice of taking onto its books the undistributed earnings of its subsidiaries. Let me explain this. A subsidiary has some earnings. The parent company picks them up and carries them into income and thence to surplus account. They are not actually received at all by the parent company. Also they have another practice. Most of the subsidiary companies have nonpar stock. When the subsidiary has had some earnings that it is carrying in its surplus account, it transfers a sum from surplus to the stated value of its nonpar stock. It does not distribute any part of the surplus. The next company in line above it in the Associated set-up writes up its investment account in that particular stock by the amount transferred from surplus to stated value of nonpar on the subsidiary's books and carries it into surplus. That process is repeated over and over again until it finally gets to the Associated Gas & Electric Co.

It is a long and complicated story to tell you what our records show about Associated Gas & Electric Co., and I cannot undertake to do it; but I have tried to indicate how the surplus account is built up, and in one instance I think I have shown that about $21,000,000, or a very large part of it, was received into surplus account of the Associated Gas & Electric Co. which really came from capital which stockholders paid into the company. So that it is not an earned surplus.

Senator KEAN. In other words, they bought the stock at a premium?

Mr. HEALY. I would not want to say that it was at a premium, Senator.

Senator KEAN. You said that the directors had valued the stock at $35 a share?

Mr. HEALY. Yes, sir.

Senator KEAN. And that they swore that that was the worth of the stock?

Mr. HEALY. I do not know that they swore that, but I think they fixed that value.

Senator KEAN. They fixed that value, and the public bought it at $50 a share?

Mr. HEALY. Yes; but the public did not buy it direct from the Associated Gas & Electric Co.

Mr. PECORA. They bought it from the securities company?

Mr. HEALY. They bought it from the securities company, and the securities company treated the $15 as profit or earnings and carried it into surplus. It is not earnings; it is paid-in capital.

Senator KEAN. Yes; but it is the profit that they made on selling the stock and a profit above what they valued the stock at.

Mr. PECORA. Is not that a paper profit?

Senator KEAN. No; it is a little different from a paper profit, because it is actual cash.

Mr. HEALY. Under the laws of the State of New York it is at least very doubtful whether under the Associated's charter the Associated in selling that nonpar stock could have carried any part of it into surplus, because the charter, by State statute, as I read it, says that they shall carry as stated value of nonpar stock what the subscribers pay for it.

Senator WAGNER. I was going to ask you whether any of these things have come within the scrutiny of the State commission; I mean, these financial transactions.

Mr. HEALY. In the case of holding companies and subholding companies, no; in the case of operating companies, yes; in the States in which there are State commissions.

Senator KEAN. There are State commissions in practically every State.

Mr. HEALY. There are some few States that have no commissions. There are quite a number in which the State commissions have authority over rates but have no authority over securities.

Senator WAGNER. New York has authority over securities; has it not?

Mr. HEALY. Yes, sir.

Senator WAGNER. Is not the State under their charter permitted to explore the activities of a holding company if their transactions relate in some way to the fixation of rates that the public utilities charge the public?

Mr. HEALY. I am not entirely clear, but my memory is that the State commission of New York has had some rather intensive litigation with the Associated Gas & Electric Co.

Senator WAGNER. Very recently?

Mr. HEALY. Yes, sir.

Senator WAGNER. The older commission I do not think ever attempted it.

Mr. HEALY. No, sir. The New Hampshire commission was taken into the Federal district court by the Associated interests when it undertook to learn what the books of certain Associated companies showed as to companies operating in New Hampshire, and the State commission was defeated.

The CHAIRMAN. This way of passing the earnings of affiliated companies or operating companies, for instance, on to parent companies and holding companies deprives the stockholders of the affiliated companies of the benefit of those earnings, does it not?

Mr. HEALY. No, sir. It results in the parent company taking into its earnings account and its surplus account earnings of subsidiaries which it does not receive, which does not mean that those earnings are diverted to interests outside of the system; it does not mean that they are embezzled or wasted. The difficulty is that the parent company takes into its earnings account and into its surplus account earnings which it may never receive.

The CHAIRMAN. The stockholders of the affiliated company did not actually lose that money?

Senator KEAN. Oh no.

Mr. HEALY. The earnings of the subsidiary company will appear in the surplus account of the subsidiary. They also appear in the surplus account of the parent company.

Mr. PECORA. It is all a piece of bookkeeping legerdemain.

Mr. HEALY. I have here the balance sheet of the Associated for December 31, 1929, and on the assets side, page 26, we read: "Plant, property, franchises, and cost of acquiring capital, $634,000,000."

The operating subsidiaries of the company, of course, have fixed capital. The Associated Gas & Electric Co. itself has very little fixed capital, such as buildings and power plants. It is more or less of a holding company. If you were to go to the books of all of the subsidiary companies of the Associated Gas & Electric Co. whose fixed capital is supposed to be reported in its balance sheet—that is, the consolidated balance sheet—you would find that the fixed capital, according to Mr. Nodder, our witness at the Commission who examined the books, appears on the books of those subsidiaries at about $402,000,000.

Mr. PECORA. As against six-hundred-odd millions?

Mr. HEALY. As against six-hundred-odd millions, as shown by the consolidated balance sheet.

Now, the question is, What does the difference represent? Here is a little memorandum that Mr. Nodder gave me in this connection, which I will read [reading]:

> The significant thing about this entire balance sheet is the fact that there has been counted in fixed capital an amount of around $200,000,000, representing excess cost to Associated Gas & Electric Co of investments in subsidiaries over and above the par or stated value of the investments in those companies, as recorded by the books of the subsidiary companies, as well as an item of Cost of Acquiring Capital exceeding $18,000,000 In other words, what appears to the reader on the printed balance sheet as fixed capital, which he naturally presumes to be of the value fixed by the balance sheet, includes a highly intangible amount in excess of $200,000,000.

Senator KEAN. In other words, if they bought an electric company at $150,000,000 and the value of that company, according to its books, and so forth, was $100,000,000, they put it in at $150,000,000?

Mr. HEALY. It is very nearly that If they paid $150,000,000 for a company whose fixed capital was stated as $100,000,000, when they reported fixed capital in the consolidated balance sheet it went in at $150,000,000.

Senator KEAN. Of course the earnings of the company may have warranted that price.

Mr. HEALY. They may have. I am not here to criticize the price that the Associated Gas & Electric Co. paid for its properties.

Senator KEAN. I say, it may have.

Mr. HEALY. I think that during the years 1927, 1928, and 1929 these holding companies paid some absurd prices for properties which they bought.

Senator KEAN. There is no doubt about that.

Mr. HEALY. But the point is that the balance-sheet statement does not disclose the facts that I have mentioned; and when you turn to the other side of the balance sheet you will find surplus reported in this fashion [reading]:

Class A (5,817,371 shares), Class B (500,000 shares), Common stock (1,703,538 shares)—Capital and surplus $261,266,024 80

In other words, the capital, except the preferred stock, and the surplus are all thrown in together in one item. There is nothing that discloses the difference between earned surplus, capital surplus, or paid-in surplus, or surplus created through write-ups, or surplus created through the type of dividends that I tried to describe a few moments ago that arose through the Securities Co. taking Associated Gas & Electric stock at arbitrary values and then selling them out at higher values.

Just a few more words, and I will finish.

Senator KEAN. I would like to call attention to the fact that you are quoting statements and statistics of 1929.

Mr. HEALY. Yes, sir

Senator KEAN. That was many years ago. Are we supposed to assume that if you get this authority, the best you can do is to furnish us with statements 7 or 8 years old?

Mr. HEALY. No, sir. I picked this statement for several reasons. I have got printed balance sheets for the Associated for every year since 1929. I took this one first because I happened to have it handy. I have only used it to illustrate or to try to prove the necessity of disclosing the content of these fixed capital and surplus accounts. My argument is that the Commission should have authority to get the facts that underlie figures like these.

A second reason for taking this statement was that in our utilities investigation we cut off investigation of this company as of the end of 1929, and I wanted to use this statement because Mr. Nodder, who made the study of the Associated Gas & Electric Co., had given me a breakdown of the information as to how these particular figures were made up. If the committee wishes information as to the Associated Gas & Electric Co. as of a later date, we have the annual reports and can give you some information about it.

Senator WAGNER. Is there not some very recent information?

Mr. HEALY. Yes, sir.

Senator KEAN. If this bill provided—and it does not so provide—that you should have authority to pass on the accountants and

engineers where an outside report is made, it seems to me that you should have authority to say that these accountants are satisfactory to us or that they are not satisfactory, or that the engineers are satisfactory to us or they are not satisfactory.

Mr. HEALY. I hope the day will come, Senator, when we will have in this country chartered accountants who will be licensed by the Government and who will be punishable for false statements, and who will make their reports to stockholders and not to directors.

Senator KEAN. At the present time, under this bill, if you had that authority you could license accountants and you could license engineers; but under these circumstances you are not going to be able possibly to do this work. To make a general report on all the corporations of the United States is just foolishness.

Mr. HEALY. Of course, under the terms of the bill accountants incur a civil liability if they are not accurate within certain limits.

Senator KEAN. I know that. But what I thought was that you ought to have authority in this bill to license accountants and engineers. What do you think of that? I have just put it to the witness, Mr. Chairman, as to whether the Commission ought to have authority to license accountants and engineers.

Mr. HEALY. My first reply was—some of the committee were busy with something else—that I would be very pleased, as far as I am concerned, if the day would come when public accountants would be licensed and would have to report to stockholders instead of to directors and would have a dignified position of responsibility under Federal laws. Whether or not public sentiment and the sentiment of Congress is at the point where they are willing that engineers and accountants should be licensed by the Federal Trade Commission I do not know. I have some doubt about it.

The CHAIRMAN. We have enough to deal with now without going into outside questions. The complaint about this bill is that it goes too far.

Senator KEAN. Yes; it does in some respects; I agree to that. I am opposed to the bill in some respects, but I am in favor of having accountants that are responsible and engineers that are responsible. For instance, if I make an issue of securities I hire the highest class and the best people that I can get, and I do not restrain them in any way. They are to make a report of the situation. I take their report and publish it, and I am bound more or less by that report. I issue securities by it, and I pick the very best I can get. If they make mistakes, I suffer.

The CHAIRMAN. Would it be any better if they were licensed? Licensed men make mistakes.

Mr. PECORA. It would not add to their knowledge or efficiency. The fact that a lawyer has a certificate of admission to the bar does not improve his knowledge of the law.

Mr. HEALY. I should like to interject an observation, if the committee will permit, which is not particularly apropos of anything, that eventually the solution for many of these problems is going to come from a compulsory incorporating or licensing of all corporations engaged in interstate commerce.

The CHAIRMAN. You mean, to give them Federal charters?

Mr. HEALY. Yes, sir; either Federal charters or Federal licenses. There is hardly a State in the United States today that will permit a foreign corporation incorporated under other laws to come in and do business in that State without complying with the State requirements. But Congress permits anybody or anything or any kind of a corporation to engage in interstate commerce almost without let or hindrance. There is considerable support in rather conservative quarters for this view. Mr. Whitney has favored it, and Attorney General Wickersham favored it and President Taft favored it, and there are in existence bills that were drawn that represented the views of some of those gentlemen.

A second thought that I wish to express, which is a little out of line, is that many of the present difficulties will never be met until there is created an authority which has the right to decide at what figures properties shall go on to the books of corporations. Watered stock and inflation of all kinds depend, according to my observation, upon the figures that corporations are allowed to put on their books, particularly in recording assets. Some day, in my opinion, there will have to be some supervision of that sort of thing in the case of all corporations who are selling their securities to the public, just as in certain States today there is that kind of supervision over public-service operating companies.

I have just one other small matter that I will refer to in connection with the Associated Gas & Electric Co. and then will conclude, unless you have some further questions to put to me.

Mr. Nodder, our accountant and examiner, made up a revised balance sheet of the Associated Gas & Electric Co. as of December 31, 1929, and then he undertook to eliminate from it all matters of write ups, nonreceived income, and certain received income which, in his view, the Associated Gas & Electric Co. was not entitled to receive. As a result of his revision making these eliminations the corporate surplus which was stated at $1,886,000 shows a deficit of $24,056,000. The capital-surplus account which, according to the statement that he made up based on the books of the company, stood at $11,167,000, after his revision had but $4,395,000 left in it. The stated value of common stock which, according to the books of the company and Mr. Nodder's interpretation of them, stood at $21,685,000, after his revision stood at $2,025,000.

The net result of all of his revisions was to reduce the total of assets by $50,387,000 out of a total of $641,000,000. The company contests his revision.

A few brief words as to some of the reasons that actuated him in making these adjustments and eliminations. First, he eliminated about $8,900,000 to eliminate the cost of acquiring capital account; the principal items comprising the same consisting of capital and surplus created for several classes of stocks; and that was done in the way that I have attempted to describe, in the first instance, earlier in my testimony.

Senator KEAN. What did he do with the $15?

Mr. HEALY. That is left in capital and surplus. You mean, if I understand you, the difference between $35 and $50?

Senator KEAN. Yes.

Mr. HEALY. Yes; he did not eliminate that, as I interpret his statement. He eliminated $17,800,000 from corporate surplus to eliminate from corporate surplus amounts received as dividends from subsidiary companies and other sources. He eliminates by this process certain dividends that they received but which, when he had traced them back through several layers of corporations, were originally paid, not out of earnings, but out of write-ups.

He next eliminates from corporate surplus a total of $7,110,000; $1,640,000 of this was compensation for management and construction services in return for which, according to Mr. Nodder, the Associated Gas & Electric Co. never rendered any management or construction service.

He next eliminates $3,400,000 and something over for current net earnings of subsidiaries transferred to the stated value of nonpar capital stock and never actually distributed——

Senator KEAN. Excuse me. Go back one item. The company received that money, did it not?

Mr. HEALY. Which money?

Senator KEAN. Money for managing.

Mr. HEALY. Yes, sir.

Senator KEAN. Then they have got the money?

Mr. HEALY. Yes, sir. The basis of Mr. Nodder's elimination of that item was that they were not entitled to receive it, that they rendered no construction or management service.

Senator KEAN. Yes; but they got the money?

Mr. HEALY. They did.

Senator KEAN. Therefore it is part of their assets.

Mr. HEALY. That is true, in that respect. That is agreed to

Senator KEAN. It is not a fair statement, so far as that goes, because they have got the money.

Mr. HEALY. I think it is a fair statement, because I said at the outset when I began to talk about it that he eliminated, among other items, items that they actually received but which, in his view, they were not entitled to receive.

The CHAIRMAN. In other words, did they have to return it to somebody else?

Senator KEAN. No. I do not think there is any chance of their returning it.

The CHAIRMAN. If they have something that they have no right to, why not return it?

Senator KEAN. The witness says that they did not have any right to it, that they did not render proper service for it; but they have the money in their account, and the only one that could sue them would be one of the subsidiaries that they own.

Mr. HEALY. One of the State commissions having supervision over the subsidiaries that paid this management fee may take a hand in it. It is not absolutely certain that none of this money will——

Mr PECORA. Rates are fixed on the basis of such expenditures?

Mr. HEALY. Yes, sir; because such expenditures are charged against income before the return permitted by law is computed.

Senator KEAN. But if they had this money and they earned it and they charged this in——

Mr HEALY. They had it, but they did not earn it.

Senator KEAN. At all events, they have it?

Mr. HEALY. They have got it, but can they keep it?

The second item, however, in this group that I have been dealing with is $3,490,000, which is simply a transfer of earnings on the books of the subsidiary company from surplus account to stated value of nonpar stock and has never been paid over.

Senator KEAN. They are not entitled to that.

Mr. HEALY. The next item is a very interesting one. I wonder if they are entitled to this one: This is $1,978,513.12, which is Federal income taxes received from subsidiaries in excess of current deduction for Federal income taxes. Let me explain what that means——

Senator KEAN. I do not think they are entitled to that.

Mr. HEALY. The practice in the Associated Gas & Electric Co. system, as in several others, is for each company to accrue and set up on its books the Federal income taxes which it would have to pay if it made a return as an individual company and did not figure in a consolidated return. The holding company for that group makes a computation of what it would have to pay on a consolidated basis if it made one return for itself and all of its subsidiaries. Thereupon the Associated Gas & Electric Co. takes on to its books what the subholding company accrues for taxes. But the Associated Gas & Electric Co. does not pay it to the United States Government. It gets out a consolidated return, and the amount that they pay being less than the amount that is in effect paid over to them by the subsidiaries, they pocket the difference. As a matter of fact, there have been several years in which this kind of income was taken up by Associated Gas & Electric Co. when they did not pay any Federal income taxes. Mr. Nodder has eliminated $1,978,000 of that kind of income.

The CHAIRMAN. Has that been brought to the attention of the Treasury?

Mr. HEALY. Yes, sir. A man named Davison from the Treasury Department has worked for many weeks in that connection. This is not the only company that does that. There are quite a few of these companies that make a profit out of their consolidated return by assessing each company what it would pay if it made an individual return, and then keeping out what it saves by making a consolidated return. There is an item of $1,900,000 shown right here [indicating]

The next adjustment of corporate surplus was $958,000. I will not stop to give the detail about that, because by comparison the amount is small and the hour is getting late.

Also, Mr. Nodder removed $15,520,000 from capital surplus to write off from the capital surplus account certain items, in view of the fact that the principal items therein consisted of write-ups of security investments.

That picture, I submit, as of December 31, 1929, can be contrasted with this one which appears in the published annual report of the Associated Gas & Electric Co. for 1929, and it seems to me it goes a long way toward proving the point that I hoped to prove when I came up here, and that is that by the provisions of sections 11 and 12 you should give the Commission power enough to learn the content of

these statements. Give it authority to get the information so that it can analyze balance sheets and income statements.

It is suggested that I ought to state that some of the appraisals reflected in the books of Associated Gas & Electric Co. have not been approved by State commissions. Many of the appraisals upon which many millions of dollars of write-ups have been recorded on the books of operating subsidiaries of the Associated Gas & Electric Co. have been made by a man named Cheney in New York; and the controlling influences in Associated Gas & Electric Co., as I think all of you know, are Mr. Hopson and Mr. Mange.

I had one of Mr. Hopson's associates on the stand the other day, a young man named Stix, and I inquired of him as to the relations between Mr. Hopson and Mr. Cheney because I wanted to know whether Mr. Cheney's appraisals were independent, and what his connections were with the system, because, as stated, there had been many million dollars of write-ups put on the Associated's books to reflect the appraisals made by Mr. Cheney. Mr. Stix said—I did not ask him this, because I do not ask witnesses for hearsay testimony, but Mr. Stix said—and he is very close to Mr. Hopson—that it was common gossip in the Hopson office that Mr. Cheney divided with Mr. Hopson one half of all the profits that Cheney made from the operation of his engineering department. We hope that before many days have passed we will be able to develop with some particularity just what the relations between Hopson and Cheney are

Senator WAGNER. Is the appraisal for the State?

Mr. HEALY. No, sir; for the company. He is represented as an independent appraiser.

Senator WAGNER. It is supposed to be a detached appraisal?

Mr. HEALY. Yes, sir.

Mr. PECORA. Did you not find two companies were in existence, the stock of which is held solely by Hopson and his associate Mange?

Mr. HEALY. Yes.

Mr. PECORA. And those two companies purport to render management and financial service and advisory service of some kind to the subsidiaries of the Associated Gas & Electric Co. for which they receive fees that guarantee a million or more dollars a year, which go simply to those two men?

Mr. HEALY. No, sir; my memory is not quite that way. The principal management companies in the Associated group are subsidiary to Associated Gas & Electric Co., so that their earnings ordinarily will go up to the Associated Gas & Electric Co. However, H. C. Hopson & Co., and a corporation owned by him and his sisters which has succeeded the old H. C. Hopson Co. partnership, does render financial service and income-tax-return service for which they get pay. They also render service in connection with the issuance of various securities; and it is my impression that those services have been rendered at a profit to Mr. Hopson and his corporation. But let me say this, that in the report of Associated Gas & Electric Securities Co., Inc., which we put into the record just about 2 weeks ago, we do show dealings between corporations owned wholly by either Mr. Hopson or Mr. Hopson and Mr. Mange together, where the dealings were to the profit and advantage of the corporations wholly owned by them and where the profits that they made entailed

some expense or loss to the companies that were subsidiaries to Associated Gas & Electric Co. I recall one such corporation that made profits through dealings with the Securities Co., and this was the Associated Securities Corporation, which is owned through a series of trusts or holding companies by Hopson and Mange. There is full detail on that in our record, giving the amounts to a penny.

I would like also to say—and this is pertinent in view of Mr. Pecora's question put to me regarding the insertion of a clause relating to accounts kept according to State requirements—that as you know, the Associated Gas & Electric Co. is not subject to the State public service commission and their accounting methods are not prescribed by State authority.

Senator KEAN. If that were put in there, it would not affect your authority to go into it, would it?

Mr. HEALY. No, sir; it would not, as the State law now stands.

Senator WAGNER. What do you mean by saying that they are not subject to the State Public Service Commission?

Mr. HEALY. That the company itself is a holding company and is not subject to the State Public Service Commission of New York.

Mr. PECORA. Judge Healy, the contention has been advanced here by opponents of the bill that the provisions of section 12 vesting the Federal Trade Commission with authority to require certain corporation reports and prescribe the form of them, and so forth, would virtually give the Federal Trade Commission absolute domination and control of the business of these corporations. Do you see anything in the provisions of section 12 or anywhere else in this bill that would so operate?

Mr. HEALY. I do not. The Commission is not seeking any such authority. The Commission, if I may speak for it—I have no authority to speak for it, but I am sure the Commission feels that you should have such provisions in the bill as to make the bill effective.

Senator KEAN. If you have authority to remove the officers at will, do you not absolutely control the company?

Mr. HEALY. In the first place, the bill does not purport to give the Commission authority to remove the officers of corporations.

Senator KEAN. It does as to the stock exchange.

Mr. HEALY. It gives authority as to the officers of the stock exchange, but only in the event that they violate the law.

Mr. PECORA. Where they fail in the duties imposed upon them by the bill. The objection advanced to this bill, among other things, was that section 12 clothes the Federal Trade Commission with a power equivalent to control and domination of the affairs of corporations, merely because that section gives the Federal Trade Commission the right to prescribe the form of reports which such corporations are required to make.

Mr. HEALY. In section 18, subdivision 3, there is a provision that after notice and opportunity for hearing the Commission may suspend or may expel any member or officer who violates the law or the rules and regulations thereunder.

Senator KEAN. You might make very unreasonable rules. Suppose you omitted the words "rules and regulations" Would you consent to that?

Mr. HEALY. I should think if the Commission made unreasonable rules and regulations, the courts would set them aside.

Senator KEAN. Probably they would, but in the meantime you have cut off the other fellow's head.

Mr. HEALY. I think we could not cut of his head under an invalid regulation; and certainly rules and regulations cannot be made in excess of the power bestowed by the act.

Senator KEAN. Yes; but suppose you omitted the words "rules and regulations"? If they violated a law as passed by Congress, which they will all know about, that is one thing; but if you make new rules and regulations every day, that is different.

Mr. HEALY Very different; and I do not think that they could be penalized for violating a rule or regulation that they did not know about. I should think the Commission would be wise enough to make its rules and regulations take effect at such a time that everybody on the exchange would know about them.

Senator KEAN. Yes; but the trouble is that you make these regulations that you think are wise, and perhaps the Commission might not always be so wise.

Mr. HEALY. That is the chance we take with the administration of any law, either in the courts or elsewhere. However, I should hope that the Commission would take counsel of those members of the New York Stock Exchange and other exchanges in whom it has confidence, to see that the rules and regulations are fair and reasonable. I do not mind saying at all that I have had correspondence with a man named Hoxsey, who is on their listing committee, and the trend of his views as shown in the subject of his correspondence with me was very pleasing to me.

Mr. PECORA. That is the Mr. Hoxsey who is executive assistant to the stock-list committee?

Mr. HEALY. Yes, sir.

But to answer the Senator's question, I do not think that the provision by which men may be suspended or expelled if they violate the rules ought to be taken out. I think if rules are promulgated inside the authority of the act, those who violate them should suffer some penalty. We cannot get effective regulation without it.

Senator KEAN. Yes; but that is a very drastic penalty, because it gives you exactly the same authority as if that were put into the bill, does it not?

Mr. HEALY. No, sir; not precisely. So far as rules and regulations are concerned that are reasonable and that are authorized by the act, you are correct, in my opinion, and only to that extent.

Mr. PECORA. The court has injunctive power to restrain the enforcement of a rule that is unreasonable or invalid?

Mr. HEALY. Yes, sir.

Mr. PECORA. After all, is this power any greater, if indeed as great as that invested in the governing authority of the stock exchange over its own members for violation of its own rules?

Mr. HEALY. I should judge not, from what I have heard, although I have very little first-hand knowledge.

Senator KEAN. That is a self-governing body. The members of the exchange vote for those people to govern them, and they have their consent. They have given them that power. We take it without consulting them. We put this bracelet around their necks.

Mr. PECORA. It is not a bracelet. It is just simply giving a desirable disciplinary power over those who are subject to its rules and regulations and who are guilty of an infraction.

Senator WAGNER. When I was a judge on the bench I issued a temporary injunction to restrain the stock exchange, until the matter could be heard by the court, from expelling a member who had, they claimed, violated their rules by some wash-selling operation, and when the matter came before the court eventually I was compelled by the evidence to sustain the stock exchange. The man was expelled, but he had his day in court absolutely.

Mr. PECORA. He will have it here.

Senator WAGNER. That is what I say.

Mr. PECORA. It provides for notice and opportunity for hearing.

The CHAIRMAN. I was just going to ask the committee to allow your testimony to be incorporated in the hearings. This is a very important statement, and I think it should go into the hearings.

Mr. HEALY. If that is done, may I have an opportunity to revise it?

The CHAIRMAN. Yes.

Mr. HEALY. Because, speaking here under tension, it is sometimes difficult to make oneself clear.

The CHAIRMAN. Without objection, it will be inserted in the hearings.

Senator KEAN. The other day Mr. Pecora produced a statement which he wanted to substitute for one made by Mr. Redmond.

Mr. PECORA. Relating to section 10?

Senator KEAN. Yes. I suppose it was in the record.

Mr. PECORA. So did I.

Senator KEAN. And so did he.

The CHAIRMAN. That may be inserted in the hearings also; and we will insert your statement in the record of the hearings so it will be printed.

Mr. HEALY. I think that is a matter that is up to the committee entirely. I would be glad to have it appear, however, that I came here at the committee's request.

The CHAIRMAN. You will be given an opportunity to revise the proof.

(The statement of Mr. Redmond, referred to, was handed to Senator Kean to be returned by him to the clerk of the committee for insertion in the record.

The CHAIRMAN. I wanted to ask you one more question. Please turn your attention to page 52, section 25. As the bill now reads [reading]:

> Any person who willfully violates any provision of this act or any rule or regulation made thereunder, or any undertaking filed thereunder, or any person who willfully and knowingly makes, or any person, including a director, officer, accountant, or other expert thereof who willfully and knowingly is responsible for any statement in any application, report—

And so forth.

What I have in mind is that expression, "Who willfully and knowingly is responsible for any statement." It seems to me that that is rather ambiguous and indefinite. Can we not explain that in some way? Can we not make that clearer? You, as a lawyer, would know how difficult it is going to be to show that someone is responsible for a thing, and whether that definition is sufficiently clear.

What do you say, Senator Wagner?

Senator WAGNER. I usually like to have a man responsible for his act.

The CHAIRMAN. How can you show that anyone is responsible for the statement? Ought we not to express clearly the idea that he must have participated in it in some way?

Senator KEAN. I think so.

Mr. PECORA. The idea, I think, was not to subject anyone to any penalty for an honest mistake.

Senator WAGNER. "Willfully and knowingly" is all right.

Senator KEAN. I think "responsible" might be left out. How would it read then?

Mr. HEALY. In reading that I did not know why it was put that way, but it occurred to me that it might be for this reason, that there might be people who did not make the statements themselves, but who were responsible for them. Very often the fellow behind the scenes who is most responsible for everything that happens does not appear much himself in the public eye.

Mr. PECORA. I think, Judge Healy, you are correct, because the previous part of that clause subjects the one actually making willfully, and knowingly, a false statement, to the penalties provided for by the act.

Senator WAGNER. Where is that?

Mr. PECORA. In section 25: Any person who willfully violates any provision, or any person who willfully and knowingly makes any such statement, or any person, including a director, officer, accountant, or other expert who willfully and knowingly is responsible for any statement. There are three different classifications of persons intended to be reached, and I think the last category is intended to apply, as Judge Healy has suggested, to those who do not themselves make the statement, because such persons would fall within the second category.

The CHAIRMAN. Would it not be better to say "knowingly and willfully procures or directs"?

Mr. PECORA. I think that would be a clarification.

Mr. HEALY. I think it would be a good change. You might say, "Any person who willfully or knowingly procures, aids, or abets"——

Senator KEAN. That is a little broad.

Mr. HEALY. Yes; it is broad; but is it too broad?

Senator KEAN. I think it is.

Mr. PECORA. That language is almost similar to the language found in penal statutes making accessories responsible as principals; that is, those who aid, abet, procure, or cause another to commit a crime.

Senator KEAN. I think Senator Fletcher's suggestion is much better.

The CHAIRMAN. It struck me that it needed a little clearing up.

Senator WAGNER. "Who knowingly procures another to make any statement", and so forth.

The CHAIRMAN. "Who procures, directs, or aids in the making of a statement." I merely suggest that. We will think about it.

I received this morning, in response to the request of the committee and in response to objections raised to the bill on constitu-

tional grounds, a statement from Prof. Noel T. Dowling, who is a professor of law at Columbia University. I would like to have his statement in the record in the open hearings.

(Statement of Noel T. Dowling, professor of law at Columbia University, entitled "Memorandum Concerning the Power of Congress, Under the Commerce Clause, to Regulate Securities Exchanges", will be found printed in full at the end of today's transcript of hearing.)

Mr. PECORA. I have just received a communication from Mr. John Dickinson, Assistant Secretary of Commerce, which I think might as well go into the executive-hearing record. The letter is accompanied by a statement of the amendments which he suggested might be made when he appeared before this committee last week. He was then requested, if you will recall, to reduce his proposed amendments to written form. There has just been handed me that list of amendments.

The CHAIRMAN. I have the original of that.

Mr. PECORA. I did not know you had that, Mr. Chairman.

Senator WAGNER. Judge Healy, I did not have the advantage of listening to your entire testimony. Did you touch the question of margins at all today?

Mr. HEALY. No, sir.

Senator WAGNER. Have you any views about that subject?

Mr HEALY No, sir; I had no hand in the writing of the bill and do not feel competent to talk about that subject.

Senator WAGNER. I wanted to get the benefit of your opinion if you had one on the subject.

Mr. HEALY. I have just one opinion, which is of a very general nature, and that is that it is in the public interest to control speculation through the control of credit in connection with margins. Further than that I would not care to go.

Senator WAGNER. What prompted my question was that in a talk with Governor Black the other day he suggested as part of the control that instead of having restrictions or limitations in the act itself, the Federal Reserve Board ought to have the authority from time to time to fix the margin limitation. I wondered whether you had any views about that.

Mr. HEALY It occurs to me that it would not be wise to leave it entirely to the Federal Reserve Board if you do something of that sort. It seems to me that if the Federal Trade Commission is going to administer the act it ought to have some official part in any activity relating to marginal requirements. I do not mean the sole authority, by any means, but some part.

Senator WAGNER. None of your activities go into the area of control of credit?

Mr HEALY. No, sir.

Senator WAGNER. Would not that be a new field for you?

Mr. HEALY. Yes, sir; but of course work in connection with securities on the stock exchange is something of a new field.

The CHAIRMAN. The law might fix a minimum and draw a line of its own and then leave the Federal Reserve Board to fix a margin within that zone.

Senator WAGNER. I have no very definite views about it myself, but I thought I would like to get Judge Healy's opinion.

(Informal discussion occurred which the reporter was directed not to record; after which the following proceedings took place:)

Mr. PECORA. Judge Healy, will you be good enough to turn to page 33 of the bill, H.R. 8720, at the top of the page, item no. 10, requiring the filing of balance sheets for preceding years certified by public accountants, and so forth?

Mr. HEALY. Yes, sir.

Mr. PECORA. It has been suggested, and I think it was Mr. Dickinson's suggestion, that after the words "balance sheets for" there should be inserted the words "not to exceed the three preceding years." That is, to have balance sheets filed for the preceding 3 years. And a similar amendment to item 11, profit and loss statements for a period not to exceed 3 preceding years. Do you think such an amendment would be a good one?

Mr. HEALY. It would not occur to me that that was an unreasonable suggestion. However, it ought to be left perfectly clear, if such an amendment is made, that nevertheless the commission or the corporation reporting must disclose the content of its fixed capital account and its surplus account, various reserve accounts, investment accounts, and so on, if necessary, in order that their content may be known. Sometimes it is necessary, in order to get that information, to go back more than 3 years.

With that much of a reservation I should think that the suggestion was rather a wise one.

Also, I would suggest that the commission should be left with authority to require balance sheets for other years without certificate, if it wants to. I do not think anybody wants a certified public accountant to go back and examine all the balance sheets that have been put out for years.

The CHAIRMAN. We are very much obliged to you, Judge Healy.

The committee will now take a recess until 10 o'clock tomorrow morning.

(Whereupon, at 1:25 p.m., a recess was taken until tomorrow, Tuesday, Apr. 3, 1934, at 10 a.m.)

For release Tuesday, April 25, 1933, after the full report of which this is only the summary, has been introduced in the official record, Federal Trade Commission, Washington (This copy will not be made available until the full report containing the summary has been introduced in the record)

The following summary of the report of the Federal Trade Commission examiner, was placed in the record in the Commission's investigation of power and gas utilities, Tuesday morning, April 25 The Examiner, Dr. Thos W Mitchell, testified regarding this report which is based on his examination of the books and accounts of Cities Service Securities Co, of the Doherty group of utilities

The Cities Service Securities Co is a securities marketing and trading agency set up in 1927 by Henry L. Doherty & Company and is wholly owned by Cities Service Company.

The report of which the following is a summary, sets out briefly in Chapter I the organization and purpose of Cities Service Securities Co and the manner of its functioning In thirteen sections of Chapters II and III are presented the activities in thirteen typical securities marketing campaigns based on the functions and purposes set out in Chapter I

The summary is as follows:

SUMMARY OF REPORT ON CITIES SERVICE SECURITIES COMPANY

Henry L Doherty & Company, managers of Cities Service Company, furnished by application of the proceeds of sales during 1927 and 1928 and up to the stock market crash in 1929, the great bulk of that demand for that latter company's common stock that was expressed in purchases on the New York Curb Exchange That stock was purchased continuously in large volume over the counter and on the New York Curb Exchange. They were enabled to do this by applying to these "market purchases" a large proportion of the funds and orders that were obtained through cash, short-time and installment sales to investors in every nook and corner of the United States. The purchases and sales were made for account of Cities Service Securities Company. The purpose claimed for these market purchases by the company was that of facilitating the sale of new blocks of original issue of the stock by providing for the investors an active resale market in which they could readily dispose of their holdings if occasion required However, the volume in which these market purchases were made was not merely sufficient to support and steady the market price but was such that the market price rose to a great height, from which it crashed in October, 1929

This organization's market activities constitute an outstanding example of what is believed to be a general practice in modern finance and stock market control. The practice has far-reaching effects upon the welfare not only of the investing and speculating public but of the entire general public. It may conceivably be carried on only in such volume as to support and steady market prices, or, as in 1927, 1928 and 1929, it may be carried on in such volume as to induce a continuous rise in the prices of stocks generally, and as to induce a general orgy of speculation in which stock prices go to absurd heights, from which they must inevitably crash to the great injury not only of the speculators but of the entire nation.

Incorporation, Capitalization and Control.—Cities Service Securities Company is a wholly owned subsidiary of Cities Service Company. Its organization on March 17, 1927, and its incorporation in Delaware on April 9th following were caused by Henry L Doherty & Co, who transferred to the new company in exchange for its capital stock ($15,000,000 par value supported by net assets valued at $20,000,000), the assets, liabilities and current situation that pertained to a certain function that previously had been performed by Henry L. Doherty & Co. as Fiscal Agent for Cities Service Company and its subsidiaries. The performance of that function had been carried on with the assistance of funds advanced by Cities Service Company; and Henry L Doherty & Co reimbursed that company for the advances by transferring to it the Securities Company's capital stock at a valuation of $20,000,000 and by causing the Securities Company to assume an open account indebtedness to Cities Service Company of $21,721,175 42

Main Function.—The Securities Company's main function, which is the certain function referred to and which is performed for it by the staff of Henry L. Doherty & Co. (for the Securities Company has no paid organization of its own), is that of obtaining or facilitating the raising of additional capital funds, and it has been variously described as follows:

To facilitate the marketing of securities of Cities Service Company and its subsidiaries;

To supervise the market, or (in connection with syndicate operations) the sole handling of the market for such securities;

To provide a ready resale market in which owners of securities of Cities Service Company and its subsidiaries can readily dispose of their holdings at retail when they desire to do so.

This function is most actively performed during those periods in which new original issues of the securities in question are being marketed by banking syndicates and distributing groups or in which preparation is being made for the issuance of such new blocks. The Securities Company usually does not itself market any considerable portion of an original issue of bonds or stocks of Cities Service Company or of its subsidiaries, although it has occasionally taken an additional original issue for the purpose of covering a technically "short" position that it has created in the course of its activities in "supervising the market" When the Securities Company does participate in the marketing of a block of original issue of securities, it usually obtains its portion of the issue, not from the issuing company, but from the managers of the syndicate that has undertaken the marketing of the block

In connection with the marketing of such blocks of original issue, the Securities Company's function may be described as that of making the security in question attractive to the public A natural effect of adding to the supply of a given security is to depress its market price. it is important from the viewpoint of the results to the issuing company that this price-depressing tendency be counteracted and, if possible, even be converted into a price-advancing tendency. One condition in conjunction with others, that makes a security attractive to the investing public is an active organized market in which the investor can readily dispose of his investment if he has occasion to do so It is therefore important from the viewpoint of results to the issuing company that such an active market be created and sustained for some time prior to and during the period in which the new block of original issue is being marketed In addition to the investment demand, a speculative demand for a given security may be stimulated by a persistently rising price of the security in question, the motive of the speculator being to obtain a profit in the purchase and resale of the security. Such speculative purchases may be made outright; but they can be made in greater volume on margins Such a speculative demand is likely to be stimulated if the sustained volume of purchases on the organized exchange is of sufficient magnitude to cause a fairly rapid and continuous rise in the market quotations However, purchases by speculators result later in speculators' sales, which add to the Security Company's burden.

Method of Performing Main Function—The method by which the Securities Company performs this function is as follows

Having regard, of course, to the volume of sales to investors effected by the selling organization, it purchases the security day by day in considerable volume on the organized exchange These purchases are made through brokers. They are made in such volume as to constitute a large supplement to the public investment and speculative demand for the security as expressed in purchases on the Curb Exchange It also purchases the security "over the counter", which has the effect of keeping such quantities out of the supply offered on the organized exchange All of those purchases have the following effects

(1) They provide the ready resale market for those investors in the securities in question who had occasion to dispose of those investments

(2) They tend to prevent the market price from sagging under the influence of the addition to the supply, because this added demand by the Securities Company competes with the public demand as expressed in purchases on the Curb Exchange and appears or is augmented in volume just before and during the period in which a new block of original issue is being offered to the investing public This supplement to such public demand may even cause the market quotations for the security in question to advance

(3). They induce investment confidence in the security in question and also speculative cupidity The latter is stimulated especially when the Securities Company's activities result in successive advances in the market price, which advances offer the speculator the prospect of reaping a profit by purchasing the security and reselling it later at a higher price

Basis of Market Purchases and Sources of Funds—These "market purchases" tend rapidly to deplete the Securities Company's cash funds, and it could not long continue to make them if it did not have means of replenishing its funds They are provided or replenished, and the Securities Company obtains a basis on which to determine the volume of its market purchases, by the following means In addition to their sales offices in New York City, Henry L Doherty & Co had, in May, 1929, district offices in 25 cities of the United States, and 802 securities salesmen reporting to these offices operated not only in those cities and adjacent communities but in 28 others also Those salesmen were continuously active in obtaining from their acquaintances and other sources the names of likely individual and institutional prospects, and in following up such leads, soliciting and obtaining orders for the securities Telegraphic reports followed by daily transmission of copies of the sales confirmations kept the New York office continuously informed as to the details and volume of orders so obtained The volume of sales orders so obtained and of sales effected "over the counter" constituted a basis of the volume of "market purchases" made by the Securities Company "over the counter" and on the organized exchange; and the down payments of cash by the customers and the later collections of cash from them constituted an important source from which were replenished the cash funds that were depleted through the aforesaid market purchases.

To some extent these sales orders and funds were supplemented for this purpose by orders and funds obtained from or through investment retailers who participated in special offerings and even in syndicate distributing groups

Thus the Securities Company, through Henry L Doherty & Co. as agent, functioned, to the extent of its market purchases, very much like a broker who received from customers orders to purchase certain designated securities in specified quantities and then purchased on the exchange or over the counter the securities with which to fill the orders However, it differed from an ordinary broker in the following respects

(1) The customer investor did not give an order to purchase the securities for him, but he contracted to purchase them from Henry L Doherty & Co ,

(2) The securities salesmen of Henry L Doherty & Co took the initiative in soliciting the orders rather than waiting for orders to come,

(3) Neither the Securities Company nor Henry L. Doherty & Co is a member of the exchange, but the purchases on the exchange were executed through broker members,

(4) The purchases of securities with which to fill the customers' orders did not necessarily have to be made immediately after receipt of the orders, because of the fact that a large portion of the orders was made on account or on 10-months installments, thereby affording the Doherty Management leeway as to the time at which to provide the securities According to the company's representatives, the shares sold on the installment plan during the period under review averaged something less than 15% of the Securities Company's total sales of this stock The securities so sold were not deliverable until paid for in full, and, according to the terms of the installment contract used in 1929, those sold on such contracts were not deliverable until the expiration of the contract period even though the customer completed his payments before that expiration Also securities needed for delivery to customers, particularly Cities Service Company common stock, could be and were provided temporarily by borrowing them from large holders This made it possible to build up sales balances to cover which securities of new original issue were disposed of to the lenders or to the ultimate investors The last step accomplished the ultimate purpose of the whole process—the acquisition of new capital.

Secondary Function—The Securities Company is also a convenient instrument through which gradually to buy in those securities that are to be retired, or that are to be tendered to sinking fund trustees, or that are to be taken out of the market temporarily, or that are to be modified

For example, Public Service Company of Colorado, an indirect subsidiary of Cities Service Company, found it advantageous to issue 6% rather than 7% preferred stock, and later to issue 5% rather than 6% preferred stock Up to January 29, 1931, the Securities Company and Henry L Doherty & Co, who functioned before the Securities Company was formed, purchased $3,939,215 12 par value of the 7% preferred stock at a cost of $4,287,062 17, exchanged $895,000 par value of it for $966,800 par value of the 6% preferred at an annual dividend saving of $4,634, exchanged $300 000 par value for $375,000 par value of the 5% preferred at an annual dividend saving of $2,250, and sold $2,690,000 par value of it to Cities Service Company Also after the marketing of 5% preferred stock was commenced, the Securities Company gathered in 6% preferred stock, and, on August 2, 1929, sold $535,700 par value of it to Cities Service Power and Light Company at cost, $547,500 94 The Securities Company also marketed $4,112,700 par value of the 6% preferred stock for $4,046,921, and, during the process, spent $991,348 34 making market purchases to the extent of $977,000 par value

Again in March, 1927, Cities Service Company sold $15,000,000 face amount of 5% debentures maturing in 1966 to A B Leach & Co , and the Securities Company participated in the distribution as a member of the distributing group The issuing company had outstanding at the time 6% debentures maturing in the same year, and the Securities Company purchased these in considerable quantities in the market. It continued these purchases up to the end of 1928, both in the market and from European bankers, while two other debenture issues bearing 5% interest were being marketed More than $17,000,000 face amount of these were sold to Cities Service Company.

Examples of buying in securities and modifying them previous to resale are the following On November 1, 1928, when the market price of Cities Service Company common stock was about $70 per share, that company sold to Harris, Forbes & Co and Halsey, Stuart & Co, who marketed them through a distributing group of retailers, $30,000,000 face amount of 5% debentures matur-

ing in 1963 at 92½ and interest These debentures bore non-detachable option warrants conferring upon the holder of each 1,000-dollar debenture the right to purchase 15 shares of Cities Service Company common stock at prices which, commencing at $72 per share, advanced $2 per share each 6 months Again, in March, 1929, when the market price of this stock was about $126 per share, that company sold to the same wholesale investment bankers at 92½ and interest, $50,000,000 face amount of 5% debentures maturing in 1969; and these debentures bore non-detachable option warrants whereby the holder of each 1,000-dollar debenture had the right to purchase 10 shares of Cities Service Company common stock at prices which increased at half-yearly intervals commencing with $122 per share if the option were exercised within the first six months. Subsequent to the issuance of these debentures the market quotations for the stock rose to such heights that sale of it at the debenture warrant prices was not advantageous to the issuing company, but at the same time the differences between the market prices of the debentures with warrants and ex-warrants were so narrow that more proceeds could be realized by purchasing the debentures with warrants, exercising the warrants and re-selling them ex-warrants The Securities Company purchased these debentures in large volume, paying high premiums It exercised the warrant options on $10,818,000 face amount of the Debenture 5's of 1963 and on $18,328,000 face amount of the Debenture 5's of 1969, thereby making them available for re-sale as debentures ex-warrants. Of their total cost, $20,996,-193 19, representing the difference between their cost and their market value ex-warrants, was treated as a part of the cost to the Securities Company of the common shares obtained in the exercise of the warrants Some of the ex-warrants debentures were re-sold, some were transferred to Cities Service Company, and, at last accounts, some were still being held by the Securities Company

Importance of The Securities Company's Chief Function —The chief function of Cities Service Securities Company was variously designated as "providing a ready resale market for securities", "facilitating the marketing of securities", "supervising the market" and "sole handling of the market" for securities Another name commonly applied to this function is "sponsoring"

Inasmuch as the Securities Company is wholly owned by Cities Service Company, its performance of this function with reference to the parent company's stock virtually amounts to Cities Service Company's trading in its own stock. Such activity is regarded with disfavor by the governing body of the New York Stock Exchange However, the securities of Cities Service Company are dealt in, not on the New York Stock Exchange, but on the New York Curb Exchange. Even in the case of many companies whose securities are listed on the New York Stock Exchange, however, the trading is nevertheless carried on by the company's Financial Agent, or by pools gotten together by the Financial Agent, or by a securities company owned by the Financial Agent

These trading activities are not of mere minor and incidental importance in modern finance They are of major importance, because of their volume and of the effects produced through their volume. While the practice of "sponsoring" stocks has been a matter of common report over several decades, the volume of trading involvid in it, the great proportion of the demand for securities on the organized exchanges that is provided by these company purchases, the extent to which funds supplied by the investing public are used for this purpose, and the extent and public importance of the effects are probably little realized The description in this report of the activities of Cities Service Securities Company in connection with campaigns to market common stock of Cities Service Company and Class A common stock of Arkansas Natural Gas Corporation furnishes outstanding illustrations that may convey such realization

When the Securities Company took over this function from Henry L Doherty & Co on April 1, 1927, an operation to distribute Cities Service Company common stock was drawing to a close, and the sale of another 250,000 shares under a special offering to dealers was under way. In the performance of its function during the remaining 9 months of 1927, the Securities Company spent nearly $45,851,000 in market purchases of 936,104 shares of this stock, its sales during the same period amounting to 938,910 shares for $45,880,759 38 By "market purchases" is meant not only purchases on the New York Curb Exchange but also purchases "over the counter". The latter did not, on the whole, exceed one-sixth of the total. These market purchases amounted to 92 4% of the total number of Cities Service Company common shares traded

on the New York Curb Exchange during the same period and they exceeded the number traded on the Curb in four of the nine months During that period, the closing Curb price of this stock, after sagging from $51⅝ to $44 in April, followed a fluctuating rise to $55⅞ at the year end

On March 9, 1928, when the market price was about $58 per share, Cities Service Company offered its common stockholders a 10% pro rata subscription for additional shares at $45 per share. In the process of supervising the market for the stock and the rights during this operation, the Securities Company and Pearsons-Taft Company formed a syndicate distributing group for the purpose of effecting sales of 300,000 shares at current closing Curb prices plus ⅛ point, and the syndicate participants sold 466,755⅛ shares for $27,327,762 25 The purpose of this distributing group was to provide a channel through which to sell such shares as the stockholders failed to take, but, the stockholders having taken the entire 10% offering, the syndicate sales were utilized along with sales effected by Henry L Doherty & Company's organization as channels through which to dispose of the shares obtained by the Securities Company in its market purchases to dispose of 100,000 additional shares of original issue and to dispose of approximately 51,892 shares held by Gas Securities Company. Preparatory to making voluminous market purchases in its process of supervising the market, the Securities Company guarded against excessive loss in the resale of such shares by forming a Put Syndicate and paying it a commission of $300,000 for the privilege of selling to the Put Syndicate not to exceed 200,000 shares obtained in such market purchases and in the exercise of rights purchased in the market, the "put" price to be $50 per share or cost, whichever should be the lower The privilege was exercised to the extent of 55,000 shares, of which 29,300 shares were repurchased The Securities Company also purchased at a cost of $2,220,219 55 the rights to subscribe for 210,897½ shares and exercised most of the rights Also during the nine months, January to September, 1928, the Securities Company's market purchases of this stock totalled 1,451,890 shares, which fell short of the total number of shares of this stock traded on the Curb Exchange by only 18,810 shares or by less than 1 3%, the Securities Company's market purchases exceeded the number traded on the Curb in five of the nine months During these nine months, the Securities Company's sales amounted to 1,867,254 shares And the closing Curb quotations for this stock continued their upward progress from $55¾ on January 1st to $68⅜ on September 30, 1928.

Up to September 30, 1928, the Securities Company's market purchases of Cities Service Company common stock frequently exceeded the total number of shares of that stock traded on the Exchange, indeed exceeded the totals in 9 out of the 18 months Thereafter the proportion of the Securities Company's market purchases to the total trading on the Exchange was less than 100% and, with exceptions, grew progressively less—not, however, through diminished volume of the market purchases (which increased, instead) but through a greater increase in the volume of purchases on the Curb Exchange by the investing and speculating public It is probable that the spectacle of the continuous and rapid rise in the market quotations for this stock attracted speculators who purchased in larger and larger volumes, doubtless on margins to a large extent, for the purpose of reaping large profits in the resale

On December 17, 1928, Cities Service Company announced to its common stockholders another offer of common stock for pro rata subscription at $65 per share to the extent of 10% of their record holdings on January 8, 1929 The Securities Company undertook supervision of the market for the rights and for the stock during this operation. It formed another Put Syndicate and paid it a fee for the privilege of putting to it not to exceed 200,000 "market shares" at $75 per share or cost, whichever should be the less In order to provide channels through which to dispose of any shares that should not be taken by the stockholders, it joined with Pearsons-Taft Company in the formation of another syndicate distribution group, which was to obtain orders at retail for 300,000 shares at the current closing Curb price plus ⅛ point. In its market "supervising" activities the Securities Company purchased in the market at a cost of nearly $2,489,000, rights to subscribe for 110,880 1/9 shares. Also, during December, 1928 and January, 1929, it spent over $56,900,000 in market purchases of approximately 649,087 shares. Its sales during the same two months amounted to 890,068 shares with contractual proceeds of $75,079,805 64 The closing Curb quotations rose from $73 on December 1, 1928 to $89½ by January 10, 1929, and to $91 by February 1 The number of shares offered to and subscribed by stockholders was 552,842½.

Although, including the Securities Company's subscriptions, the pro rata subscription offer to the stockholders was a complete success, extensive sales had been effected by the syndicate distributing group and by Henry L. Doherty & Company's organization These sales were sufficient not only to cover the Securities Company's market purchases but to leave a margin to which could be applied more shares With market quotations approaching and attaining $120 per share, the Doherty Management continued the marketing campaign, also Mr. Doherty decided to sell 200,000 shares of his personal holdings. Steps were also taken whereby he reinvested $1,000,000 in Cities Service Company's newly created noncumulative stock in such manner as to increase his voting power from 144,813 votes or 6 19% of the total voting power to 1,104,813 votes or 33.11% of the total The company's representatives averred that there was no connection between these two transactions. With such high prices for a 20-dollar par stock, steps were also taken to change the common stock to the non-par variety and split it four shares for one, which became effective on May 2, 1929. A new selling campaign was launched in April, 1929, and was carried on through a dealers' special offering and through the Doherty organization until the end of September While the market quotations held at about $120 per share from about March 19th to the date of the split-up, their upward movement resumed after the split-up and continued to a maximum of $68⅛ for the new non-par stock (equivalent to $272 50 per share of the 20-dollar par stock) which was attained on October 15, 1929

In this connection the Company's representatives urged that the advance in market price of this stock during 1927 and the greater part of 1928 lagged noticeably behind the upward trend of the general market for stocks They also point out that on December 4, 1928 one of the Cities Service Company subsidiaries brought in the discovery well in the now famous Oklahoma City oil pool, and they claim that this discovery attracted public interest and focused attention of investors and speculators upon Cities Service common stock, that this interest was stimulated as other wells in this pool came in later; and they point out that it was during this period from November, 1928 to October, 1929—particularly from July to October, 1929—that the market price of Cities Service common stock had its spectacular rise They point out that during the period the management was engaged in raising a large amount of new capital with which to develop its holdings in this oil field However, that may be, it is a fact that during the 11 months and 6 days from October 31, 1928 to October 5, 1929, during which large additional amounts of new capital were sought, the management spent nearly $389,250,000 in the purchase of the equivalent of nearly 12,072,000 non-par shares of Cities Service Company common stock over the counter and on the Curb Exchange, with which to fill sales orders from customers.

The extent to which the Securities Company's market activities influenced and contributed to that spectacular elevation of the market quotations for Cities Service Company common stock and to the general market condition that was attained by the beginning of October, 1929, and that culminated in the stock market crash of that month, may be judged from the following summary of significant facts. The records of Cities Service Company show that, from November 1, 1928 to October 5, 1929, that company issued, exclusive of stock dividends, new original issues of common stock to the extent equivalent to 5,763,850 shares of the present non-par variety, for proceeds amounting to $86,789,125 During identically the same period, the Doherty Management, as agent for the Securities Company, spent $389,248,248 77 in the purchase, mostly on the Curb Exchange, of the equivalent of 12,071,692 812 non-par shares of Cities Service Company common stock Of course, all of the shares so purchased and several millions more were resold over the counter, by Henry L Doherty & Company's stock salesmen and through other channels During that period, the market quotations for the stock rose from the equivalent of about $17 69 to $61 75 per share The contribution of those market activities to that price elevation may be inferred from the fact that those purchases amounted to 73 5% for the entire reported demand on the Curb Exchange Any percentages are subject to qualification because not all transactions on the Curb Exchange may have been reported—in fact, particularly in the early years (1927 and 1928) numerous discrepancies occurred between quantities reported by different agencies

Prior to September 30, 1928, the Securities Company's market purchases of Cities Service Company common stock frequently exceeded the total number traded on the Curb Exchange The last statement in the preceding paragraph shows the proportion from November 1, 1928 to October 5, 1929 at 73 5%.

The proportion from October 1, 1928 to October 5, 1929 was about 74 4% Even this is a very large proportion, and indicates that the public market demand of investors and speculators for this stock was a very small proportion of the total market demand expressed on the Curb Exchange It also indicates, however, that the general public had been attracted to this stock Probably these purchases by the general public consisted in large part of margin purchases by speculators for the purpose of reaping large profits in the re-sale at still higher prices

In September, 1929, the Doherty Management planned another 10% pro rata subscription offer to Cities Service Company common stockholders of record November 7th, 1929 In order to provide an alternative channel in case the stockholders did not respond fully, another syndicate distributing group was arranged, and marketing commenced on October 1st. The Securities Company undertook supervision of the market

The market condition was exceedingly precarious, however Doubtless stimulated by the sustained upward trends of market prices of stocks which in turn were doubtless stimulated by the large and sustained volumes of market purchases by "sponsors" such as Cities Service Securities Company, there was a very large volume of margin holdings of stocks—10 to 12 billions of dollars—as was evidenced by brokers loans which stood on October 3, 1929, at the stupendous total of $8,549,383,979 and which had increased during the preceding four months to the extent of nearly $1,868,000,000 Call loan rates were high The prices of many stocks were so high that the income accruing to them represented yields of 2% or less on those prices, a fact that would naturally precipitate investment selling Speculators would have to sell in order to realize their paper profits in cash These facts invited short selling raids by "bear" cliques in the hope of producing sufficient drops in market quotations to precipitate a large amount of forced selling by the margin speculators, which would enable the "bear" operators to cover their short sales at a profit Once such forced selling was commenced there was not necessarily any stopping point until the last speculator was squeezed out

During the first half of October, 1929, the Securities Company spent vast sums of money in withstanding the selling pressure on Cities Service Company common stock, and it was so successful that the market quotations actually advanced from a closing $60¼ on September 30 to a high of $68⅛ on October 15th However, on Monday, October 21st, in a panic that was precipitated on the preceding Saturday, 936,500 shares of Cities Service Company common stock were hurled onto the market The Securities Company, in an endeavor to allay the panic, spent more than $48,886,000 in the purchase of 784,644 of those shares It was only partially successful, however, the price having broken from $66⅝ to $59¾ This price break was followed by even heavier selling pressure—1,151,900 shares on October 24th, 976,700 shares on October 28th and 1,105,900 shares on October 29th During the whole course of the stock market crash in the latter half of October, 1929, the Securities Company spent more than $138,000,000 in the purchase of 2,372,101 shares of Cities Service Company common stock, but, as these amounted only to about two-fifths of the total quantity of that stock thrown onto the market, they were not sufficient to uphold the market price, which broke to a low of $20 on October 29th During October the Securities Company sold, exclusive of the shares taken by warrant-exercising debenture holders, 3,401,462 shares, the contractual proceeds of which, after certain adjustments, amounted to $180,314,663 10 as against purchases during October of 3,080,392 shares at a cost of $181,825,808

The rapid changes in market quotations during this period resulted in numerous price adjustments to the customers for Cities Service Company common stock By the end of the year these amounted to $10,605,811 52 on sales effected through the syndicate and to $2,168,658 55 on sales effected by Henry L Doherty & Company's organization

As a result of the relatively low-market quotations prevailing for Cities Service Company common stock after the stock-market crash of October, 1929. the pro rata subscription offer to the stockholders was abandoned, and modifications were made in the syndicate distribution group agreement. A new special offering to dealers was announced in February, 1930 During 1930, the sales of this stock through all channels amounted to 7,382,696 16 shares, with a gross invoice value of $210,441,088 86 The company made market purchases aggregating 7,337,156⅛ shares at a cost of $218,803,730 37 There was a period of upward trend in the market price of the stock—from a low

of $25¼ on December 20, 1929 to $41⅞ on May 1, 1930 But during this period, the Securities Company's market purchases exceeded its total sales through all distribution channels A market decline set in, in May, 1930, during which the sales exceeded 1,000,000 shares and exceeded the market purchases by nearly 279,000 shares; and a fluctuating decline continued throughout the remainder of that year, the market price at the very end being $14⅝ per share

On January 17, 1930, Cities Service Company provided the Securities Company with 600 000 common shares with which to make deliveries to customers Although the market price at the time was about $28 per share, the gross proceeds available from accumulated sales averaged only $15 91 per share to be provided, and the price to the Securities Company for these shares was $12 50, which left the latter a margin of about $3 41 per share with which to cover commissions and expenses As of December 31, 1930, Cities Service Company provided the Securities Company with another 633,879,206 shares at $10 per share This price left the Securities Company with a margin of about 53 82 cents per share with which to cover commissions and expenses

The Securities Company's accounts represented that company as selling, to the holders of Cities Service Company debentures, the common shares that were issued to them when they exercised the warrant options carried by their debentures, and as obtaining the requisite shares from the issuing company at prices from $5 50 to $7 per non-par share less than the prices paid by the debenture holders. As the Securities Company had no function to perform in the issuance of these shares, this resulted in counting for it a gross profit of $18,429,723 23 for which it did not render service However this made no difference in the ultimate proceeds to Cities Service Company because the Securities Company's net deficits from these operations were charged back to it

As of December 31, 1929, the Securities Company wrote down the book cost of its "Trading Purchases" of Cities Service Company common stock, $21,121,-097 98 This was not an inventory adjustment, as the company had no unsold shares, its aggregate sales up to that time having exceeded its aggregate purchases by 1,946,941 shares Such bookkeeping enabled the Securities Company a year later to count on certain classes of sales of this stock a gross profit of $99,642 39 instead of an actual gross loss of $21,021,455 29 Profits and losses made by trading in securities are not, however, taken into earnings but are treated as more or less capital proceeds from the securities of new original issue, which treatment is represented on the company's books by carrying them, not to Surplus, but to an account called "Reserve for Cost of Distribution".

After counting profits and losses on December 31, 1930, the Securities Company emerged with a deficit in its "Reserve for Cost of Distribution" of $1,956,-775 71 This was charged back to Cities Service Company, as also was $12,518,-998 55 of uncollectible balances of breached partial payment contracts.

Memorandum Concerning the Power of Congress, Under the Commerce Clause, to Regulate Security Exchanges

This memorandum is concerned with the basic question whether Congress, by virtue of the commerce clause, has power to regulate security exchanges Its purpose is to show that a constitutional foundation exists upon which may be built a statutory structure for the regulation of such exchanges For if this power can be established, as in my opinion it can, then it becomes largely a question of fact and of administrative judgment whether and how far the regulation shall be extended beyond the exchanges themselves and applied to related and collateral activities

I REGULATION OF SECURITY EXCHANGES IS A NATIONAL PROBLEM

The national character of the problem of the regulation of security exchanges is shown by the facts Some of them are subject to judicial notice Others have been brought out by the Congressional investigations or have been gathered as a result of independent studies A few of the broader aspects may be noted here as bearing on the national interest

Transactions upon the security exchanges may have a direct effect upon the ability of the instrumentalities of interstate commerce to perform their functions New security flotation is difficult if, because of manipulation or loss of public confidence, existing securities have shrunk to abnormally low

values. With this should be considered the frequent refunding operations made necessary for the American railways by virtue of their heavy funded debt The other carriers (air and motor transport, pipe lines) have in general a small funded debt but their stock distribution is more limited, making speculative movements more severe No reason appears why the burden which may thus be imposed upon the efficient functioning of the interstate transportation system is any less direct or real than that of low intrastate passenger fares, *Railroad Commission of Wisconsin* v *Chicago, B & Q R Co*, 257 U S 563

Interstate commerce in largest part consists of the movement of goods financed by credit Without adequate credit facilities the physical instrumentalities of interstate commerce are near to useless An unrestrained speculative activity absorbing, at times, billions of dollars of credit, at high interest rates, of necessity increases the cost of financing and, to a significant extent, diminishes the volume of credit available for the interstate transaction An even more serious impediment to the continued functioning of this interstate shipment is found in the vulnerability of the commercial banking system to extreme fluctuations in the quoted values of securities. Through direct investment and through collateral required of the borrower, the commercial banks are so circumstanced that an abrupt decline from a speculative peak must leap a heavy toll in insolvency, with consequent attrition of the interstate movement of commodities A Congressional power which can reach the purchase of stock in competing businesses, *Northern Securities Co.* v *United States*, 193 U S 197, the charging of discriminatory prices, *Van Camp & Sons* v *American Can Co*, 278 U S 235, and the publication of an "unfair" list, *Loewe* v *Lawler*, 208 U S 274, because of a possible diminution of interstate commerce, hardly can be said to fall short of protecting the essential credit foundation from the dangers presented by an unrestrained speculative market for securities

Since "commerce among the states is not a technical legal conception, but a practical one, drawn from the course of business," (*Swift & Co* v *United States*, 196 U S. 375, 399) one must take a practical view of the nature of interstate commerce In commercial realty it is, in the largest part, the result of orders placed by business hoping to resell at a profit If their predictions of their markets fluctuate, so will fluctuate the volume of interstate commerce. The movement of securities on organized exchanges is an important matter in shaping the judgment of business men as to the future It seems clear that a power to regulate interstate commerce is incomplete if it cannot serve to guard the exchanges from manipulated movements and speculative hysteria. The words of Woolsey, J. are peculiarly appropriate in this regard (*United States* v. *Brown*, 5 F Supp 81, 85, (D C, S D N Y. 1933))

"When an outsider, a member of the public, reads the price quotations of a stock listed on an exchange, he is justified in supposing that the quoted price is an appraisal of the value of that stock due to a series of actual sales between various persons dealing at arms' length in a free and open market on the exchange, and so represents a true chancering of the market value of that stock thereon under the process of attrition due to supply operating against demand"

None but the brave could say that interstate commerce is more directly burdened by the exclusion of cooperative marketing associations from grain exchanges, *Board of Trade* v *Olsen*, 262 U S 1, than by speculative upheavals on the securities markets

The marketing of securities in interstate commerce has recently been subjected to a large measure of Congressional control See, *The Securities Act of 1933*, 33 Columbia Law Review 1220 This control is incomplete without control of the securities exchanges "Market support" is an almost invariable corollary of security distribution and, in the case of stocks, is often accompanied by additional sales on the exchange made by the sponsoring banking house or syndicate

The strength of the national interest in the proper functioning of the securities exchanges hardly can be questioned Ours is a credit economy, dependent upon the exchanges for the liquidity of its fixed assets and for the solvency of its financial institutions This national interest is a factor which of necessity colors any judicial consideration of the implications of the commerce clause As Holmes, J writing for the Court in *Missouri* v *Holland*, 252 U S 416, 433, 435, (sustaining an Act of Congress to carry out a treaty relating to the protection of migratory birds) said.

" * * * it is not lightly to be assumed that, in matters requiring national action, 'a power which must belong to and somewhere reside in every civilized government' is not to be found * * * Here a national interest of very nearly the first magnitude is involved * * * We see nothing in the Constitution that compels the government to sit by while a food supply is cut off and the protectors of our forests and of our crops are destroyed. It is not sufficient to rely upon the states The reliance is vain, and were it otherwise, the question is whether the United States is forbidden to act"

While the existence of a national problem does not prove the existence of a national power, it does at least provide a good place to begin the inquiry In the same case from which we have just quoted and in answer to the contention that the Migratory Bird Act constituted an invasion of power reserved to the States by the Tenth Amendment, Mr Justice Holmes said (at 434):

"We must consider what this country has become in deciding what that Amendment has reserved"

II *The scope of the commerce clause is largely a question of fact*

That the scope of the commerce clause is commensurate with the national interest and that in proper circumstances Congress may control situations normally considered intrastate, is a doctrine announced by John Marshall more than a century ago In discussing the power of Congress in *Gibbons* v *Ogden*, 9 Wheaton 1, he attempted to indicate something of its range by suggesting what it could not reach

"The genius and character of the whole government seem to be, that its action is to be applied to all the external concerns of the nation, and to those internal concerns which affect the States generally, but not to those which are completely within a particular State, which do not affect other States, and with which it is not necessary to interfere, for the purpose of executing some of the general powers of the government" (at 195)

Thus was the matter put in 1824 And it should not be forgotten that this case, with its wide suggestion concerning the extent to which the delegated power over commerce may reach intrastate came shortly after *M'Culloch* v. *Maryland*, 4 Wheaton 316, with its doctrine of implied powers written into the theory of delegated powers, and constitutes part of Marshall's general development of constitutional interpretation. Under the affirmative implications of the words just quoted, it is permissible for Congress to regulate the internal concerns of a State if they affect other States and if it is necessary to interfere with them for the purpose of executing some of the general powers of the Nation

As a corollary of the general rule that Congress has the implied power to take such steps as may be necessary to make effective its exercise of an express power, the Supreme Court has established the authority of Congress to enact whatever legislation is appropriate to "foster, protect, control, and restrain" interstate commerce *Second Employers' Liability Cases*, 223 U S 1; *Mobile County* v *Kimball*, 102 U S 691, 697; *The Daniel Ball*, 10 Wall 557, 564. This power, when need arises, extends not only to strictly interstate matters, but also to intrastate matters whenever the two are so intertwined or related as to effect interstate commerce or its successful regulation by the Federal Government This exertion of Congressional power is not restricted in niggardly fashion, but is recognized to be a governmental necessity and a beneficent adjunct of Federal authority

But before examining the method by which the power may be extended to embrace intrastate affairs, it is well to note that, for the regulation of security exchanges, there is a core of interstate transactions around which the power of Congress may be built. For considerable proportions of the sales on the larger exchanges are made by interstate communication or contemplate physical delivery across state lines That the transportation occurs before or after the sale does not serve to remove the transaction from the power of Congress to regulate under the commerce clause *Dahnke-Walker Milling Co* v *Bondurant*, 257 U.S. 282, *McDermott* v *Wisconsin*, 228 U S 115. That the thing sold is not tangible property but rather the evidence of indebtedness or of ownership does not serve to remove the transaction from the scope of the commerce clause *United States* v. *Ferger*, 250 U.S. 199; *Champion* v. *Ames*, 188 U S 321.

Interstate Commerce Commission v *Goodrich T. Co.*, 224 U S 194, is illustrative In that case the Commission, acting under a Congressional mandate, ordered the Goodrich Transit Company and a number of other Great Lakes water carriers to file with the Commission on prescribed forms a statement of their operating revenues and expenses, their corporate organization and financial condition, and other desired data. The required statements were to contain information not only concerning joint rail and water business, which was the portion of the carriers' business subject to Federal regulation under the then applicable statute, but also concerning other aspects of the carriers' operations, both intrastate and interstate The Supreme Court held that the Commission's orders were valid. Separation of the total business of the carriers into its component parts seemed impracticable, and the accounting instructions were needed in order that the Commission could inform itself so as to enable it properly to regulate the matters within its authority. The decision is especially noticeable in view of the fact that, in the case of one of the objecting carriers, the revenue derived from joint rail and water traffic was less than one percent of its entire revenue

Review of the decided cases indicates that the scope of Congressional power is ascertainable only by reference to the facts surrounding each application of it. The problem and its treatment are strikingly similar to the procedure in cases involving the due process clause. For example, in *Stafford* v. *Wallace*, 258 U.S. 495, the Supreme Court sustained the Packers and Stockyards Act against attack under the commerce clause, noting that the business regulated was interstate commerce or so associated with it as to be within the Federal powers. The late Chief Justice Taft there said (at 513):

"It was for Congress to decide from its general information and from such special evidence as was brought before it, the nature of the evils actually present or threatening, and to take such steps by legislation within its power as it deemed proper to remedy them."

Some years later, in *Tagg Brothers & Moorehead* v. *United States*, 280 U S. 420, the Court had before it a case arising under the same statute; in this instance complaint was made that the act, in permitting the fixing of permissible charges of market agencies, violated the due process clause The Court again upheld the act, saying (at 439) that fixing the commission merchants' fees was reasonable because "the purpose of the regulation attacked is to prevent their (the merchants') service from thus becoming an undue burden upon, and obstruction of that (interstate) commerce" In each case, the ultimate question was whether there was a reasonable connection between the means adopted by Congress and a permissible end. In each case the question was answered affirmatively

The Supreme Court has often indicated its adherence to the doctrine that a declaration of a legislative body, charged with the duty of knowing public conditions, is of great weight in determining whether a particular statute is a reasonable and necessary exercise of power This rule, while originally applied in due process cases (see, for example, *Block* v *Hirsh*, 256 U S 135) has also been utilized by the Court in commerce clause cases

Of the latter class, *Chicago Board of Trade* v. *Olsen*, 262 U S. 1, sustaining the Grain Futures Act, is of special significance. And its significance becomes clear when the case is compared with *Hill* v. *Wallace*, 259 U S 44, holding the Future Trading Act (a tax measure) unconstitutional After the decision in the *Hill* case Congress, as a result of an investigation, concluded that regulation of boards of trade was necessary because trading in grain futures involved, or tended to involve, a burden upon interstate commerce; and passed the Grain Futures Act Measured in terms of their objectives, there was no essential difference between the two statutes But the tax statute was invalidated, the commerce one sustained. The difference in result turned on the finding by Congress as to the effect of futures trading upon interstate commerce.

It is apparent, then, that regulation of intrastate transactions may be embraced within the Congressional authority over interstate and and foreign commerce, if the fact is that such regulation is related to regulation of interstate commerce and implements or perfects the latter. A declaration by Congress, such as the declaration in an introductory section of the proposed act to regulate security exchanges, is affirmative evidence of the existence of the required relationship; the Supreme Court will not lightly disregard it.

III. ON FOUNDATIONS OF FACT, A WIDE EXPANSION OF THE COMMERCE POWER HAS BEEN ESTABLISHED

The application and results of the doctrine described in Part II of this memorandum are illustrated by a long line of cases in the Supreme Court of the United States They show a steady and significant expansion of the acknowledged power of Congress "to foster, protect, control, and restrain" where interstate or foreign commerce is concerned They make manifest, in particular, the reach of Congressional power to remove or to prevent interferences with or burdens upon interstate commerce. Such interferences or burdens may arise from the violent actions of individuals (*In re Debs*, 158 U S. 574), or the peaceful activities of state corporations (*Northern Securities Co.* v. *United States*, 193 U.S 197), or the duties imposed on public officers by state laws (*Shreveport Rate Cases*, 234 U S 342). Whatever may be the source and whatever the kind of interference or obstruction, the subject matter is one for the consideration of Congress

The cases have arisen under various statutes the Interstate Commerce Act, Anti-Trust Laws, Federal Trade Commission Act, and others. They have covered a wide range. Aside from differences on the facts, however, all of them stand together on a common ground, namely, that they are concerned with the development and expansion of the auxiliary power of Congress to reach as far into the States as may be necessary effectively to foster and protect interstate commerce. They make an elaborate array of authority for the exercise of the power of Congress over affairs normally considered intrastate In addition to those already cited, and sometimes by way of repetition in order to emphasize the development, the most significant cases follow.

Earliest in point of time, as the first important national development, are the railroad cases *In re Debs*, 158 U S 564, (removal of obstructions to interstate commerce caused by strikers), *Southern Ry* vs *United States*, 222 U.S 20 (Federal Safety Appliance Act applied to intrastate equipment of interstate railroad); *Shreveport Rate Cases*, 234 U S 342 and the *Wisconsin Rate Case*, 257 U S. 563 (discontinuance of intrastate rates discriminating against interstate commerce), *Colorado* v *United States*, 271 U S 153, and *Transit Comm. of N Y* v *United States*, 284 U S 360 (discontinuance of intrastate branches under orders from Interstate Commerce Commission); and *Texas & N O R Co* v. *Brotherhood*, 281 U S 548 (compelling employers to grant free choice of arbitrators to employees

Paralleling this expansion of federal power over transportation facilities has been the growth of supervision over commercial corporations Powerful combinations threatening the welfare of commerce led successively to the Sherman Anti-Trust Act, the Clayton Act, and the Federal Trade Commission Act. Within the scope of these statutes, practices have been deemed restraints which concerned the organization and security structure of the corporation, not of themselves interstate commerce *Northern Securities Co* v *United States*, 193 U.S 197 (consolidation of competing railroads by stock transfer to a holding company); *Federal Trade Commission* v. *Western Meat Co*, 272 U S 554 (acquiring stock in a competitor); *Standard Oil Co* v *United States*, 221 U S 1 (formation of holding company out of stock of various petroleum corporatins); *United States* v *Union Pac R Co*, 226 U S 61 (purchase by one railroad of dominating stock interest in another), *United States* v *American Tobacco Co*, 221 U. S 106 (monopolizing tobacco industry by stock acquisition), *United States* v *Reading Co*, 253 U S 26 (holding company controlling coal companies and their railroad facilities)

As coming closer to the present problem the following may be noted. *Swift & Co* v *United States*, 196 U S 375 (combination of livestock commission merchants violates the Sherman Act), *United States* v *Patten*, 226 U S. 525 (corner of the N Y cotton market a restraint of trade), *Stafford* v *Wallace*, *supra* (sustaining the Packers and Stockyards Act); *Chicago Board of Trade* v *Olsen*, *supra* (upholding the grain Futures Act); *Binderup* v. *Pathe Exchange*, 263 U S. 291 ("exchange" receiving interstate shipments of films and redistributing them to local exhibitors in the same state held to be a restraint on interstate commerce).

In the light of these cases alone, it is no longer open to question that Congress may reach and control intrastate affairs whenever such control is necessary to the effective exercise of its power over interstate commerce. Ample *power* exists; and, as the Supreme Court has said in *Florida* v. *United States*, 282 U S 194, it becomes only a question as to the "propriety of the exertion" of the power.

IV THE EXERTION OF FEDERAL POWER IS NOT RESTRICTED TO THE INTERSTATE TRANSPORTATION OF COMMODITIES NOR IS IT LIMITED TO PERSONS ENGAGED IN INTERSTATE COMMERCE

It is not indispensable for the exertion of federal power that it be directed to a specific interstate commerce transaction No commodity need move from State to State To be sure, where an actual interstate transaction is involved the exercise of power by Congress is more easily supported But Congress is not so limited Thus, in *United States* v *Ferger*, 250 U S 199, the question was whether the United States could impose punishment where a bill of lading had been fraudulently issued, no goods having been offered or delivered for shipment The existence of power was vigorously objected to on the ground that there was no interstate commerce whatever but only a fraudulent scheme. Yet, the power was sustained In regard to the objection the Court said:

"This mistakenly assumes that the power of Congress is to be necessarily tested by the intrinsic existence of commerce in the particular subject dealt with, instead of the relation of that subject to commerce, and its effects upon it We say mistakenly assumes, because we think it clear that if the proposition were sustained it would destroy the power of Congress to regulate, as obviously that power, if it is to exist, must include authority to deal with obstructions * * ' and with a host of other acts which because of their relationship to and influence upon commerce, come within the power of Congress to regulate, although they are not interstate commerce in and of themselves" (at 203)

Probably no one would contend that the hatters (*Loewe* v *Lawlor*, 208 U S. 274) or the coal miners (*Coronada Coal Co* v *United Mine Workers of America*, 268 U S 295) or the lessors of shoe machinery (*United States Machine Co* v. *United States*, 258 U S 451) were engaged in interstate commerce Still, because what they were doing had a certain relationship to and undesirable effect upon interstate commerce in a general sense they were held subject to Congressional power.

Further illustrations may be found in cases having to do with transactions sometimes described as interstate contracts Here the cases are chiefly those holding certain transactions immune from state regulation because of their interstate character, and invalidating state statutes as applied to them To the extent that these decisions turn upon objections under the commerce clause, they identify transactions to which Congressional power may extend Perhaps the most significant case in this group is *Dahnke-Walker Milling Co.* v. *Bondurant*, 257 U S 282 In that case there was a contract, between a corporation of Tennessee and a person in Kentucky, under which certain quantities of grain were to be purchased by the corporation and delivered by the seller in Kentucky for transportation to Tennessee Default having occurred through non-delivery and the corporation having brought an action in the courts of Kentucky, a defense was interposed on the ground that the plaintiff had not complied with the state corporation laws The defense was disallowed, the Court holding this to be an interstate transaction which the corporation was entitled to enter into without complying with the state law. To a like effect are *Lemke* v *Farmers' Grain Co*, 258 U S. 50 (state grain grading and inspection act invalid; *Robbins* v *Shelby County Taxing District*, 120 U S 489 (state tax on interstate soliciting agent invalid); *International Text Book Co.* v. *Pigg*, 217 U S 91 (correspondence school corporation not compelled to comply with conditions imposed by State) That the solicitation of orders for interstate shipment is part of the interstate transaction, see *Weeks* v. *United States*, 245 U.S 618 (regulation sustained under the Food and Drugs Act); and see *Hall* v *Geiger Jones*, 242 U S 509, for the suggestion that a security, although a chose in action, is subject to federal control as an object of interstate commerce Nor should *Champion* v. *Ames*, popularly known as the *Lottery Case*, previously cited, be forgotten in considering the power of Congress over the interstate transportation of such documents as lottery tickets.

V CASES SUSTAINING STATE REGULATION OF INSURANCE AND OTHER SUBJECTS AS NOT INVOLVING INTERSTATE COMMERCE DO NOT STAND IN THE WAY OF FEDERAL POWER.

An array of cases in which various state statutes were sustained must be considered, for the reason that the cases are so much relied on in support of the contention that the transactions with which they had to do are beyond

the power of Congress Chief among them all is *Paul* v *Virginia*, 75 U S 168. An insurance contract was held to be not interstate commerce and a condition imposed by the State upon the entry of the foreign insurance company was sustained Following that case it has been repeatedly declared that insurance is not interstate commerce *New York Life Insurance Co.* v. *Deer Lodge County*, 231 U S 495 Of a somewhat like character and antedating *Paul* v *Virginia* is *Nathan* v *Louisiana*, 8 Howard 73, sustaining a state tax on the brokerage business With these cases also may be grouped *Hatch* v. *Reardon*, 204 U S. 152 (state stamp tax on stock sales), *Ware & Leland* vs. *Mobile County*, 209 U S 405 (state license tax on brokers in futures); and *United States F. & G Co*, v *Kentucky*, 231 U S 394 (state privilege tax on commercial agencies) *Moore* v *New York Cotton Exchange*, 270 U.S 593, may be noticed here, though it did not turn on a state statute A contention that the Cotton Exchange was engaged in interstate commerce was denied and certain relief sought on the ground that the Exchange's monopoly of its price quotations was a restraint of interstate commerce was refused Mr Justice Sutherland's statement (at 604) that "there is no averment of fact in the bill on which a violation of the Anti-Trust law can be predicated" probably means no more than that

But these cases do not stand in the way of Congressional power They may all be put to one side. In the first place, decisions sustaining state statutes over objections on the commerce clause are hardly in point, certainly not authoritative, on the question of the power possessed by Congress Assertion of the contrary would in effect mean that there is a definite division of power between the Nation and the States in regard to interstate commerce But we know, the cases make it perfectly plain, that sometimes Congress can regulate *intra*state commerce and sometimes the States can regulate *inter*state commerce. "It does not follow that because a thing is subject to state taxation, it is also immune from federal regulation under the Commerce Clause", said Sutherland, J in *Binderup* v. *Pathe Exchange*, 263 U S 291, 311 (federal anti-trust litigation), as he called attention to the fact that "cases cited * * * * upholding state taxation as not constituting an interference with interstate commerce are of little value to the inquiry here" And see the recent case of *Minnesota* v *Blasius*, 54 Sup Ct. 34 (state taxation of livestock in the "current of commerce.")

In the second place, aside from the emphasis repeatedly put on the personal nature of insurance contracts as taking them out of an interstate commerce classification, *Paul* v. *Virginia* and other cases of like character belong to a period prior to the fullest development by the Supreme Court of the present constitutional doctrine concerning the effect of the commerce clause on state power It will be recalled that up to *Cooley* v *Board of Wardens*, 12 How. 299, there had been differences of opinion in the Court on the question whether the commerce clause *per se* deprived the States of power to regulate interstate commerce. In sustaining the state action (regulation of pilotage) called in question in that case the Court announced its much discussed doctrine of interstate commerce of two kinds, namely, local and national As to the former, state action was permissible in the absence of inconsistent federal action (though as a matter of fact the case actually involved the exercise of power by the State supported by an express Congressional permission) As to the latter, state action was inadmissible, it being indicated that in this field the States were deprived of power Interstate transportation of an article was thought to be commerce of a national character

Consequently, when the Court faced the question, as it did in *Paul* v *Virginia*, where interstate transportation of insurance policies was involved, it would have been difficult to uphold state action if the subject matter, insurance, was conceded to be interstate commerce at all A further reason for upholding state power came from Chief Justice Taney's doctrine, in *Bank of Augusta* v. *Earle*, 13 Peters 519, asserting an unlimited power of the States over foreign corporations *Paul* v *Virginia* thus belongs to a period not only of uncertainty about the effect of the commerce clause but also of distrust of foreign corporations. Such corporations, it was assumed, must be held in subjection to state power Difficulty in so doing would be encountered if their activities were classified as interstate commerce But the Supreme Court long since has pushed the development of the commerce clause to such a point that difficulties of that kind have substantially disappeared. Not only may a State regulate interstate commerce of local character; it may even regulate that which is national in character, if Congress permits it so to do

VI THE RESPECTIVE FIELDS OF ACTION OF THE NATION AND THE STATES ARE NOT FIXED BY THE COMMERCE CLAUSE BUT DEPEND UPON THE WILL OF CONGRESS

As a result of the constitutional doctrine developed around the commerce clause and in the light of a few additional cases presently to be mentioned, it may be said that the true significance of the commerce clause is found in treating it, not as fixing a division of powers between the Nation and the States, but as investing Congress with the primary power and responsibility to do two things, first, to determine, from a national estimate of interstate commerce as a whole, the respective fields of action by the Nation and the States, and second, to use its powers within the national field for advancing the general welfare

The second is clearly established and so well known that the citation of authority is unnecessary. Under the first, however, a greater power than is commonly understood is ascribed to Congress for the purpose of coordinating and harmonizing state and national action The discernment by Congress of national needs and its initiative (as well as its ingenuity) in moving to meet them by means of the power exercisable under the commerce clause have produced the vast expansion of federal regulation in part pictured in the cases cited herein

But, an aspect of the matter not so frequently noted, Congress has also moved in the opposite direction when the general interests so required It has restricted the effect of the commerce clause in the furtherance of state action. Witness, the *Wilson Act* (sustained *In Re Rahrer*, 140 U S 545) and the *Webb-Kenyon Act* (sustained in *Clark Dist Co* v *Western Md Ry Co*, 242 U S 311) to enable the States to deal with the interstate aspects of the prohibition problem, and the *Hawes-Cooper Act* (validity not yet passed on) to enable the States to deal with interstate traffic in convict-made goods

The truth of the matter is that Congress has the power to expand or contract the area of national action under the commerce clause Over against this power is set, of course, the function of the Supreme Court to check the expansion (and possibly also the contraction) if Congress should become arbitrary in dealing with the facts and attempt to go too far

The check is a real one But that the responsibility is after all upon the Congress is shown by the fact that in the course of the expansion above indicated only three statutes have been held invalid As far as two of those statutes are concerned, it may well be doubted whether they would be held invalid on *de novo* proceedings today· *The Employers' Liability Cases*, 207 U S 463 (holding the federal liability act unconstitutional because it included employees injured in intrastate commerce) and *Adair* v *United States*, 208 U S 161 (invalidating the federal statute aimed at so-called yellow-dog contracts) Cf *Texas & N O R Co*, v *Brotherhood, etc*, 281 U S 548 *Hammer* v *Dagenhart*, 247, U S 251, generally known as the *Child Labor Case*, remains Whatever may be thought of the soundness of that case and the theory on which it was decided, it may at least be distinguished on the facts from the present proposal as well as on the objectives which Congress seeks now to attain

It will be noted that the foregoing discussion is directed, not to what may be done in "emergencies", but to the normal powers of Congress But since, as shown in Part II hereof, the expanded range of Congressional action is dependent upon fact foundations, there is ample room for the play of forces of an emergency character Ineed, an enlarging function of government to meet new needs is indicated in a passage from the opinion by Mr Chief Justice Hughes in the recent case sustaining the Minnesota Mortgage Moratorium Law (*Home B & L Assn* v *Blaisdell*, 54 Sup Ct 231) Speaking particularly of the contract clause, but possibly with wider implications, he said (at 239)·

"The policy of protecting contracts against impairment presupposes the maintenance of a government by virtue of which contractual relations are worth while,—a government which retains adequate authority to secure the peace and good order of society This principle of harmonizing the constitutional prohibition with the necessary residuum of state power has had progressive recognition in the decisions of this Court"

In view of the national character of the problem here involved and the method of solving such problems on the facts, on the basis of the expansion of power described in this memorandum and on the recognized function of Congress to adjust national and state relationships, it is my opinion that Congress may establish and maintain its regulatory power over security exchanges It

may go further, though how far it may go in the regulation of related and collateral activities will depend on the fact foundation laid therefor, in the hearings and otherwise, and on the considered judgment of Congress concerning the public needs

* * * * * * *

Professor Walter Gellhorn, of the Faculty of Law of Columbia University, joins me in the opinions herein expressed. We have been assisted in the preparation of this memorandum by Messrs W W Gardner and T E Jenks, both of the Legislative Drafting Research Fund of Columbia University

NOEL T DOWLING

NEW YORK, *March 23, 1934.*

NATIONAL RETAIL DRY GOODS ASSOCIATION,
WASHINGTON OFFICE,
Washington, D C, March 29, 1934

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

MY DEAR SENATOR FLETCHER This is a protest against certain of the provisions of H R 8720, a bill "to provide for the regulation of National Securities Exchanges and of over-counter markets operating in interstate and foreign commerce or through the mails, and to prevent inequitable and unfair practices thereon, and for other purposes"

The President forwarded to the Congress a message calling for the enactment of legislation to regulate stock exchanges to make "certain that abuses are eliminated", and the President further said "I therefore recommend to the Congress the enactment of legislation providing for the regulation by the Federal Government of the operations of exchanges dealing in securities and commodities *for the protection of investors, for the safeguarding of values, and so far as it may be possible for the elimination of unnecessary, unwise and destructive speculation*"

It has been apparent to all observers that there would be definite proposals looking toward the regulation of security dealing on exchanges as the outgrowth of the long investigation by the Senate Banking and Currency Committee of what has been broadly termed "Stock Exchange practices" Upon the broad principle that specific legislation was required to correct and endeavor to prevent some of the prior evils, it would seem, there has been universal recognition that such control was both necessary and expedient. It can be said that there has been a national feeling that control of stock exchanges was desirable Those who were in accord with the basic idea, however, had a very shocked awakening when the bill was analyzed

The bill provides *a control of credit by the Federal Trade Commission where the credit is based upon securities as collateral loans* This feature of the bill may itself be divided into four distinct parts

1 The maximum percentage that may be loaned on any securities listed on a stock exchange is statutorily provided for;

2 Another provision is that such loans may only be made by members of the Federal Reserve system;

3 The prohibiting of loans on all unlisted securities; and

4 The establishment of the Federal Trade Commission as the arbiter of this credit control

The bill *goes directly to the control of corporate accounting and management, and again these provisions may be divided* into three separate categories·

1 It is provided that corporations whose securities are listed on an exchange must not only file certain specific information with that exchange upon which it is listed, but also with the Federal Trade Commission in Washington The Commission is also given power to request any additional information that it "may by its rules and regulations require in the public interest or for the protection of investors"

It has been suggested that the powers given to the Commission are so broad that it practically sets up the Federal Trade Commission somewhat along the idea of the war-time "Capital Issues Committee" by providing powers to deny a lister filing a registration statement the facilities of any exchange, if it be decided by the Commission that such a listing of an issue was not "in the public interest and for the protection of investors" In effect this section also

makes the Securities Act of 1933 retroactive for all listers, and that means that the majority of our large corporations must of necessity file a complete registration statement in such form as the Commission may prescribe in Washington.

It further provides penalties somewhat analagous to those contained in the Securities Act for misleading statements, unless officers, directors, accountants, and others can "sustain the burden of proof that they acted in good faith and, in the exercise of reasonable care, had no grounds to believe that such statement was false or misleading."

2. Certain transactions by directors, officers and principal stockholders are declared unlawful and make violators subject to heavy penalties

That 10 days after the close of each calendar month "if there has been any change in his (an officer's, directors, etc) record or beneficial ownership during such month," in the securities of a corporation, each officer, director and principal stockholder holding 5 per cent or more of any class securities of any issuer "shall file with the exchange and with the Commission a statement indicating his ownership at the close of the calendar month"

That if any officer, director or stockholder owning 5 per cent of any class of securities of any issuer who "purchased any such registered security with the intension or expectation of selling the same security within six months, and any profit made by such person on any transaction" extending over a period of less than six months "shall inure to and be recoverable by the issuer"

It prohibits "any such registered security if the person selling does not own the security sold, or if the person selling owns the security but does not deliver it against such sale within 5 days", which means that the bill would prohibit short selling by officials of any corporation

The requirement is laid down that each security registrant on a national exchange shall file with the exchange and also with the Commission "in such form and such details as the Commission may by rules and regulations prescribe" annual and quarterly reports certified by an independent public accountant, and "monthly reports including among other things a statement of sales or gross income", *and such other reports as the Commission may prescribe from time to time* It is also provided under this section that should an issuer fail to provide the Commission with such information as may be requested or laid down in rules and regulations, it will be sufficient justification for the removal of its securities from a national exchange "by the exchange or by the Commission"

3 We also find a provision that when proxies are solicited a list of other persons being solicited must be sent to those who are solicited Various corporate officials have demonstrated the folly of such a provision, and it is believed that this provision will be corrected to provide simply that a list of stockholders will be rendered to the exchange or the commission, or both.

The whole effect of the bill, if enacted into law without very substantial change, would be in my opinion to clothe the Federal Trade Commission with such vast powers as to make it not only the most important branch of the Federal Government, but actually to make it the dictator of the corporate and financial life of the nation

Those who were actively engaged in the actual writing of the bill disclaim any hidden motives of social control of industry through the proposed measure, and scoff at the idea suggested by a great many of our public men that the bill has such purposes But certainly it goes far beyond what the President specifically called for in his own words, which was the regulation of exchanges *"for the protection of investors, for the safeguarding of values, and so far as it may be possible, for the elimination of unnecessary, unwise and destructive speculation"*

Not a word in the President's message points to any desire on his part to go beyond the regulation of national exchanges The bill violates the principles laid down by experts in their studies of what is actually required to eliminate the practices that have been so greatly condemned

The House Interstate and Foreign Commerce Committee and the Senate Banking and Currency Committee have both held hearings upon the proposed regulatory measure Before these committees have appeared many of our business leaders and representatives of the financial community have tried to indicate the seriousness of the outcome of a measure of the character that has been proposed if it were enacted into law

There is no reason why absolute, detailed control of corporate management should be exercised through the control of the regulation of stock exchanges The functions of stock exchanges are to promote reasonable, honest and fair open markets for the purchase and sale of securities and for the dissemination of such corporate information as is necessary for the public to have in order to pass sound judgment upon the securities of listers Beyond that it is neither fair nor honest to endeavor to rigidly control corporations through the medium of a proposed stock exchange regulating bill

The agency given such broad powers under these bills is the Federal Trade Commission. This Commission has never before operated in this field unless it may be said that they have gained certain knowledge of securities through the administration of the Securities Act This, however, is hardly the type of experience that is necessary to formulate sound judgment on credit control, which rightfully falls in the experienced hands of the Federal Reserve Board with the supplementing assistance of exchanges themselves, who are equipped to supply much technical information regarding the loan values that should be placed upon securities

There should be no setting up of a great bureaucracy in Washington to dictate every single detail of what a corporation may and may not do, or what sort of accounting system they may operate under, and all of the other multitudinous affairs it is proposed to bring under the wing of the Federal Trade Commission.

As I have previously pointed out, many executives have appeared before the committees and given their views, pointing out the far-reaching effect of what the proposed bill means to every banker, insurance company, corporation and individual who handle securities, who issue securities or who own securities

It must be said, however, that industry generally is not alive, it would appear, to the dynamite contained in this proposed bill If this legislation is passed as written, *or even with some of the minor amendments that have been suggested by the drafters as a peace offering to those who have raised objections*, it will mean that the country will at a future date realize that they not only have an onerous Securities Act to contend with but also a piece of legislation that goes far beyond anything heretofore conceived The statutory powers set out in this bill in almost every section of the proposal provide the Federal Trade Commission, heretofore mainly identified with inquisitorial investigations, with the power to assume command over each and every corporation having securities listed on even the smallest exchange, of not only information to be supplied in order to keep their securities listed, and it is impossible to use unlisted securities as collateral, but also to operate their business in such a way that it receives the approval of this Commission

The bill also provides for the regulation of transactions in all securities other than those listed on an exchange which may become licensed, that is, where their sale may involve the use of the mails or any instrumentality of interstate commerce One must draw upon his imagination or personal experience to visualize just what this means Many of us have seen to what lengths a Bureau once established with powers to act may go in the direction of exercising those powers

It will be seen, therefore, that the bill involves important considerations not only to the corporations whose stock or other securities may be listed on some exchange, but to the securities of all other corporations regardless of their soundness or character, and certainly every present security holder in the nation should be genuinely interested.

Objection is not directed to the provisions of this bill dealing with the stock market regulation except insofar as the provisions of the bill tend to put business or mercantile corporations in a straight jacket and vest in the Federal Trade Commission or other governmental agencies jurisdiction to dictate accounting methods and reports, the burdens of which may prove exceedingly onerous

Respectfully,

NATIONAL RETAIL DRY GOODS ASSOCIATION,
HAROLD R YOUNG,
Washington Representative.

STOCK-EXCHANGE PRACTICES

TUESDAY, APRIL 3, 1934

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

The subcommittee met at 10 a.m., pursuant to call, in room 301 of the Senate Office Building, Senator Duncan U. Fletcher presiding.

Present: Senators Fletcher (chairman), Costigan, Adams, Goldsborough, Townsend, and Couzens.

Present also: Senators Wagner, Byrnes, McAdoo, Walcott, Kean, and Representative Francis Henry Shoemaker, of Minnesota.

Present also: Ferdinand Pecora, counsel to the committee; Julius Silver and David Saperstein, associate counsel to the committee, and Frank J. Meehan, chief statistician to the committee.

The CHAIRMAN. This hearing is being held before the subcommittee of our Committee on Banking and Currency under the resolutions S. Res. 84, 56, and 97. Senator Schall and others have requested the committee to hear Mr. Backus. He has some important matter in reference to practices of banks and corporations, as well as stock dealings, and so forth, to present to the subcommittee, and we will let him proceed in his own way.

Mr. Backus, if you will stand, hold up your right hand, and be sworn:

You solemnly swear that you will tell the truth, the whole truth, and nothing but the truth, regarding the matters now under investigation by the committee, so help you God.

Mr. BACKUS. I do.

TESTIMONY OF EDWARD W. BACKUS, MINNEAPOLIS, MINN.

The CHAIRMAN. Mr. Backus, what is your name?

Mr. BACKUS. Edward W. Backus.

The CHAIRMAN. And your address?

Mr. BACKUS. Baker Building, Minneapolis, Minn.

The CHAIRMAN. What is your occupation, Mr. Backus?

Mr. BACKUS. Manufacturer of paper, lumber, and other forest products.

The CHAIRMAN. How long have you been engaged in that business?

Mr. BACKUS. A little over 50 years.

The CHAIRMAN. Now, you have, I believe, a prepared statement, Mr. Backus?

Mr. BACKUS. Yes.

The CHAIRMAN. Do you want to submit that to the subcommittee?

Mr. BACKUS. I do.

The CHAIRMAN. You may proceed, then, with that, and we will ask you questions as we see fit.

Mr. BACKUS. I thank you.

The CHAIRMAN. You may just sit down at the table there.

Mr. BACKUS. I should first like to submit a signed copy of my letter addressed to you under date of March 17, 1934.

The CHAIRMAN. All right. The committee reporter will make it a part of our record.

BACKUS-BROOKS CO,
MINNEAPOLIS, MINN, *March 17, 1934.*

Senator DUNCAN U. FLETCHER,
Chairman Senate Committee on Banking and Currency,
Senate Office Building, Washington, D C.

MY DEAR SENATOR FLETCHER: Your telegram of February 19 in which you requested me to appear before your committee on Friday, February 23, was duly received.

As it was impossible for me to respond immediately, I sent you the following telegram:

"Telegram received I am wiring Senator Schall to explain to you the necessity of asking for later date to appear before your committee and will appreciate your favorable consideration."

My telegram to Senator Schall was as follows:

"Senator Fletcher, chairman Senate Committee on Banking and Currency, has telegraphed me to appear before this committee next Friday the 23rd This date is practically impossible owing to decision pending in Circuit Court of Appeals which may demand my immediate attendance in Federal court here on our receivership matters. Kindly see Senator Fletcher and arrange for my appearance before this committee 1 week or 10 days later and greatly oblige Am wiring Senator Fletcher advising that you will see him and explain situation."

In reply, Senator Schall telephoned me that he had conferred with you and that I should report in Washington as promptly as possible and that your committee would hear me at its earliest convenience I am now here subject to your call and will be pleased to appear before the Senate Committee on Banking and Currency to place in its records a statement of financial recketeering (as you call it in Liberty of March 17) which has attempted to destroy the property of thousands of bondholders in the Minnesota & Ontario Paper Co and the Great Lakes Paper Co, Ltd. About 25,000 had invested in a great property built up in nearly 50 years of constructive business effort and with a full sense of the social responsibility which ought to underlie all business promotion and the use of natural resources The livelihood of about 7,500 workers and 30,000 dependents is involved

I therefore ask your committee and your counsel, Mr Ferdinand Pecora, to consider the methods through which the receivership of the Minnesota & Ontario Paper Co, which was forced in 1931, principally by the officials of the Chase National Bank of New York and the First National Bank of Boston, though the Minnesota & Ontario Paper Co was then solvent, the campaign of the so-called "Bondholders Protective Committee" to depress the values of bonds to secure their sacrifice, the waste of capital and resources through the unwarranted mismanagement of receivers appointed through the insistence of the Officials of the Chase National Bank and the First National Bank of Boston; these receivers having no knowledge of the technical problems of paper, pulp, and forest products manufacturing, and the persistent injection of the International Paper & Power Co in the conspiracy to destroy my life's work The trail of evil doing runs chiefly through officials of the Chase National Bank, First National Bank of Boston, Halsey, Stuart & Co, and Bond & Goodwin, one of the close affiliates of the First National Bank of Boston, and the International Paper & Power Co

It might be argued by the public, under ordinary circumstances, that your committee should not be expected to take up the troubles of any particular organization, to follow the trail of any wrong that has been done to it by bankers working in harmony with the rivals or competitors of such an organization, yet what the Minnesota & Ontario Paper Co. has suffered is a perfect

illustration of the greed, double crossing, and willful penetration and meddling of banks into all lines of manufacture, which your committee has under the cross-questioning of counsel and more particularly in recent months through Mr Ferdinand Pecora, so fearlessly proved in the hearings from 1932 up to the present

It will, therefore, give me pleasure to appear before your committee I shall come prepared with a formal statement, but I shall welcome cross-questioning, for I have nothing to conceal in over 50 years of participation in the development of the Northwest.

Through your various articles published in the press, an immense service has and can be done by showing how the bankers have exploited the public and how helpless the holders of securities have been.

Permit me in closing to quote from an issue of the New Republic (Jan 3, 1934) ·

" Reorganization of bankrupt or embarrassed corporations have been a scandal for many years The practice has been almost uniform As soon as a large corporation falls upon default, the bankers and insiders, who almost invariably have been responsible for the disaster, rush upon the prostrate carcass and assume possession of it This they do, first, by getting their representatives named as receivers, and second, by organizing protective committees of stockholders and bondholders These protective committees ostensibly keep an eye on the special interests of their respective groups of security holders They exercise what in practice is more important, a controlling influence over the reorganization of the corporation And as it is the reorganization of the corporation in which the promoters and bankers and insiders are chiefly interested, it is a matter of great importance to them to capture the control of these committees Anyone who wants to know what grave abuses, what serious infractions of the simple law of trust, have been practiced by such committees has only to read Mr Lowenthal's book "

I can substantiate every point as to the practices that would have destroyed us, except for your decision to hear us.

Very respectfully your,

E W BACKUS, *President*

The CHAIRMAN. You may proceed, Mr. Backus.

Mr. BACKUS. Supplementing my letter to your chairman, dated March 17, I ask that the following statement be made part of your records.

Pioneering Development of Northwest Resources: The Minnesota & Ontario Paper Co. represents, in a large measure, the consummation of a constructive and well-laid plan by Backus-Brooks Co. conceived over 25 years ago to coordinate its forest products and hydroelectric properties into one operating unit and under one management. These properties had been acquired and developed, wholly or in part, during the previous 25 years. To carry out this plan the Minnesota & Ontario Paper Co. was duly incorporated in 1908 as the operating organization which took over certain of these properties.

The plan also provided that from time to time additional forest products and hydroelectric properties of Backus-Brooks Co. would be taken over and coordinated with this organization, as and when developed by Backus-Brooks Co. Prior to the year 1931 this company had developed several of its latent properties which from time to time had been taken over by the Minnesota & Ontario Paper Co. However, at the time of the Minnesota & Ontario Paper Co's receivership on February 28, 1931, one of the largest properties, and the most recently developed by Backus-Brooks Co., namely, Great Lakes Paper Co., Ltd., was in the process of being coordinated with the Minnesota & Ontario Paper Co., but the receivership prevented its final, legal consummation.

At that time these properties had been developed, organized, and were in profitable operation. In the year 1930, during which period the business depression was keenly manifest, the net earnings of Minnesota & Ontario Paper Co. (including Great Lakes Paper Co., Ltd., which for all practical purposes was then assumed by both companies to have been coordinated, after all charges, were substantially in excess of $1,000,000, in face of the fact that the combined operations were at less than 50 percent of capacity. In years of ordinary business conditions, when operating at capacity, minimum net profits after all charges should be $6,000,000 and in prosperous years $10,000,000 to $12,000,000.

Outstanding business structure: At that point the Minnesota & Ontario Paper Co. and subsidiaries (including Great Lakes Paper Co., Ltd.) had attained a position as one of the largest organizations of its kind in the world. Thus from a very meager beginning these vast properties were acquired and had been developed through my initiative and efforts covering nearly half a century, during all of which time the active executive management was vested in me and represented my entire life's work. The locations of these operations are strategic from every essential standpoint; namely, natural resources, logical markets, ample provisions for further expansion, and perpetual operation. My whole purpose and ambition was to create, operate, retain practically the entire earnings in the business, and build a sound, creditable, and permanent structure.

At the time of the receivership, namely, February 28, 1931, the amount of outstanding bonds were as follows: Minnesota & Ontario Paper Co., $24,400,000; Great Lakes Paper Co., Ltd., $10,000,000.

Several expert independent appraisers in 1930 valued these properties at a minimum of $100,000,000.

Approximately 95 percent of the combined common and preferred stock in these companies was owned directly and indirectly by me and my close associates, our accumulated earnings having gone into these properties. The first-mortgage bonds of these companies then outstanding had been purchased by our fiscal agents when issued and were widely distributed to some 25,000 holders

The financial crash came in 1929, and I advised with several of our company's commercial bankers early in 1930 respecting their views on future economic conditions. The concensus of their opinion was that the worst was over and that conditions would gradually improve; that any expansion of plants and properties that had been planned could be proceeded with in the regular course of business with entire confidence. On the strength of this encouragement our companies proceeded to carry out their plans previously made, and expended approximately $3,000,000 on same during the year 1930. Not the slightest thought was harbored respecting any possible default in outstanding obligations. Our companies enjoyed the highest credit standing, without the use of collateral, and our commitments had always been promptly met.

Mr. PECORA. Mr. Backus, might I interrupt you right there for a moment to ask a question?

Mr. BACKUS. Certainly.

Mr. PECORA. Who were the commercial bankers with whom you met and conferred as you say early in 1930?

Mr. BACKUS. The Chase National Bank, the Northwestern National Bank of Minneapolis, the Continental National Bank of Chicago, and two or three of the others.

The CHAIRMAN. Who, connected with the Chase National Bank, did you confer with?

Mr. BACKUS. With Mr. A. H. Wiggin, chairman of the executive committee.

Mr. PECORA. Chairman of the governing board was his title, Mr. Backus.

Mr. BACKUS. Yes.

The CHAIRMAN. You may proceed, Mr. Backus.

Mr. BACKUS. Anticipating obligations: In the early summer of 1930 I began to anticipate making provisions for our funded obligations maturing in 1931. I took the matter up with our fiscal agents, Halsey, Stuart & Co., of Chicago, who then assured me that these obligations would be provided for at the proper time, but that it was then too early to give the matter consideration.

In the fall of 1930 several conferences were held with this fiscal agent in reference to meeting these maturities and alternate plans were discussed. However, they finally advised me that owing to the unsatisfactory bond market at that time, I should arrange with our company's commercial bankers to carry the additional $9,000,000 of first-mortgage bonds which we had agreed with them to issue, until they could be sold. I followed this suggestion, and as a result secured the pledges of our bankers and fiscal agents to do this. With this assurance I caused the Minnesota & Ontario Paper Co. to register its mortgage for $9,000,000, which was filed in February 1931, and to issue $9,000,000 of series D, first-mortgage bonds which were delivered to the trustee, namely, the Minnesota Loan and Trust Co., of Minneapolis, for certification as per agreement.

Bankers' pledges broken: Shortly before the middle of February 1931, I discussed these matters in detail with Mr. A. H. Wiggin of the Chase National Bank, and was definitely assured by him that the above plan would be carried through; and further, that if there should be any failure on the part of any of the several banks to keep their promises, the Chase National Bank would make good any such deficit by increasing its quota to insure that the plan would be consummated as agreed, and he firmly reiterated this assurance.

By appointment I met our fiscal agents and our several commercial bankers in New York on February 26, 1931. At that meeting, in addition to our fiscal agents, there were present among the others, representatives of the Chase National Bank; the First National Bank of Boston, and the National Shawmut Bank of Boston. However, Mr. Wiggin was absent, having gone south on his vacation. This meeting was held at the offices of the Chase National Bank, in New York, where a formal agreement, covering the promises already made, was to be concluded, and the funds for liquidating the early funded maturities were to be credited to the company's account in the various banks involved. At this preliminary meeting these bankers promised to have an agreement prepared and in readiness the day following, which was to embody the promises and agreements previously made. When I arrived at the Chase Bank the

following day, February 27, 1931, at the appointed time, I found these bankers and fiscal agents in private conference discussing our affairs, and was requested to wait outside.

Solvency disregarded: Later in the day they came to me and informed me that they had decided not to carry out the pledges and agreements previously made and that a receivership was the only solution. They then inquired how much cash the company had on hand, and further, whether, in my opinion, in case the receivership plan was adopted, one third of the $9,000,000 previously agreed to and promised, would be sufficient to take care of the company's needs and permit operations to continue without sacrificing any assets. The announcement was a terrific shock to me, but I finally replied that, in case of a receivership, $3,000,000 would take care of the company's ordinary needs. I also informed them that the company then had on hand over $1,100,000 in cash, on deposit with its several commercial banks.

Evidently to lessen the force of the blow, they then stated, among other things, that if I would turn over to them the cash on deposit in each of their respective banks, to apply on the company's notes they then held, and consent to the receivership, they would have me appointed sole receiver for the company and provide $3,000,000 for the company's use, and allow me to work out the company's affairs. Also that they would advance forthwith $500,000 for the Minnesota & Ontario Paper Co. on receiver's certificates, to enable the company to carry on; and later provide the balance of the $3,000,000 as and when required. Also to advance forthwith $125,000 for the Great Lakes Paper Co, Ltd., with which to carry on (which latter amount was liquidated within 4 months). All of this was predicated on my turning over to them the amount of cash then on deposit in each of their banks, totaling as aforesaid over $1,100,000.

I protested putting the company into receivership and stated that such action was entirely unwarranted, even under the then existing economic conditions. However, in view of the fact that over $4,000,000 of funded indebtedness, including interest, would mature 3 days later, I had no alternative, and under duress was forced to accept their ultimatum.

The receivership followed the next day, February 28, 1931. I was appointed receiver. The court also appointed Mr. E. W. Decker, president of the Northwestern National Bank, of Minneapolis, and Mr. C. R. Fowler, a local attorney, as coreceivers. These bankers had been the bankers of our companies for many years. Our relations had always been most cordial. I had agreed to their demands respecting the receivership of the Minnesota & Ontario Paper Co.—under protest, to be sure—but in the utmost good faith and confidence in them. I relied implicitly upon their promises that I would be undisturbed as receiver and allowed to reestablish the financial standing of the company, which I knew I could do. I had every reason to believe that they had the fullest confidence in me, in my ability and integrity, which during the long period of our business dealings they had never had occasion to question.

I feel it is pertinent to state here that I had the fullest confidence in the soundness of our company's financial structure and worth. Also that I placed complete reliance in the promises of our bankers

and fiscal agents, to provide the funds with which to meet our company's maturing obligations. As proof of this, Backus-Brooks Co. and myself made a loan of $500,000 from the Continental National Bank & Trust Co., of Chicago, only a short time before the bankers' meeting on February 28, 1931, and turned the proceeds over to the Minnesota & Ontario Paper Co. to enable it to meet maturing notes payable pending the said bankers' meeting.

In order to secure this loan I was compelled to pledge as security the only personal bankable collateral I owned, namely, 12,000 shares of Northwest Bancorporation stock valued at $900,000, which was to be returned to me after the proposed meeting with the bankers in New York when the promised financing was to be completed and Minnesota & Ontario Paper Co. bonds substituted for this personal stock. Through the failure of the financing plan this was not done, and later my bank stock was sold for $276,000. This was my first experience in financing the business of my companies when collateral was required.

Bond values vitiated: However, in a comparatively short time it became apparent that there was a marked change in the attitude of these bankers, which indicated that they might not keep their promises made to me and that their selfish purpose might be to undermine the company's structure to the detriment of its many thousands of widely scattered and helpless bondholders. Their first move which indicated this purpose was the designation of a bank controlled so-called "Bondholders' Protective Committee" (which protected none but themselves), composed as follows: Two members and the secretary are employees of Halsey, Stuart & Co., investment bankers of Chicago; one member each is respectively an employee of the First National Bank, of Chicago; Brown Bros., Harriman & Co., of New York; Bond & Goodwin, investment bankers of Boston and New York; and one associated with Minnesota Loan & Trust Co., of Minneapolis. And one, since resigned, and which vacancy was filled by a successor of unknown affiliation to me, of Toronto, Canada. They were securities salesmen, having no knowledge whatever of the diversified problems involved in the operations of our immense estate and therefore totally incompetent to serve in such capacity, as their disastrous administration has proven.

Graustein's attempt at bribery: Their next move, as has been brought to light by subsequent events, was the planning of a conference by Mr. Archibald R. Graustein, president of International Paper & Power Co., of New York, between myself and my coreceivers and the executives of that company, the principal rival of our company, for the purpose of negotiating the taking over of the properties of the Minnesota & Ontario Paper Co. and Great Lakes Paper Co., Ltd., by that company. That conference was held in the early summer of 1931 at the Drake Hotel, Chicago, and accomplished no results. Briefly, it was obvious that they did not intend to take over our properties excepting at a fraction of their real value, to be fixed arbitrarily by themselves.

When the conference was about to disband, Mr. Graustein expressed a wish to have a private conference with me, to which I assented. At that conference Mr. Graustein made me the following proposition, namely: That I should exchange approximately 95 per-

cent of the combined issued and outstanding common and preferred stock of Minnesota & Ontario Paper Co. and Great Lakes Paper Co., Ltd., owned directly and indirectly by myself and close associates, for 750,000 shares of common stock in the International Paper & Power Co. They, in turn, would then purchase from me 50,000 shares of said International Paper & Power Co. stock at $100 per share, or for $5,000,000 in cash. The result of that transaction when made would have been that I would still own 700,000 shares of International Paper & Power Co. stock and would have received $5,000,000 in cash.

Further, that in that event I would be made a high official in the International Paper & Power Co. and would have been required to cooperate with Mr. Graustein in making the best settlement possible with the bondholders and creditors of the Minnesota & Ontario Paper Co. and the Great Lakes Paper Co., Ltd., in the interest of the International Paper & Power Co.

I declined his offer then and would decline it now if it were renewed, for the fundamental reason that during all of my business career I have enjoyed the highest credit standing and have had the fullest confidence of all those with whom I have had business relations. I would not put myself in a position where I could not protect our many thousands of bondholders, funded noteholders, general creditors, and minority stockholders. I feared they might suffer under the proposed change in ownership. Further, the proposed exchange was unfair from a value standpoint.

Mr. PECORA. To whom would the exchange you refer to that was proposed have been unfair?

Mr. BACKUS. Do you mean unfair from a value standpoint?

Mr. PECORA. Yes. To whom do you mean it would have been unfair?

Mr. BACKUS. To myself and close associates.

Mr. PECORA. And to the other holders of the securities issued by your companies?

Mr. BACKUS. Yes; the 95 percent of stock in both companies.

Mr. PECORA. All right.

The CHAIRMAN. You may resume your statement.

Mr. BACKUS. Wiggin, Chase, and Graustein in plot: Later on in the summer of 1931 this conference was followed by another held at the Chase National Bank in New York City, which conference was attended by Mr. Graustein and his bankers, Mr. A. H. Wiggin and Mr. Malcolm Chase. It was there again apparent to me, as it had been since 1925, that these interests were determined to secure our properties regardless of the methods necessary to be employed to achieve that objective. This meeting disbanded without having accomplished any results other than it was arranged that certain officials of the International Paper & Power Co. would visit and inspect our properties, after which the negotiations would be resumed. This inspection trip was made, but thereafter I was ignored and all negotiations were deliberately kept from me. Matters then stood in abeyance until after the New York and Boston bankers and bank-controlled so-called "Bondholders' Protective Committee" had succeeded in removing me as a receiver.

It was at this point that these eastern banks and bank-controlled so-called "Bondholders' Protective Committee" began demanding

my resignation. They could give me no reason for this, as I had managed the affairs well, and they so admitted. They, however, were determined to eliminate me from any participation in the company's affairs. Their motive could only have been that they realized that the widely scattered 25,000 bondholders would then be an easy prey.

There would then be no one to protect their interests and prevent these most valuable properties from being practically confiscated through the purchase of bonds from the widely scattered bondholders at their own convenient time and at their own price. Their selfish purpose here began to manifest itself clearly. The deposit agreement of the so-called "bondholders' protective committee" was of the venomous "air-tight, ironclad" type, which conveyed title to the bonds to the bondholders' protective committee. By that time more than a majority of the bonds had been deposited. That placed them in complete control of the bondholders' interest in the estate. It put them in position to manipulate and depress the unlisted market prices of the bonds so they could be purchased from distressed holders at distressed prices. They planned to completely wipe out the equity. They were determined to eliminate me, fearing I would obstruct their plans. Therefore only a comparatively short time elapsed before I was forced to resign, likewise my corecelvers.

Receivers ignorant and impotent: I had remained as operating receiver for 9 months and during that period, in the normal course of business, I accumulated and had on deposit in the Northwestern National Bank of Minneapolis a cash balance of over $2,000,000 (including $500,000 which the bankers had provided immediately following the receivership), without sacrificing any of the current assets or from the sale of any of the capital assets of the estate.

Messrs. R. H. M. Robinson and C. T. Jaffray were appointed as receivers on November 30, 1931 Mr. Robinson was a former employee of Mr. Harriman of Brown Brothers, Harriman & Co., New York bankers, and his affiliated interests; Mr. C. T. Jaffray is president of the First National Bank of Minneapolis and of the Soo Line Railway. Both were totally lacking in any qualification which justified them in attempting to manage our huge and varied estate, and much less in meriting their excessive fees as fixed by the court at the request of the so-called "bondholders' protective committee", hereinafter referred to. However, I was assured that I would be retained in the service of the estate and be associated with the new receivers in an advisory capacity, and therefore, felt in that way I would be able to prevent mismanagement, waste, and sacrifice of assets. Otherwise, under no circumstances would I have resigned. I had a right to rely on the court, administering the estate, for reasonable cooperation in protecting it from dissipation and waste, but got none. In fact Judge Molyneaux apparently found satisfaction in vetoing all of my advice and warnings.

At the time of their appointment, I turned over to them the company's cash bank balance of over $2,000,000. Receiver Robinson assumed dictatorial control from the outset. He ignorantly attempted to reorganize all departments in our various lines of business without any knowledge of the personnel. He delegated

the management of most departments to totally incompetent heads, most of whom had previously had my constant guidance. He attempted to create a personal organization loyal to himself and hostile to me. His staff was not allowed to confer with me.

In short, his appointment as receiver was designed by the New York and Boston bankers and the bank-controlled so-called "bondholders' protective committee" for the real purpose of removing me from any association with the company as quickly as possible, and thereby prevent me, with my personal knowledge and experience, from protecting the interests of the company and its investors.

DELIBERATE RACKETEERING BEGUN

Then began a most deplorable campaign of mismanagement, extravagance, waste, and sacrifice of cash and other assets, which has continued up to and is continuing at the present time. Already their losses aggregate over $12,000,000. The receiver's last report, dated December 31, 1933, admits a net loss in current assets alone of $5,968,447.29. To this loss should be added the increase in current assets, during their administration, by the liquidation of capital assets not heretofore included in that item, but which are now automatically reflected in the current assets through cash received from capital sales. This would automatically increase the loss to approximately $7,500,000 in current assets. The present receivers have liquidated the cream of our quick assets, at sacrifice prices, leaving the remaining current assets of less realizable value than stated in said report, thereby still further increasing the loss in that item. Further, the said receiver's report also admits a loss in total assets of $14,510,889.26, all in the short period of 25 months.

The items of waste, extravagance, mismanagement, and dissipation of assets which I allege, are as follows:

(1) Amounts paid for receiver's fees, attorneys' fees, and expenses during the receivership period, $700,000.

This exorbitant item includes the unjustifiable fees paid to Receiver Robinson, namely, at the rate of $70,000 per annum for the first 13 months of his incumbency, with a reduction of only 10 percent, or at the rate of $63,000 per annum during the succeeding period up to the present time; and to Receiver Jaffray at the rate of $30,000 per annum for the first 13 months with no appreciable compensating service to the estate, and at the rate of $10,000 per annum for the succeeding period. In the receivers' report of December 31, 1933, the statements concerning these fees are erroneous and intended to becloud the true facts and deceive the bondholders.

This item also includes the exorbitant and unjustifiable fees paid to attorneys, and all expenses during the full receivership period including previous receiver's fees. All of which were presented to the court by Receiver Robinson and Jaffray and allowed by him during my absence from the city, contrary to their assurance to me that this would not be done.

Therefore, in this respect also the report of December 31, 1933, is intended to deceive the bondholders. In fact, in this report of the receivers they attempt to deny all the losses I allege, making up the stupendous total of over $12,000,000. In some instances it is

willful misrepresentation of the facts, in some it may be ignorance. Nevertheless, the denials are intended as a smoke screen to cover up the flagrant mismanagement of the receivers, which I can substantiate by the receivers' records.

(2) Unnecessary compromising of accounts receivable which could have been collected in full (in this item an account of International Paper Co. for $175,000 was settled for $50,000, or a loss of $125,000), $570,000.

(3) Unjustifiable cash expenditure in National Pole & Treating Co. refinancing, $525,000.

The above cash items total $1,795,000, which were unnecessarily and unwisely expended or compromised. In addition are the following stupendous losses:

(1) Operating loss due to mismanagement and ill-conceived operating policies and excessive overhead expenditures, $1,095,000.

(2) Investment loss on sale of Memphis Commercial Appeal (a morning, evening, and Sunday newspaper of high standing published at Memphis, Tenn., wholly owned and constituting part of the assets of the said Minnesota & Ontario Paper Co.) as appears by receiver's report dated September 30, 1933, $1,718,570.96.

Our equity in this property was conservatively appraised at over $3,000,000. Our cash investment was approximately $2,700,000. Sold by receivers for $962,000 of which $300,000 has been paid in cash and balance in deferred payments covering several years with no guaranty of future payments. The receivers have delivered the entire capital stock to purchaser. During my period of receivership this publication was operated profitably, but under the mismanagement of Receivers Robinson and Jaffray it promptly dropped into the losing class along with all other departments under their management. (An appeal has been taken to the circuit court of appeals.)

(3) Loss due to inefficient supervision and management of logging operations of International Lumber Co. (a wholly owned Minnesota & Ontario Paper Co. subsidiary) together with losses sustained by reason of sale of lumber at cut prices and losses occasioned by the wholly unwarranted and astounding voluntary destruction by fire of a vast store of merchantable pulpwood and the intentional burning down of valuable and necessary camp buildings—mismanagement and ignorance, $1,559,000.

(4) Losses estimated if contracts entered into by receivers are fully performed by Minnesota Forest Products Co. (a wholly owned Minnesota & Ontario Paper Co. subsidiary) with Northwestern Paper Co. (a competitive Weyerhauser company) for the exchange of timber located in Cook County, Minn.; for cancelation without payment of the account of $90,000 owing by Northwestern Paper Co. to Minnesota Forest Products Co.; contract for sale of Minnesota Forest Products Co. timber to Consolidated Water Power & Paper Co.; and proposed contract for sale of Minnesota Forest Products Co. to United States Forestry Department; and loss resulting from receivers' failure to cut timber on Isle Royale, which timber was deteriorating on account of insect infection; total gross loss on account of willful surrender of property and ignorant mismanagement, $1,480,000. (Appeal taken to circuit court of appeals respecting timber sales.)

(5) Loss to National Pole & Treating Co. (a 90 percent owned Minnesota & Ontario Paper Co. subsidiary) due to unsound and wholly unwarranted refinancing; operating loss during present receivership; and unwarranted cut in inventory, $1,675,000. This large loss is positively unpardonable.

(6) Unnecessary and unjustifiable capital expenditure in paper mills and subsidiary properties, including loss in manufacturing operations of paper specialties and including loss in burning sawmill materials, $750,000. This loss displays total ignorance.

(7) Losses estimated incurred through receivers joining a combination in restraint of trade, restricting newsprint paper output, which has resulted in a huge loss in sales of newsprint paper, which combination at the time was in contravention to Federal law and opposed to the best interests of the estate and bondholders, $1,250,000. This loss borders on criminal conspiracy which no competent court could permit.

(8) Lapsing of timber permits held by International Lumber Co. (a Minnesota & Ontario Paper Co. subsidiary) without cutting timber thereon before expiration of permits, and sacrifice sales of timber, $95,000. Total ignorance of values.

(9) Loss to estate on account of surrender of newsprint tonnage to Great Lakes Paper Co. and of commissions, $595,000. At this time both companies were in receivership and legally dissolved.

These losses total the stupendous sum of $12 012,570.96. I protested vigorously the confirmation of four of the principal items making up this loss. The items protested are as follows: Concessions made to Great Lakes Paper Co., Ltd., now in receivership; compromise of accounts receivable; sale of Memphis Commercial Appeal property; sale of Minnesota Forest Products Co. timber.

In the last two mentioned protests appeals have been taken to the circuit court from the order of the district judge confirming the receivers' sales.

With the passing of time it became necessary to protest the acts of the receivers more vigorously but to no avail. Mr. Robinson stated repeatedly to the court in my presence, and to me, that he had the approval of the so-called "bondholders' protective committee" in respect to all the transactions I protested from time to time. This fact, therefore, involved that committee in the dissipation of assets jointly with the receivers and the court.

LIBELOUS PERSONAL ATTACKS

My watchfulness over the interest of our many thousands of bondholders, various equity holders, and other investors exasperated Receiver Robinson and the conspiring bankers and bank-controlled so-called "bondholders' protective committee" until the friction finally climaxed in a suit brought by the receivers against Backus-Brooks Co. and myself to recover approximately $7,000,000, claimed to have been abstracted by us from the business for our own personal ends. A baser and more groundless charge was never preferred against any man. A short time previously these conspiring eastern bankers—namely, the Chase National Bank, of New York; the First National Bank of Boston; and National Shawmut Bank,

of Boston—had brought suit against me for approximately $2,500,000 to enforce payment on my endorsement of Minnesota & Ontario Paper Co. notes, in violation of their agreement on February 27, 1931, preceding the receivership. As an indication of their animus, the receivers moved my desk and furniture from the company's office during the night, without notice to me.

INTIMIDATION OF BONDHOLDERS

In the receivers' report to the court, dated October 31, 1933, this $7,000,000 suit against Backus-Brooks Co. and myself was conspicuously referred to. The so-called "bondholders' protective committee" emphasized the incident in its letter dated November 17, 1933, to all bondholders, creditors, and the financial world in general.

This blow, namely, the suits mentioned above, and the wide publicity which followed, was intended to put the finishing touches to my complete elimination and destruction and leave the path clear and unobstructed to exploit our many thousands of bondholders. The final step in the tragedy was nearing completion. I was their only obstacle and, therefore, must be effectively discredited in the eyes of the bondholders, through whose helpless condition, these banks and their coconspirators saw the sure and easy way to their objective. The lawsuits brought against Backus-Brooks Co. and myself, as related above, by the conspiring New York and Boston banks and the receivers, then removed all previous disguise and brought them into the open. They well knew they would realize no money recovery even if they should secure judgment, for they knew we had no funds. I repeat—their purpose was my final destruction and elimination. Now, and henceforth, they must fight in the open, for I refuse to be eliminated.

My answer to the receivers' suit discloses the true facts, namely, that the receivers had no claim whatever against Backus-Brooks Co. and myself, but on the contrary that we had substantial claims against the company, which we had intended to satisfy by accepting additional stock.

I have also answered these false charges in a libel suit for damages in the sum of $2,000,000 and have challenged them to prove their untrue charges before an independent and unbiased tribunal. I have also brought suit for the removal of Receivers Robinson & Jaffray on the grounds of inefficiency, incompetency, and maladministration.

Following the events recited in the three preceding paragraphs I demanded from the so-called "bondholders' protective committee" a correct list of all present bondholders—giving names and addresses—both of bonds deposited and bonds not deposited. This they refused to give me. The reason for their refusal is obviously significant. My only recourse then was to secure a list of such bondholders as the Federal revenue department was able to provide, which proved incomplete. To this incomplete list of bondholders I issued a letter of warning dated January 5, 1934, with accompanying pamphlet giving greater detail, both of which I offer with your approval for this record.

The CHAIRMAN. Let them be entered.

(Letter dated Minneapolis, Minn., Jan. 5, 1934, addressed to the bondholders of the Minnesota & Ontario Paper Co. and signed by

E. W. Backus, with accompanying pamphlet referred to and submitted by the witness, will be found printed in full at the end of today's transcript.)

Mr. BACKUS. This brought to a partial halt the rapidly developing plans of these plotting conspirators. Bringing them into the open caused consternation in their camp and now they have changed their tactics. On March 17, just past, they brought suit in foreclosure proceedings under the terms of the mortgage, anticipating in that process the wiping out of the stockholders' equity, and in so doing to promptly eliminate me.

FABULOUS STAKE OF CONSPIRATORS

Now let us consider what these investment bankers have already been paid by our companies in commissions and management fees. Then let us review the future stake which is their objective.

Halsey, Stuart & Co.—and members of their underwriting syndicate—several of whom are now represented on the so-called "Bondholders' Protective Committee"—sold the following securities for these companies:

Minnesota & Ontario Paper Co:	
First-mortgage bonds	$25,000,000
Gold notes	5,000,000
National Pole & Treating Co, gold notes	2,000,000
Great Lakes Paper Co., Ltd, first-mortgage bonds	10,000,000
	42,000,000
Average commission and interest payment charge, 5¾ percent	2,415,000
Management fee for refunding National Pole & Treating Co	100,000
Total fees paid Halsey, Stuart & Co	2,515,000

Senator KEAN. What do you mean by "average commission and interest payment"?

Mr. BACKUS. I mean the average rate of discount on the bonds and the interest collection charge that we paid.

Senator KEAN. What do you mean by the interest charge?

Mr. BACKUS. The interest was payable at their offices and they made a charge for collecting.

Senator KEAN. You mean that the interest was payable at their offices, but you do not say how much they charged you for making the issue.

Mr. BACKUS. No; I just figured that the average was 5¾ percent, discount on bonds and collection charge.

Senator KEAN. But the collection charge was a recurring charge for services each year?

Mr. BACKUS. Yes, sir.

Representative SHOEMAKER This does not include the interest on the bonds; this is just the commission they got for collecting it.

Senator KEAN. I understand that But the point is that I wanted to know what they charged for the $42,000,000.

Mr. BACKUS. For distributing the bonds?

Senator KEAN. They bought the bonds from you?

Mr. BACKUS. Yes.

Senator KEAN. And then they formed a syndicate to sell them?

Mr BACKUS. Yes.

Senator KEAN. At what price did they buy the bonds from you?

Mr. BACKUS. They bought the bonds at an average of slightly over 94

Senator KEAN. What were the bonds?

Mr. BACKUS. Six's.

Now, what is the objective? The stakes they are greedily reaching for respecting only Minnesota & Ontario Paper Co., namely:

So-called "Bondholders Protective Committee", 5-percent fee on deposited bonds, $20,968,700, at 5 percent	$1,048,534
Estimated reorganization management fee	1,000,000
Total	2,048,534

(The foregoing two items of estimated cost could be accomplished for not to exceed $50,000 by the company's own organization.)

Through the unlisted market manipulation of these conspirators, viz, the New York and Boston banks heretofore named; the latter's close affiliate, Bond & Goodwin, whose representative is a member of the so-called "bondholders protective committee"; the bank controlled so-called "bondholders protective committee" and its affiliated investment bankers; aided by deliberate or ignorant mismanagement on the part of the receivers, the price of these bonds has been depressed to the low point of $3 25 per hundred dollars. They and their affiliates have accumulated the bonds of the companies, mostly under cover, in face value totaling several millions of dollars, averaging between $10 and $15 per hundred dollars. Their objective has been to finally secure the entire outstanding issue at an average price of approximately $200 for each $1,000 bond; then to foreclose the mortgage and virtually confiscate this enormous estate for approximately $5,000,000 plus commissions and minor expenses. A conservative valuation of Minnesota & Ontario Paper Co. properties—exclusive of Great Lakes Paper Co., Ltd.—would be not less than $75,000,000 under normal conditions. Accordingly, if this conspiracy should succeed, the huge $70,000,000 steal will be shared by the scheming banks; their bank controlled so-called "bondholders protective committee" and their affiliated investment bankers; the bank-dominated International Paper & Power Co, and lastly Receiver Robinson (the last named in the way of continuing compensation).

BRIEF SUMMARY

The foregoing statement portrays the status of this outstanding business structure at the date of the receivership, February 28, 1931, the upbuilding of which covered nearly 50 years of constant, intensive effort on my part, during which period much pioneering was necessary and much hardship encountered. I built several hundred miles of standard-gage railroad and branches; opened up several million acres of Federal and State lands theretofore inaccessible for agriculture or business purposes, which has produced many millions of dollars for them through sales and taxes. I encountered powerful opposition from competitive interests. I created a huge varied forest products organization and operated same profitably up to the

date of the receivership. Joseph W. Molyneaux, presiding Federal district judge at Minneapolis, Minn., in granting the receivership of Minnesota & Ontario Paper Co., adjudged and decreed that the defendant company was solvent on February 28, 1931.

The foregoing statement also portrays its present status; the deplorable mismanagement and huge unwarranted losses; the conspiring bankers' unpardonable violation of their prereceiver promises; and finally the envious greed of the aforesaid conspirators to virtually confiscate the entire estate.

The foregoing statement also portrays the final chapter in the conspiracy and the objective of the plotting conspirators named. They are greedily looking to their own interests, not those of the investors or equity owners. If they can crush and destroy the latter they are improving their own condition and that of the heavier debtor and our company's main competitor, the International Paper & Power Co. If they can continue to force the distressed and discouraged bondholders to liquidate at a mere fraction of the actual worth, they will have accomplished their end through the ruthless sacrifice of bondholders and other unprotected interests, including stockholders.

That is what has been going on for many months and is still going on in devious ways. The original bondholders are the first victims for sacrifice; after that has been accomplished, the problem of confiscating all junior equities is simple.

Obviously, if this conspiracy is successful, I will stand stripped of my equity; likewise my close associates and minority stockholders. I have no resources other than my stock interest in these companies. In protecting all interests and defending this unjustifiable litigation, we are forced to undergo heavy expense.

As previously stated, this litigation against me is not in anticipation of financial recovery but solely for the purpose of assuring the destruction of my personal, commercial, and moral standing, which in turn is intended to remove my protection of unprotected investors in our company and leave them to the willful destruction of these financial racketeers operating under the cover of the law.

APPEAL TO FEDERAL POWERS FOR SUCCOR

Finally, therefore, unless we can secure the sympathetic interest and assistance of some Federal tribunal, which has the power to prevent the successful consummation of this diabolical steal, the innocent investors—many of whose life savings are represented in these bonds—and other unprotected creditors will receive only a small fraction of their original investment; and the equity of myself and minority stockholders, which has been valued at many millions of dollars by the Internal Revenue Department in their valuation for tax purposes, will be wiped out completely.

Moreover, the future welfare of 30,000 people, depending on the income of some 7,500 workers, will be materially jeopardized, as all plans for large future expansion contemplated by me will die, and operations of existing plants will be materially reduced under the control of the International Paper & Power Co., whose operation of competitive plants already established, will be continued for the benefit of the communities in which they are now situated.

In the magazine Liberty, under date of March 17, 1934, in an article entitled "Our Financial Racketeers", Senator Fletcher, your chairman, has characterized them in the following words:

> Men in high places have betrayed their trust In theory the corporation official, whether in a bank or other corporate capacity, is a trustee of "other people's money." Investigation shows that this feeling of trusteeship has come to be very rare in financial circles
>
> The acts of financial crooks and racketeers make it plain that efforts must be made to safeguard legitimate depositors and investors
>
> This same practice over in the commercial field may likewise be made to serve their purpose by restricting credit alternatives with the ultimate capture, even destruction, of profitable and legitimate enterprises to the detriment of security holders and the general public.

In conclusion, gentlemen, permit me to say I have described to you as simply and clearly as I could, how the financial racketeers mentioned are plotting and scheming under the guise of legality to virtually confiscate the life savings of many thousands of our investors, and the constructive efforts of my life's work. I have full confidence that as a result of the comprehensive investigation to be conducted by the honorable committees of the United States Senate, those guilty of this diabolical conspiracy and these immoral acts will be prevented from consummating their well-laid designs and justice will be awarded where it is deserved.

The CHAIRMAN. Was the International Paper Co. a competitor of the Minnesota & Ontario Paper Co.?

Mr. BACKUS. Oh, yes; the principal competitor.

The CHAIRMAN. Did you make an effort to cooperate with the receivers?

Mr. BACKUS. How is that?

The CHAIRMAN. Did you make an effort to cooperate with the receivers?

Mr. BACKUS. I certainly did everything possible, but they refused to be advised by me.

The CHAIRMAN. Do any members of the committee desire to ask any questions? [No response.] Mr. Pecora, do you desire to ask any questions?

Mr. PECORA. No, Mr. Chairman.

The CHAIRMAN. Mr. Shoemaker?

Representative SHOEMAKER. I have a question or two, Mr. Chairman.

During the time that certain of the receivers there whom you have mentioned were in charge of the receivership the company made money, did it not?

Mr. BACKUS. Well, they played even, at least. But I do not figure that you are making any money if you do not pay interest. Without paying interest they were ahead.

Representative SHOEMAKER. And if this goes into the control of the International Paper Co. it will place about 7,500 men out of work in the State of Minnesota as a result of it?

Mr. BACKUS. I could not say that, but the operations will be lessened and there will be no expansion; so that it will mean more than that, as a result, in the end.

Representative SHOEMAKER. The judge handling this case, the Federal judge, in every instance gives the receivers practically everything they ask for?

Mr. BACKUS. He signs on the dotted line.

Representative SHOEMAKER. In other words, this judge several times has signed bills that they have made, not granting them the privilege of making them, but has signed them after the bills were made?

Mr. BACKUS. Yes, sir.

Representative SHOEMAKER. In disposing of assets?

Mr. BACKUS. Yes, sir.

Senator TOWNSEND. What is the judge's name?

Representative SHOEMAKER. Joseph W. Molyneaux.

Senator COUZENS. Why is not that a matter for the House of Representatives to institute impeachment proceedings?

Representative SHOEMAKER. I have a resolution pending at the present time, Senator.

It is common knowledge, is it not, that this judge is in no way capable, from a mental standpoint, to act as a Federal judge?

Mr. BACKUS. He has not demonstrated——

The CHAIRMAN. I do not think we ought to go into that here.

Is that all, Mr. Shoemaker?

Representative SHOEMAKER. For the present; yes.

The CHAIRMAN. Mr. Backus, the Senate Committee on Banking and Currency have heard with interest your recital and charges of a conspiracy between banks and the bank-controlled competitive corporation to destroy the Minnesota & Ontario Paper Co. and its subsidiaries.

You charge or claim, in substance, to the effect that a receivership was forced upon your company in violation of pledges made to you; the organization of a bondholders' protective committee, controlled by these bankers; forcing a contract upon the bondholders, giving title to this protective committee; the attempt to bribe you; the depressing and manipulating of the market of the company's bonds from near par to $3.25; the accumulating, under cover, of the bonds at such depressed prices; the apparent mismanagement of the estate to further depress the bondholders' hopes; the seemingly unwarranted sale of properties and finally the malignment of you by the suits brought against you and against Backus-Brooks Co.; the threatening of a final stroke, namely, the attempt at foreclosure, that will strip every equity and inure solely to the benefit of the alleged conspirators.

In view of the evidence you have presented and the references to the alleged racketeering under the guise of apparent legality, it is my judgment, in which I feel that my colleagues will acquiesce, that you should present the evidence in this matter to the Special Committee of the Senate on Receiverships and Bankruptcies, as I feel that that committee will consider the matter and has the necessary jurisdiction. That committee is under the chairmanship, ex officio, of Senator Ashurst. He is the chairman of the Judiciary Committee, and a comprehensive hearing may be conducted if he so desires.

The Committee on Banking and Currency therefore respectfully refers you in this important matter to the Special Committee on Receiverships and Bankruptcies.

Is that the consensus of opinion of the committee?

Senator COUZENS. I think so.

Senator TOWNSEND. Yes.

The CHAIRMAN. That will be our action in reference to the matter.

Representative SHOEMAKER. May I add the request that there be inserted in the record a copy of the contract that the so-called "Bondholders' protective committee" sent out to the bondholders for them to sign, in which they waived practically their rights and turned them over to this same group of bankers?

Senator GOLDSBOROUGH. That is for the consideration of the committee to which the matter is referred.

The CHAIRMAN. There was something of that kind offered in the course of Mr. Backus' statement.

Mr. BACKUS. The contract has not been submitted, but I can submit it.

Senator KEAN. I think it should be referred to the proper committee.

Mr. PECORA. You have made references to it in your statement?

Mr. BACKUS. Yes; I have.

Representative SHOEMAKER. I thought it might be illuminating to include it. It is just a short letter.

The CHAIRMAN. I think there is no real objection to that.

Senator KEAN. It is quite a long printed document, is it not?

Representative SHOEMAKER. No, sir.

Senator COUZENS. It really belongs to the committee to which the matter has been referred if they are going into it. We are not going to do anything more about it here.

Senator WALCOTT. There is no reason to duplicate records. It costs money, and we are on the economy plan.

The CHAIRMAN. That is all with reference to this matter, then.

Representative SHOEMAKER. May I, in behalf of my constituent, Mr. Backus, thank the committee for its courtesy and the time that it has given to this hearing.

(Whereupon, at 11:05 a.m., the subcommittee adjourned.)

BACKUS-BROOKS CO.,
Minneapolis, Minn., January 5, 1934

To the bondholders of Minnesota & Ontario Paper Co:

This letter offers no apologies. It concerns a subject of vital importance to you, and one which represents life and death, so to speak, to myself. Broadly stated, it relates to the process of strangulation now being administered by Receivers Robinson and Jaffray to the vast enterprises controlled by Backus-Brooks Co. and its principal subsidiary, the Minnesota & Ontario Paper Co., representing my life work, in the welfare of which our interests are in common.

I fully realize the dangers involved in a communication of this character. My motives may be misinterpreted. I may even be maligned by those who pretend they are acting in your behalf and protecting your interests. I refuse to be deterred by any anticipated attacks which this letter may inspire at the hands of those who are now conspiring to shape the destinies of the widely diversified and complicated business enterprises which are now largely consolidated in the organization whose bonds you hold, and in the ultimate solution of whose problems you are equally interested with myself.

My whole life has been devoted to a single purpose. In the accomplishment of that purpose I have been compelled to fight powerful interests and combinations in this and other countries. We have now reached a point where a battle to save these vast properties is imperative. I do not desire to fight this battle single-handed. If you will read and digest this letter, together with the facts and charges set forth in the enclosed pamphlet, you will understand that my fight will be greatly strengthened by your cooperation. I am not asking for

your financial assistance in waging this fight, as the necessary financing has been contributed by a small group of bondholders, friendly to me, who have, in their own way, investigated the deplorable mismanagement of this company under Receivers Robinson and Jaffray and have urged me to take steps for their removal Numerous other bondholders have also urged me to take this action.

I requested an up-to-date list of the Minnesota & Ontario Paper Co bondholders from the secretary of the so-called "Bondholders Protective Committee", but to no avail I was, therefore, obliged to obtain a list from the United States Treasury Department, which list numbering approximately 15,000 bondholders was compiled during 1931, and, therefore, not entirely up-to-date In failing to furnish this list I believe the so-called "Bondholders Protective Committee" desired to prevent my communicating with you I feel certain that you will understand their failing to give me such a list after reading this letter If you have disposed of your bonds, will you kindly pass this letter and pamphlet on to the purchaser or the broker to whom you sold with the request that it be submitted to the present owner

While our common enemy includes in addition to Receivers Robinson and Jaffray, powerfully entrenched financial interests, the cold-blooded unscrupulousness of which is only matched by their available resources, they are nevertheless vulnerable because of previous public disclosures, the ignominy of which has been flung through the columns of the press to the four corners of the world

The Minnesota & Ontario Paper Co represents in part the consummation of a comprehensive plan by Backus-Brooks Co of some 25 years ago intended to bring together under a single management the widely diversified operating properties acquired and developed through my efforts covering nearly half a century The executive management during all this period was vested in myself Hence, the statement already made that it represented my life's work At the time of the Minnesota & Ontario Paper Co receivership the Great Lakes Paper Co, Ltd, another major operating company owned by Backus-Brooks Co, was in the process of being taken over by the Minnesota & Ontario Paper Co, but the receivership prevented its consummation

All idea of personal gain was wholly foreign to my underlying purpose during the upbuilding of these companies The properties acquired, figuratively speaking, represented an empire The organization had been developed and brought to the point of profitable operation The localities of such operation had been strategically selected as a result of long years of experience The requirements of future expansion had been thoughtfully anticipated. The foundations of a great and prosperous business had been carefully prepared

When the crash of 1929 swept the country, the newsprint industry was keenly feeling the effects of overproduction However, there was neither hesitation nor fear on my part The thought of any default on outstanding obligations never entered my mind, a fact perhaps best attested in that approximately $3,000,000 was expended during 1930 in expanding our properties in the United States, Canada, and Europe

Looking back now, I can see where I made one mistake I placed my reliance in banks and investment bankers At that time I had no more conception of their inherent untrustworthiness than that possessed by the public generally.

In the summer of 1930, business judgment suggested the advisability of anticipating our requirements and making provision for our funded obligations maturing in 1931 The subject was accordingly taken up with the investment bankers. by whom I was assured these obligations would be cared for in due course, but that it was then too early to consider the matter. Relying on this promise, I returned to the duties of the active business management Later in the fall several plans for refunding were considered Arrangements were finally reached under which our commercial bankers and fiscal agents agreed to provide the amounts necessary to retire all of our funded maturities and other extraordinary requirements for 1931

Late in February 1931 I made an appointment with the bankers for a conference in New York City, where the details of what had already been promised could be carried out At that conference I was for the first time informed that the bankers would not keep their pledge, and that a receivership was the only solution To lessen the force of this blow, it was then agreed that I should be made the sole receiver, thus preserving my managerial status and affording me the opportunity of working out the company's affairs.

At this conference the bankers demanded that substantially all of the cash working capital on hand, amounting to over $1,100,000, should be turned over to them and applied on their unsecured and unmatured obligations This I was obliged to agree to, but only after receiving assurance that $3,000,000 would be provided by issuing receiver's certificates to enable us to conduct and operate the business Only $500,000 of this sum, however, was furnished. Through this maneuver the banks were able to replace their unsecured notes with receiver's certificates, which are a preferred claim and a lien prior to your bonds In the then conditions, with funded obligations maturing the following week, I had no alternative but to accede to their proposals. Then followed the original receivership with which you are already familiar

In the following 9 months, during which I was the operating receiver, I accumulated a bank balance of over $2,000,000, including $500,000 borrowed on receiver's certificates, after defraying all operating and maintenance expenses. This $2,000,000 was turned over to Receivers Robinson and Jaffray upon their appointment as receivers on November 30, 1931 Immediately a campaign of extravagance, mismanagement, and waste began and continued until at one time the cash balance was reduced to slightly over $600,000 With proper management the cash bank balance at this time should be at least $5,000,000, or more than e ght times the present balance

Only a relatively short time following my appointment was required to demonstrate that unseen and unknown forces were working against the interests of the bondholders and myself The bankers, obviously, never intended that I should remain as receiver. Their first and underlying selfish motive was to get possession of the $1,100,000 of cash, and the second to remove me as receiver immediately the opportunity was afforded These unseen and unknown forces have now been brought into the open and the maneuvering and manipulation resorted to is now apparent The matters thus stated proved to be the initial steps of the conspiracy herein disclosed The successive steps in its development will appear from what follows

As the first move, our bankers designated and selected the so-called "Bondholders Protective Committee." The subservience of this committee to the interests to which its members owe their appointment has been and is apparent. Two members and the secretary are employees of Halsey-Stuart & Co., investment bankers of Chicago, and of recent "Insull fame" One member each is respectively an employee of the First National Bank of Chicago; Brown Bros. & Harriman, of New York; Bond & Goodwin, investment bankers, of Boston; Wood Gundy & Co, investment bankers, of Toronto. One member was formerly with Minnesota Loan & Trust Co, of Minneapolis, and one member is of affiliation unknown to me These men are securities salesmen. They have had no experience or training as industrial operators; their advice in such matters is of no value in the administration of our vast properties

It was these bankers and this committee, who so soon demanded my resignation, and insisted upon the appointment of Receiver Robinson The latter's incompetency and inexperience in the management of our estate in which the so-called "Protective Committee" has acquiesced, is nothing less than a stupendous tragedy

Receiver Robinson is reputed to be a man of large inherited wealth, yet, I am told, his entire business life has been spent as an employee of others. Receiver Jaffray is at the head of a banking organization the past transactions of which are now being investigated by the securities commission of the State of Minnesota.

I put to you the plain question: What protection can we expect for our interests through the office of a committee and receivership thus comprised?

I have no personal animosity toward any of the individuals comprising this committee or Receivers Robinson and Jaffray, but I do know from my association with these receivers, that they and the committee are utterly incompetent to manage the Minnesota & Ontario Paper Co. and its numerous subsidiaries.

How can we expect these receivers and this so-called "Protective Committee" to successfully manage and rehabilitate our vast properties? Well * * * as a matter of fact, they are not managing * * * they are destroying. Our estate will soon be of comparatively little value if we allow the present receivers to continue If you have read the many disclosures of protective committees in general, I know you will have satisfied yourself that under their misguided directions the bondholders and stockholders always lose.

It is apparent that the real objective of the bankers from the outset was to eliminate and destroy me as quickly as possible, the plan being to discredit me in the eyes of the bondholders and creditors; and thereby clear the way to carry out their diabolical scheme at the proper time

The first move was in the pretended interest of assumed harmony. They prevailed upon me to retire voluntarily as a receiver, and to consent to the appointment of Messrs. Robinson and Jaffray I would never have consented to this radical and unbusinesslike change but for the assurance that I should be maintained and continued by the newly designated receivers in an advisory capacity to safeguard the estate against mismanagement and loss

The disillusionment in this letter regard was not long postponed Receiver Robinson immediately assumed dictatorial control, he ignorantly attempted a reorganization of all the departments of the business without any knowledge of the ability or capacity of the old department heads, disregarded all my advice and suggestions on important matters of business policy, and in general inaugurated the unprecedented policy of extravagance and waste which has characterized his operations throughout While creating his personal organization, Receiver Robinson gave general instructions that none of his newly constituted department heads were to confer or advise with me on any matter of business This was naturally taken by such employees to mean that if they did consult with me they would be discharged I know you will agree with me when I say that any organization constructed on the above lines and without a real leader always results in heavy losses and inevitably spells ruin

In the paper, lumber, and timber industry losses largely occur in the timber and logging departments where steady waste is usually prevalent when skillful management is lacking Neither Receiver Robinson, or Jaffray, or any of their present advisors or staff, are capable of managing these departments and these steady losses are mounting day by day. To meet these operating losses and replenish the treasury, our quick assets are being sacrificed at whatever price they will bring

I do not wish to unduly extend this letter I feel, however, that certain outstanding facts may interest you.

The receiver's last official report, dated September 30, 1933, discloses the fact that current assets during the receivership period have shrunk $4,677,586 01 Receiver Robinson has liquidated the cream so to speak, of our quick assets In the remainder of the current assets will be found a very broken lumber assortment, slow accounts receivable, and other slow items.

A few of the items of waste, extravagance, and mismanagement are as follows (1) Amounts paid for receivers' fees, attorney's fees, and expenses during the receivership period, $700,000; (2) unnecessary compromising of accounts receivable which could have been collected in full, $570,000, and (3) unjustifiable cash expenditure in National Pole & Treating Co. refinancing, $525,000

The above items total $1,795,000, all of which was unnecessarily and unwisely expended Taking these current items together with the other items set forth in detail in the pamphlet herewith enclosed brings the total loss up to over $12,000,000 during the administration of Receiver Robinson I vigorously protested the confirmation of the principal items making up this loss. The items protested are as follows: (1) Concessions made to Great Lakes Paper Co, Ltd, now in receivership, (2) compromising of accounts receivable; (3) sale of Memphis Commercial Appeal property; and (4) sale of Minnesota Forest Products property

In the two last-mentioned protests, appeals have been taken to the circuit court of appeals from the order of the district judge confirming sale, because I feel that if the court had any knowledge of the real value of the properties sold it would not have permitted them to be sacrificed as they were

Mr Robinson has stated to the court several times in my presence that his recommendations have been referred to and approved by the so-called " bondholders' protective committee." My watchfulness over the interests of our bondholders exasperated Receiver Robinson and those conspiring with him and finally climaxed in a suit brought by the receivers against myself to recover $7,000,000 claimed to have been abstracted by me from the business for my own personal ends A baser and more groundless charge was never preferred against any man

In the receiver's report of October 31, this $7,000,000 suit against me was conspicuously referred to. The so-called " protective committee " emphasized the incident in its letter dated November 17, 1933, to the bondholders, and as I

understand to all our creditors and the financial world in general This was intended as the finishing touch to my absolute elimination and destruction. Their sole purpose was to make certain that I would be completely discredited and my continued opposition eliminated.

The pamphlet enclosed herewith contains my answer to that suit and discloses the facts, viz, that the receivers have no claim against myself, but on the contrary that I have substantial claims against the company, which I had intended to satisfy by accepting additional stock I have answered these false charges in a suit which I have instituted against the receivers individually for $2,000,000 damages for libel, and have challenged them to prove their untrue charges before an independent tribunal

The final step in their conspiracy was my complete discharge from any connection with the affairs or business of either the Minnesota & Ontario Paper Co. or its subsidiaries, by reason of which they expected me to abandon all hope of realizing any recovery from my equity in this company, which has been my life work I have publicly made all these charges in proceedings before the court to remove the present receivers for incompetency and waste of the assets of the receivership estate

By the time you have reached this point you will doubtless be asking yourself the question, Why things are as they are? The answer may be expressed in three words, "too many bankers"

The Minnesota & Ontario Paper Co attained its position as one of the largest organizations of its kind in the United States and Canada in the face of severe competition of powerful money interests behind competing industries These competing organizations, owing to prevailing conditions, are heavily indebted, their obligations are held by certain of the banks to which we are to some extent indebted, these banks are looking exclusively to their own, not our interests If they can destroy us, they are improving the condition of the heavier debtor, if they can destroy us, they will lessen competition; if they can force us to liquidate our affairs in such a way that the competitor may acquire our property at a small fraction of its fair and actual worth, they will have accomplished their end even though your interests and mine are ruthlessly sacrificed in the process.

This is precisely what is going on today In the hands of your protective committee and the present receivers you are the victims for the sacrifice Are you going to stand by and be led to the slaughter?

The final steps in the tragedy are near completion Do not be surprised if shortly after the receipt of this letter there is presented for your consideration a plan of reorganization However, their plan may not be presented after these disclosures

This communication may be given relatively wide publicity You will doubtless receive from your so-called "protective committee" extended communications showing their solicitude for your welfare Incidentally, these communications may center their attacks on myself You will be told that the present receivers are men of eminence and standing, with experience in large affairs And, finally, that the whole administration of your interests has been under the jurisdiction of the court. As to the experience of the receivers, however broadly it may be postulated or exaggerated, there is one inescapable fact, viz That neither of them is possessed of any experience calculated to qualify him for the handling and administration of the business and properties in which both you and I are interested As to the court, it need only be said that the ordinary judge is lamentably inexperienced in practical business affairs

I only ask you, if such communications are received, to bear a few salient facts in mind I built the Backus-Brooks Co. organization, which owns over 90 percent of Minnesota & Ontario Co's stock, from the point where its capital investment was $3,000 to one where that investment was over $100,000,000 In this fight to protect my interests I am protecting yours I believe I know far better the needs and necessities of the situation than any syndicate of eastern bankers or Receiver Robinson, their emissary I will welcome and extend my full cooperation to any management which is conscientiously working to salvage and reorganize our vast interests and which is not subject to banking domination

If you agree with me in the policy thus outlined, your first step should be to withdraw your securities from the hands of the present committee; revoke its authority to act in your behalf, and stand firm in the independent exercise of your own rights I myself will assume the burden of the fight to protect your interests as well as my own, and without cost to you

One further feature exists from which you may draw your own conclusions. There is every reason to believe that the banking interests, parties to the conspiracy above outlined, have been systematically buying up our bonds at sacrifice prices during the pendency of the receivership Recently, one of these investment banking concerns, and one, whose employee is a member of your protective committee, has bought several hundred thousand dollars of the bonds of the same issue which you hold, for approximately 10 cents on the dollar.

What can be expected when those in whom you are reposing your confidence, on whom you are relying for the protection and conservation of your interests are carrying on a campaign of sniping, preying upon the misfortunes of those of your number who may be financially distressed? What reliance may be placed in a so-called "protective committee" designated by those who are working in their own interests, in total disregard of yours and mine?

In conclusion, I know you will forgive my briefly displaying a sentimental view in connection with this enterprise In the 1890's when conducting my logging operations in northern Minnesota, I was 200 miles from the Canadian boundary at the point on Rainy River where International Falls, Minn, and Fort Frances, Ontario, are now situated There were no roads It was midwinter and a blanket of snow 3 feet deep made travel difficult Accompanied by my head timber cruiser we covered the distance on foot and finally arrived at the Hudson Bay trading post one beautiful moonlight night after midnight with the thermometer at 40 below zero. I viewed the wonderful waterfalls there and decided to do some constructive pioneering. The outcome was the building of 200 miles of railroad, now the Minnesota & International Railway Co , the development of the water power and paper mills on both sides of the river, the building of saw mills, planing mills, Insulite mills; 200 miles of additional railways, the purchase of timber holdings in large amounts; and finally a total investment of $50,000,000 Why should I not be sentimental and strive to rehabilitate this organization which has been my life work and my pride?

And so, fellow bondholders, I ask you, in the same spirit created during this past year, by our worthy leader, President Roosevelt, let us work together and put to an end the destructive practices of the "money changers"

I invite your personal response to this letter and shall welcome all constructive suggestions you may care to make.

Very respectfully yours,

E W Backus,
President Backus-Brooks Co, and Minnesota & Ontario Paper Co

BACKUS-BROOKS COMPANY—OFFICE OF THE PRESIDENT

To the Bondholders of Minnesota and Ontario Paper Company:

The properties of the Minnesota and Ontario Paper Company, whose bonds you hold, is the prey of a so-called "Bondholders' Protective Committee," under circumstances comparable to the plan so vividly portrayed in the article, "Other People's Money," which appears on the opposite page

Every bondholder of the Minnesota and Ontario Paper Company should be informed that the Court, in its order appointing the original receivers, specifically found the company to be in a solvent condition

The purpose of the receivership, therefore, must have been rehabilitation and not the liquidation of its affairs But what does the record show? When you have read my personal statement and this pamphlet disclosing the colossal wastages committed, you will be convinced that the policies of the present receivers are destined to destroy and not to rebuild

I understand that Eastern Bankers and the Receivers, in the case of the Minnesota and Ontario Paper Company, are evolving a scheme to seize the properties of our company for a mere fraction of their value If this happens, both you and I will be the victims Heartless Financial Giants in the form of Eastern Bankers and their allied Newsprint competitive company have marked us as they prey in this colossal tragedy. To accomplish their purpose, more easily and surely, they have determined that my business life and reputation be sacrificed on the altar of the "Money-Changers"

I accept their challenge and will fight to the finish, but I need your help

Herein is set forth the history of legal proceedings that have been instituted by me to block this ruthless plan I most earnestly urge that you read it carefully throughout to get the facts When you know the truth of the impending

vicious scheme, I feel confident you will heartily co-operate with me in this fight to protect my equity and save your investment By working together we can win.

Please write immediately that you are with me.

Respectfully yours,

(Signed) E W BACKUS,
President Backus-Brooks Company and Minnesota and Ontario Paper Company.

JANUARY 5, 1934
BAKER BUILDING, MINNEAPOLIS, MINN.

The Legal Proceedings herein set forth are as follows:

I. Petition asking for Removal of Receivers Robinson and Jaffray, for inefficiency, incompetency and maladministration

II Answer of E W Backus and other defendants, to the suit brought by Receivers, which answer sets forth that the action is based solely on desire to destroy business reputation of Mr. Backus

III Complaint in suit brought by Mr E W Backus against R. H M. Robinson and C. T Jaffray asking $2,000,000 damages for Libel

I. PETITION ASKING FOR REMOVAL OF RECEIVERS ROBINSON AND JAFFRAY, FOR INEFFICIENCY, INCOMPETENCY AND MALADMINISTRATION

IN THE DISTRICT COURT FOR THE UNITED STATES IN AND FOR THE DISTRICT OF MINNESOTA FOURTH DIVISION

(Equity No. 1950)

Wirt Wilson & Company, a Corporation, Complainant,
v.
Minnesota and Ontario Paper Company, a Corporation, Defendant

Petition for removal of receivers

To the Honorable Judges of the United States District Court in and for the Fourth Division of the District of Minnesota:

The petitioners, Minnesota and Ontario Paper Company and Backus Brooks Company, bring this their petition against R H M. Robinson and C T. Jaffray, receivers in this cause, and pray an appropriate order of the court removing such receivers and appointing a successor receiver or receivers for the administration of the properties involved in this proceeding, and thereupon allege and state to the court as follows

1. That your petitioner, Minnesota and Ontario Paper Company, is the defendant in the above entitled cause and owner of the various properties involved in the pending receivership administration; that your petitioner, the Backus Brooks Company, has, at all times since the inception of the receivership, been the owner and holder, and still is the owner and holder, of approximately ninety (90) per cent of the total outstanding shares of capital stock of the said Minnesota and Ontario Paper Company; that your petitioners are the owners and holders of outstanding first mortgage bonds of said Minnesota and Ontario Paper Company, secured by that certain mortgage or deed of trust executed by the last named company to The Minnesota Loan and Trust Company as trustee under date of April 1, 1925.

2 That under the order of the court made and entered in this cause on or about the 30th day of November, 1931, the aforesaid R H M Robinson and C. T Jaffray were designated as receivers of the properties and affairs of the said Minnesota and Ontario Paper Company, and on or about the same date said last named parties qualified as such receivers and have ever since continued as such receivers in the handling and administration of the estate herein, that by the order of appointment, such receivers were authorized to carry on and conduct the business which the said Minnesota and Ontario Paper Company was conducting and carrying on at the date of the receivership herein and since their appointment as such receivers, they have at all times been engaged and still are engaged in the ostensible carrying on and conducting of such business.

3. That in the administration of such receivership estate and the carrying on and conduct of the business aforesaid by the last named receivers, such receivers have been guilty of various and sundry acts of misfeasance, nonfeasance, and negligence, owing to inexperience, inefficiency, lack of knowledge of the practical requirements of the business committed to their administration, misconduct and lack of business judgment, as a result whereof, the creditors interested in said estate as well as the owners of the equity therein, have heretofore sustained great and irreparable loss and damage for which they are without adequate or any redress and which, if continued, will result in the sacrifice and dissipation of the receivership estate.

4. That in the inception of the administration of the receivers herein mentioned, the estate and property of said Minnesota and Ontario Paper Company (including that of its subsidiaries), at a fair and reasonable valuation, was largely in excess of the amount of its outstanding debts and obligations, funded as well as current, and such Minnesota and Ontario Paper Company and its stockholders were possessed of a large and valuable equity in such properties and estate That due and owing to the utter incapacity and incompetency of the receivers herein mentioned, such value has been largely dissipated and sacrificed; the business of the Minnesota and Ontario Paper Company has been demoralized and the standing and prestige of the last named company in the commercial world, has been largely sacrificed and ruined

5. That up to the date of the receivership herein, the business of the Minnesota and Ontario Paper Company had been profitably conducted and no default at any time made in meeting both the principal and interest of its obligations as they respectively matured; that its business had been constantly expanding and the scope of its various industries enlarged in the United States, Canada, and Europe; that during the year preceding the receivership, its capital expenditures, in the expansion of the field of its operations, amounted to approximately $3,000,000 00, and that as a result of sound progressive business policy, it had achieved recognition and standing as one of the leading industries of its character on the American continent

6 That, during the administration of said estate under receivers Robinson and Jaffray, nothing of a constructive nature whatsoever has been accomplished by said receivers on behalf of said estate; that, on the contrary, the administration of this estate is a glaring example of mismanagement of the affairs of an industry perhaps never equaled in the industrial history of this nation; that, under the administration of the receivers herein mentioned, there has been committed a colossal wastage and loss of the assets of said estate, all of which were avoidable and could have, and would have, been saved under competent management; that properties have been ruthlessly sacrificed to provide funds to defray the expenses of extravagant administration wholly regardless of the ultimate effect of such procedure upon the estate in its entirety; that illy advised policies and inexperienced management have been responsible for heavy and wholly unnecessary losses in business volume, that the interest of all parties concerned in such estate are seriously jeopardized, and particularly the interest of thousands of small investors who are holders of bonds of said Minnsota and Ontario Paper Company, and which bondholders and other creditors have suffered, and will continue to suffer, from such misguided methods and policies; that the bondholders have been lulled into a sense of false security and led to assume that their interests are being adequately protected by the so-called Bondholders Protective Committee; that said committee has utterly failed to exercise the proper initiative or attention to the affairs of said estate, and apparently has carelessly and negligently relied upon and accepted without question the gross mismanagement of the affairs of said estate by said receivers, Robinson and Jaffray

7. That under the unwise and wasteful administration of receivers, Robinson and Jaffray, the monies and properties of this estate were and are being recklessly dissipated, resulting in the stupendous aggregate loss to date of approximately

TWELVE MILLION TWELVE THOUSAND FIVE HUNDRED SEVENTY AND 96/100 DOLLARS ($12,012,570 96)—

all of which has jeopardized and gravely impaired the interests and security of thousands of bondholders, creditors, and owners of said estate. That said unwarranted losses and expenditures are made up of the following major items, to wit:

(*a*) Cash paid for receivers' and attorneys' fees since the inception of the receivership, approximately	$700,000.00
(*b*) Cash loss by reason of unjustified compromise settlement of sundry accounts receivable due Minnesota and Ontario Paper Company, and subsidiaries	445,000.00
(*c*) Cash loss by reason of compromise settlement of account owed by International Paper Company (a company operating in competition with the Minnesota and Ontario Paper Company) in principal amount of $175,000 00, and which was settled for $50,000 00, a net loss of	525,000 00
(*d*) Cash loss as a result of National Pole and Treating Company (a Minnesota and Ontario Paper Company subsidiary) gold note refunding plan, including $100,000 00 broker's commissions	525,000 00
(From the above—total cash losses—$1,795,000 00.)	
(*e*) Operation loss due to mismanagement and ill-conceived operating policies and excessive overhead expenditures	1,095,000.00
(*f*) Investment loss on sale of Memphis Commercial Appeal (a daily newspaper constituting part of the assets of said Minnesota and Ontario Paper Company) as appears by Receivers' Report dated September 30, 1933	1,718,570.96
(*g*) Loss due to inefficient supervision and management of logging operations of International Lumber Company (a Minnesota and Ontario Paper Company subsidiary), together with losses sustained by reason of sale of lumber at bargain prices and losses occasioned by the wholly unwarranted and astounding voluntary destruction by fire of a vast store of pulpwood and the intentional burning down of necessary camp buildings	1,559,000.00
(*h*) Losses estimated if contracts are fully performed as entered into by Minnesota Forest Products Company (a Minnesota and Ontario Paper Company) with Northwest Paper Company (a competitive Weyerhauser Company) for the exchange of timber between the above companies, and for the sale of timber located in Cook County, Minnesota, to Consolidated Water Power and Paper Company, and for sale to the United States Forestry Department, and losses sustained from cancellation without payment of account of $90,000 00 owing by Northwest Paper Company to Minnesota Forest Products Company, and loss resulting from Receiver's failure to cut timber on Isle Royale which timber was deteriorating because of insect infection, a gross total loss of	1,480,000.00
(*i*) Loss to National Pole and Treating Company (a Minnesota and Ontario Paper Company subsidiary) due to unsound and wholly unwarranted refinancing; operating loss during present receivership, and cut in inventory	1,675,000.00
(*j*) Unnecessary and unjustifiable capital expenditure in paper mills and subsidiary properties, including loss in manufacturing operations of paper specialties and including loss in burning sawmill materials	750,000.00
(*k*) Losses estimated incurred through receivers' joining a combination in Restraint of Trade, restricting newsprint paper output, which has resulted in a huge loss in sales of newsprint paper, which combination at the time was in contravention to Federal law and opposed to the best interests of the estate and bondholders	1,250,000.00
(*l*) Lapsing of timber permits held by International Lumber Company (a Minnesota and Ontario Paper Company subsidiary) without cutting timber thereon before expiration of permits, and sacrifice sales of timber	95,000 00
(*m*) Loss to estate on account of surrender of newsprint tonnage to Great Lakes Paper Co and of commissions	595,000.00
Total	12,012,570.96

8. That, at the time of receivership, there was cash on hand in excess of One Million Dollars ($1,000,000.00), which amount was credited by bank creditors on notes payable held by them on the understanding that a working fund

of Three Million Dollars ($3,000,000 00) would be made available by them on receivers' certificates and that the former management should act as receiver; that as a result of said bankers' acts at the inception of this receivership, there was no cash whatsoever on hand with said estate, that at the inception of this receivership, E W. Backus was named as one of the three receivers serving as such for a period of nine (9) months; that, because of lack of co-operation on the part of big Eastern banking creditors in particular, the said E W. Backus voluntarily resigned as such receiver on the 30th day of November, 1931; that during said nine months' period, the said E W Backus was acting as such co-receiver, the affairs of said estate were largely under his control and subject to his direct management, and, during such time, there was accumulated a cash working fund for said estate, by reason of the efficient management of its affairs, in the sum of over Two Million Dollars ($2,000,000 00) in cash including Five Hundred Thousand Dollars ($500,000 00) through receivers' certificates, that since December 1, 1931, and during the administration of said receivership by Robinson and Jaffray, the present receivers, said Two Million Dollars ($2,000,000 00) cash working fund was reduced and dissipated by mismanagement and waste by said present receivers to an amount of approximately One Million Dollars ($1,000,000 00)

9 That neither of such receivers at the date of their appointment as such, as aforesaid, had any practical knowledge or experience in or respecting any of the various lines of business in which the said Minnesota and Ontario Paper Company was engaged; that neither thereof had any familiarity with the intricate and widely diversified details of such business nor any knowledge or acquaintance with the local conditions affecting such business in the various localities where such business was being conducted and carried on; that neither of such receivers had any acquaintance with the personnel of the complicated operating organization nor as to the capacity and qualifications of the members of such organization, that shortly following the date of their appointment, solely with the objective of creating an administrative organization beholden and committed to themselves, said receivers substituted for the previously existing experienced administrative organization, one, newly created by themselves, with the result that the affairs and business of the Minnesota and Ontario Paper Company was largely disorganized and demoralized in that persons were appointed to managerial positions who were utterly lacking in capacity or experience for their new responsibilities, the business now being largely committed to untrained and incapable individuals That as a result of the matters in this subdivision stated, the operations of such business have sustained losses aggregating, as petitioner is informed and believes, a sum approximately as hereinbefore set forth

10. That during the administration of such receivers, the current cash assets of the receivership estate have been reduced from approximately Thirteen Million Two Hundred Forty Thousand Five Hundred Fifty-six and 88/100 Dollars ($13,240,556 88) to Eight Million Five Hundred Sixty-two Thousand Nine Hundred Seventy and 87/100 Dollars ($8,562,970 87), due to the incompetency of such receivers, without any commensurate return to the receivership estate.

11 That said Minnesota and Ontario Paper Company has, at all times, expended the major portion of its monies in the Dominion of Canada; that shortly after Great Britain went off the gold standard, your petitioner, E W. Backus, urged upon receiver Jaffray the advisability and necessity of transferring funds of said company on deposit in banks of the United States into Canadian Exchange; that said receiver Jaffray wholly disregarded said urgent advice, thereby forfeiting an opportunity to gain a sum of money for said corporation on the favorable resultant rate of exchange in excess of Two Hundred Twenty Thousand Dollars ($220,000 00).

12 That your petitioners allege that receiver Robinson was, and is wholly unqualified by reason of lack of training and experience to administer the complicated affairs and business of this estate; that said Robinson was recommended for said receivership by certain large Eastern banking interests; that such Eastern banking interests represented that Robinson's alleged broad and varied experience justified his appointment as receiver and the payment to him of an annual salary of Seventy-two Thousand Dollars ($72,000 00), that such Eastern banking interests misled the bondholders, the various protective committees, and the court who made such appointment and approved such salary, through creating the impression that receiver Robinson was a man with an exceptional record of administrative ability in management of vast industries, and that he was ideally qualified to act for the estate; that, as a matter of fact, receiver Robinson had no actual experience in receiverships or

otherwise, that would qualify him for management of this or any similar enterprise, and that such representations were false in that he had at no time received a salary equal to that allowed him from this estate, that the loss of over Twelve Million Dollars ($12,000,000 00) as hereinbefore set forth sustained under his administration and policies, demonstrates beyond peradventure his total and abject unfitness to administer the affairs of this estate, that the removal of said receivers Robinson and Jaffray is imperative and absolutely essential if the holding of many thousands of bondholders and the interests of creditors are to be preserved, that receiver Robinson has not devoted a fair share of his time in the interest of said estate and has taken two wholly unnecessary trips to Europe paid for by the estate and bondholders thereof

That your petitioners, upon information and belief, allege that receiver Robinson, conspiring with Eastern bankers and with Eastern competitive paper mill interests, has recently devoted the major portion of his time to a plan of reorganization which your petitioners believe is designed to deliver to said competitive interests, the vast properties of this estate on a basis so completely disproportionate to their actual present market value as will shock public conscience and constitute the most brazen of many unsavory banking transactions witnessed in the past decade; that receiver Jaffray has devoted practically none of his time to affairs of said estate, but has submitted to the will of receiver Robinson apparently without question, that until January 1, 1933, receiver Jaffray was allowed a salary on the basis of Thirty Thousand Dollars ($30,000 00) per annum, which, together with receiver Robinson's salary to said date of Seventy-two Thousand Dollars ($72,000 00) per annum, made a total aggregate of One Hundred Two Thousand Dollars ($102,000 00) per annum salary to said receivers.

That said receivers approved and recommended payment of local attorneys' fees up to January 1, 1933, on a basis of Fifty-four Thousand Dollars ($54,000 00) per annum, and approved and recommended the aggregate sum of Seven Hundred Thousand Dollars ($700,000 00) actually paid for receivers' and attorneys' fees and traveling expenses since the inception of receivership, all of which constitute a gross violation of the trust imposed upon them

13 That such receivers have demonstrated, by reason of the matters herein stated, their utter disqualification for the responsibility and management of said estate and, unless removed, will continue to mulct said estate in excessive costs and expenditures, in unnecessary sacrifice and loss of capital assets and in wholly unjustifiable and inexcusable losses to the receivership estate in the active administration of its affairs

WHEREFORE, and by reason of the matters in this petition stated, petitioners pray that such receivers be cited and required to be and appear before the court at a time and place designated and then and there make answer to the matters alleged in this petition and then and there show cause why their authority as such receivers should not be revoked and why they should not be removed from the office of such receivers and successor or successors appointed to such office.

Petitioners further pray that an appropriate order of reference may be made herein, for the hearing and determination of the matters herein alleged and particularly for a full and complete accounting of the administration of such receivership and disclosure on the part of such receivers of the matters in their petition referred to and for such other and further relief as to the court shall appear just and equitable and consistent with the matters alleged herein

This petition will be based on the allegations hereinbefore set forth, and the affidavits hereto attached and hereby made a part hereof as though set out herein in full

(Signed) DAVIS & MICHEL,
Attorneys for Petitioners,
419 Metropolitan Bank Bldg,
Minneapolis, Minnesota.

Dated this 8th day of January, 1934

MORTIMER H BOUTELLE,
1500 Rand Tower
and
JOHN H HOUGEN
and
JOHN C HOLTEN,
1300 Rand Tower,
Minneapolis, Minnesota,
of Counsel

AFFIDAVIT OF E W BACKUS, PRESIDENT OF MINNESOTA AND ONTARIO PAPER COMPANY, IN SUPPORT OF ABOVE PETITION

STATE OF MINNESOTA,
COUNTY OF HENNEPIN—ss.

EDWARD W. BACKUS, being first duly sworn, deposes and says that he is now and has been at all times since their organization, the president and executive manager of the Minnesota and Ontario Paper Company and the Backus-Brooks Company, respectively, petitioners in the foregoing and attached petition, that the Minnesota and Ontario Paper Company was the outgrowth of a general plan conceived twenty-five years ago for the consolidating of the widely diversified enterprises which were organized and developed in the United States and Canada, by the Backus-Brooks Company, which company was the owner of the diverse industries then engaged in the manufacture of newsprint and lumber commodities and also owned or controlled, in both the United States and Canada, extensive power rights and properties, both developed and undeveloped, large timber interests, variously located power plants and sites, railroads and other transportation facilities, that ownership of the major portion of the various properties thus indicated finally vested in the Minnesota and Ontario Paper Company, a subsidiary of the said Backus-Brooks Company in the year 1908

That from the date last mentioned, the entire executive organization was at all times under the exclusive management and direction of this affiant and so continued down to the date of the receivership in the within entitled action. That at the date of the receivership herein, the various properties and interests of the consolidated Backus-Brooks Company organization had been developed and expanded until the same had, at the date of the receivership herein, a book value of over One Hundred Million Dollars ($100,000,000 00) which affiant believes, in the light of his knowledge and experience with the properties involved, represented conservatively a fair valuation under normal business conditions

That the operations of such consolidated organization were, for the most part, profitably conducted with the profits in the main retained in the business for the purpose of enlarging and expanding its various enterprises, developing its diversified industries and otherwise contributing to establishing one of the largest industries of its character on the North American continent

That at and previous to the naming of Receivers R H M Robinson and C T. Jaffray, it was understood and agreed between affiant and such receivers that affiant should be retained in the capacity of an adviser and consultant, making available for such receivers the knowledge and experience of affiant in all the branches and departments of the widely diversified business of the Minnesota and Ontario Paper Company

That shortly following their qualifying as such receivers and the taking over by them of the conduct and administration of such business, receiver R H M. Robinson, who assumed active management and control, repudiated such understanding and agreement and declined to generally consult with affiant respecting many matters regarding which the said Robinson had no knowledge or experience; that employees of the various branches of the business were, as affiant is informed and believes, instructed that affiant should be kept in ignorance of matters of vital importance on the penalty of losing their respective positions, if such instructions were disregarded, and also were instructed not to consult with or confer with affiant on matters pertaining to the business; that in many matters of importance business policy, in which affiant was consulted by either the said Robinson or his coreceiver or both, his advice was ignored and disregarded and such receivers through incompetency and inexperience adopted and followed out policies resulting in each instance to the disadvantage and serious loss of the receivership estate, many of which instances are later herein referred to

That in addition to the matters last stated, receiver Robinson, shortly following his appointment, adopted the policy of practically reorganizing the entire executive and administrative departments of the business, and, as affiant is informed and believes, on such plan as would ultimately exclude all participation on the part of affiant in any capacity whatever in connection with the operation of such business; that as a result of the policy last indicated, departmental heads were created covering the various branches, most of whom were

without the personal ability or experience for assuming the important duties to which they were severally assigned and lacking the guidance had previously

That the result of the policy last above described left the general control of the affairs of all the various branches and departments of the business of the Minnesota and Ontario Paper Company, and all of its subsidiaries, with the receiver Robinson, with no practical knowledge or experience in anywise qualifying him for the responsibilities of his position, that the administrative organization was so demoralized and disorganized as to result in large losses being sustained under the administration of receiver Robinson, as hereinafter referred to and considered under the respective captions following, viz

(a) NATIONAL POLE AND TREATING COMPANY

That the first major matter before the present receivers was the maturing notes of the company indicated in the caption, aggregating $2,000,000 00, the said company being controlled by International Lumber Company, a subsidiary of the Minnesota and Ontario Paper Company That said company had an outstanding capitalization comprising 30,000 shares of preferred stock par value $100 00 per share, and 30,000 shares no par value common shares, with outstanding $2,000,000 00 of 5 year gold notes being substantially its entire obligation; that for the purpose of meeting the situation thus indicated, the receivers, acting upon the recommendation of Halsey Stuart & Company, investment bankers of Chicago, evolved the plan that the capital of the company should be modified so the only outstanding stock should be 60,000 shares of no par value common, of which last named total, one-third should be donated to the noteholders (deposited with option to repurchase for $1,000,000 00) assenting to the plan of accepting secured bonds of the company in lieu of notes and extending maturity of their outstanding obligation, that to carry out so much of the plan as entailed the reduction of the outstanding capital stock, the International Lumber Company was required to purchase the outstanding minority stock interests comprising approximately 10 per cent of the total, and purchased such minority interests for an aggregate amount of approximately $305,000 00, that the investment bankers, Halsey Stuart & Company, above mentioned, received a commission for carrying through this improvident, ill-advised and wholly unnecessary adjustment, in the amount of $100,000 00, that there was voluntarily and unnecessarily dissipated and given away by the receivers in this transaction, the following sums:

Purchase of minority stock (approximately)	$305,000 00
Purchasing of notes from holders refusing to accept the plan	120,000 00
Commissions paid investment banker Halsey Stuart & Co	100,000 00
Gratuitous surrender of one-third of the capital stock	1,000,000 00

That before its consumption, the above plan was submitted to affiant and disapproved by him, and affiant proposed as a more practical solution that the receivers seek a voluntary extension of the notes, failing in which, the affairs of the company should be placed in the hands of a receiver pending the return to normal commercial conditions, that during the operations by such receivers of the affairs of the company indicated in the caption, owing to incompetent management and administration, an operating loss was incurred, which together with ill-advised and unnecessary cut in inventory made arbitrarily and without reason, amounted in the aggregate to about $675,000 00

That affiant verily believes there was no occasion or necessity for paying out one dollar in cash on account of the matters indicated in this subdivision and that the property of the company in the amount indicated could and should have been preserved intact for the benefit of the receivership estate and the parties interested therein.

(B) UNNECESSARY CAPITAL AND OTHER EXPENDITURES

That shortly following the date the affairs and business of the Minnesota and Ontario Papr Company was taken over by the present receivers, receiver Robinson, for no good reason, conceived the propriety of remodeling the International Falls Paper Mills to provide for the manufacture of a superior grade of Kraft paper, as well as miscellaneous other papers; that in the then demoralized condition of the paper market, there was no plausible reason or excuse for the receivers incurring any such expense in connection with the

administration, but, notwithstanding, the following capital expenditures were made.

Remodeling expense (approximately)	$200,000.00
Minnesota, Dakota & Western Railway Company, Bridges and Branch Lines expenditure	75,000.00
Paid for Refuse Burner at saw mill and sundries at other mills	75,000 00
Total	350,000.00

That all of the expense above indicated was ill-advised, unnecessary and improvident; that the operation of the Kraft mills resulted in an operating loss during the receivership period of over $200,000 00; that the refuse burner was and is a destructive adjunct to a saw mill, resulting in the burning and destruction of commercial material which, in normal times, had an annual value of over $200,000 00, thus making the total loss from the improvident policy in this subdivision mentioned of approximately $750,000 00.

(C) DIVISION OF VOLUME OF BUSINESS WITH COMPETITIVE INDUSTRIES

That shortly following the date upon which active administration was assumed by the receiver Robinson, with affiant's disapproval, said receiver attended a meeting in New York and there agreed with competitive companies upon a plan on behalf of the Minnesota and Ontario Paper Company, under which all sales efforts would be withdrawn, in consideration of which there should be allotted to the Minnesota and Ontario Paper Company 1,000 tons a month or a maximum of 12,000 tons a year; that the said Robinson took upon himself in this matter the handling of a situation wholly beyond his knowledge, experience or capacity, in dealing with some of the shrewdest and most plausible managers of the newsprint industry in the United States and Canada, with the result that he was prevailed upon to make the disastrous concession above indicated; that as a matter of fact at that time the said agreement was a conspiracy in restraint of trade and contrary to the statutes of the United States, and undoubtedly the court supervising the administration of this receivership estate was kept in ignorance of the said agreement, that as a result of the same, the Minnesota and Ontario Paper Company committed itself to a plan which resulted in a loss of approximately $1,250,000 00, during the present receivership, and which will result in further losses of substantially the same magnitude so long as this policy is continued.

(D) INTERNATIONAL LUMBER COMPANY (MINNESOTA AND ONTARIO SUBSIDIARY)

Lumber Department—That shortly following the date the business was taken over by the present receivers, a new sales policy was inaugurated in connection with the lumber branch of the business of accepting all offers for lumber regardless of price with the underlying objective of moving the lumber; that this policy resulted not only in making sales at prices substantially below the market but also in breaking the stock assortment, which is poor practice in that once the assortment is broken the buyer is in position to name his own price, and further entails the necessity of remanufacturing material parts of the stock, an extra cost in resorting, duplication of handling and repiling, thus in many instances doubling the cost, that from this ill-advised policy, there resulted a loss of approximately $720,000 00

Pulpwood Department—That under the management of the present receivers during slow down operations in the paper mills, the stock of pulpwood accumulated in relatively large proportions, and the oldest of this wood was gradually depreciating, that notwithstanding, with efficient management, it was possible to mix the older wood with that which was newer and produce a grade of paper satisfying the requirements of the market, receiver Robinson took apparent alarm at isolated complaints respecting the grade of paper produced by the mills and issued instructions that the old wood, comprising approximately 50,000 cords should be burned, which order was carried out with a loss to the receivership estate of approximately $350,000 00

Logging Department—That the instructions of receiver Robinson to the operating staff, forbidding reporting to or consulting with affiant on penalty of discharge for violation as above stated, were applied in the case of the company's logging superintendent, an operative of twenty-two years of experience, capacity and high ability in the operating field and resulted in the

discharge of such superintendent at about the middle of the logging operations of the years 1932–1933; that a camp bookkeeper was appointed by receiver Robinson as successor to the logging superintendent, with serious and costly consequences in various departments of the active operations, the same resulting from wasting of timber, removal of branch railway lines before the adjacent or tributary timber was cut, permitting timber permits to expire and other details. That the loss from the ill-advised experiments referred to in this subdivision is, as affiant is informed and believes, at least $489,000 00 during operations under present receivers. The losses total:

Lumber Department	$720,000 00
Pulpwood burned	350,000.00
Excess operating costs, 1932–1933–1934	489,000.00

(E) COMPROMISE SETTLEMENTS OF ACCOUNTS RECEIVABLE

That during the management of the present receivers, a general policy has been adopted of settling outstanding accounts receivable, regardless of consequences to the receivership estate; that upon information and belief, affiant states that the policy thus indicated has entailed a loss to the receivership estate to date in the amount of over $570,000 00; that a flagrant illustration of resorting to the policy thus indicated appears in the case of the account in the amount of $175,000 00 owing by International Paper Company, one of the largest competitive organizations of the Minnesota and Ontario Paper Company, and which obligation was settled for $50,000 00 or a loss in the sum of approximately $125,000 00, wholly, as affiant is informed and believes, without necessity or justification.

(F) MEMPHIS COMMERCIAL APPEAL

That the cash investment by the Minnesota and Ontario Paper Company in the Memphis Commercial Appeal Newspaper amounted to over $2,595,000.00; that the physical properties and going business of said newspaper was and is fairly and reasonably worth $5,000,000 00, the same being one of the biggest and best known newsapers of the Southerly United States, as well as one of the National Key papers; that the loss through such ill-advised sale by the present Receivers exceeds (loss on investment account, as set out and admitted in last Receivers' Report dated September 30, 1933) a loss of $1,718,570 96

(G) MINNESOTA FOREST PRODUCTS COMPANY

That the International Lumber Company (a subsidiary of the Minnesota and Ontario Paper Company), owns all of the stock in the Minnesota Forest Products Company; that the latter company has entered into a contract with the Northwest Paper Company (a competitive company), The Consolidated Water Power and Paper Company, and the United States Government for the sale of timber located in Cook County, Minnesota, at a price that will not realize more than one-fourth of the money invested therein, that Receivers Robinson and Jaffray have urged and recommended such sale without regard to value of said property, in which there was invested upwards of $1,500,000 00; that the contemplated sale to the United States Government will be at a price of approximately $172,405 00, comprising 34,481 acres, which acreage represents approximately 60 per cent of the holdings by above captioned company in Cook County, Minnesota, and on that basis of valuation the remaining 40 per cent of scattered properties cannot be sold at such price as to realize a gross return in excess of $400,000 00; that as a result thereof a vast loss will result in the sum of approximately $1,100,000 00, based on the actual worth of said properties; added losses due to failure to cut insect infested timber owned by said company on Isle Royale amount to $300,000 00; for a total loss to said company of $1,480,000 00, including settlement with Northwest Paper Company

(H) GREAT LAKES PAPER COMPANY, LTD

That Receivers Robinson and Jaffray involved the Minnesota and Ontario Paper Company in a contract with the company named in the caption, and through wrongful diversion of newsprint sales and commissions allowed there resulted a loss, as affiant is informed and believes, of approximately $595,000 00.

(I) PREMIUM ON CANADIAN FUNDS

That shortly following the date on which the present receivers assumed management of the receivership, Canadian exchange declined very materially; that a relatively large portion of the operating expense of the receivership was then, and still is, in Canada, and at the time when Canadian exchange was at a discount of 24½ per cent, affiant urged the present receivers to transfer $1,000,000.00 of the balance then carried by the receivers in banks of the United States, to Canada; that Canadian exchange rose rapidly and within approximately two weeks from such date was at a discount of only 10 per cent; that the advice and recommendation of affiant was disregarded, and the present receivers sacrificed a profit of over $200,000 00, which could have been made for the benefit of the estate.

That under the administration of the present receivers economies have been totally disregarded; that in the year 1931 a readjustment of the various operating departments was carried into effect, which effected a saving in operating expense of $480,000 00 per annum; that the policy was reversed by the present receivers with the result that the personnel of the organization was unduly increased to the point where the operating force was far in excess of actual needs; that the said policy of extravagance has characterized the administration of the present receivers as a whole; and, that the same will be disclosed from a fair and impartial audit, and examination of the books of the receivers, conducted under the direction of the court by experienced auditors, other than those employed by the present receivers

(Signed) EDWARD W. BACKUS.

Subscribed and sworn to before me this 5th day of January, 1934.

HARRIET M. RENSHAW,
Notary Public, Hennepin County, Minn.

My Commission Expires March 31, 1936.
[NOTARIAL SEAL]

AFFIDAVIT OF LOUIS HARMON, FORMER SUPERINTENDENT OF TIMBER AND LOGGING OPERATIONS OF MINNESOTA AND ONTARIO PAPER COMPANY

STATE OF MINNESOTA,
County of Ramsey.

Louis Harmon, being first duly sworn on oath, deposes and says

That he is a resident of the State of Minnesota and that he is now engaged as superintendent and in the employ of the United States Government, having under his direction and supervision two Civilian Conservation Corps camps and two N R A concentration camps, that affiant has been engaged in the general timber and logging business for the past thirty-six years, chiefly in the State of Minnesota, that his experience in such logging and timber business has consisted of cruising, river driving, laying out of logging camps and logging railroads, and general supervision of logging operations, that at the age of nineteen affiant became a logging foreman, supervising the erection of camps and in general managing all logging operations, that affiant has at various times in Minnesota served as superintendent in charge of general logging operations, having under his direction, control, and management from four to twenty logging camps, with a force and crew of men ranging from five hundred to two thousand, that during his thirty-six years of experience in the general logging and timber business affiant has worked for the following firms: I Stevenson Company for a period of sixteen years, seven of which years he served as general superintendent of all logging and timber operations, as camp foreman for the H C Akley Company, and as district manager and as general timber superintendent for the International Lumber Company for a period of eleven years, commencing with the year 1922 and ending in the early part of January, 1933, that affiant continued to serve as general manager and supervisor of logging and timber operations of the said International Lumber Company from the time the Minnesota and Ontario Paper Company went into receivership up until September, 193.., and that from September, 1932, until the forepart of January, 1933, affiant served as district superintendent under the receivership of the said Minnesota and Ontario Paper Company

That from September, 1932, to the forepart of January, 1933, while serving as such district manager under the receivership of the Minnesota and Ontario Paper Company, affiant opened up six camps into complete and full operation and had under his supervision and direction during such period approximately nine hundred men, that during such period and under the direction of said receivers he constructed and repaired skeleton logging railroads to serve each of the said six camps, said roads being constructed in the timber lands adjacent to said camps; under affiant's said supervision and direction operations were placed into full swing at all camps, affiant caused all landings and necessary skidways to be prepared at various points along the spurs and the main railroad tracks, that such work and operations continued under affiant's supervision and direction until on or about November 1, 1932, that said logging operations were carried forth under orders of the receivers of the said Minnesota and Ontario Paper Company, and which orders called for the cutting and landing of approximately 60,000 cords of pulpwood and 10,000,000 feet of saw log timber, that all camps coming under affiant's supervision and direction were fully equipped to cut, land, and load on to cars the amount of pulpwood and saw log timber above specified, at a minimum of cost such equipment of material, men, and horses being adequate to handle said complete operations on all timber on lands adjacent to the various camps, as well as such additional timbers as might be purchased from other owners in the adjacent surrounding territories of each camp

That on or about the first of November, 1933, and after the major portion of the pulpwood and the saw log timber had been cut and swamped out, affiant received orders to cease operations and to disband all six camps Upon receiving such orders, affiant protested that a disbandonment of operations at that juncture would incur to the company serious and irreparable loss and that said timber and pulpwood should immediately be moved to the tracks for loading on cars in order to avoid the heavy snows and the necessary additional cost to be encountered under more adverse weather conditions; that, notwithstanding said protest affiant was ordered to cease operations and disband all six of the said logging camps, and was informed that such order was necessary for the reason that the receivers of the said Minnesota and Ontario Paper Company were without requisite funds to complete said logging operations

That in the forepart of January, 1933, and after said fallen timber had been heavily covered with snow, the receivers of the said Minnesota and Ontario Paper Company ordered the resumption of the logging operations of five of the said six camps

That affiant was in charge of said operations at the time that said order was issued and personally supervised the reorganization of said five camps; that the resumption of logging and timber operations, after a suspension of two months, caused serious and irreparable loss to said receivership by reason of the extraordinary time required to perfect such reorganization and by reason of the further fact that the removal of said fallen timber was made a far greater expensive operation than had such timber been removed in November and December and prior to the reorganization of said camps

That, at intervals during the first eight months of the year 1932, affiant had been warned by his superiors and other employees of the Minnesota and Ontario Paper Company not to communicate with E W Backus, the President of the said Minnesota and Ontario Paper Company, on any matters pertaining to the operations under his supervision, that affiant, notwithstanding said warnings, did on different occasions properly advise with the said E. W. Backus pertaining to the method and scope of said logging and timber operations, that affiant is informed and believes that when he was removed as general superintendent and made district manager in September, 1932, such change was made by the receivers of the Minnesota and Ontario Paper Company because of consultations had by him with Mr Backus

That affiant was discharged from his duties as such district manager on or about the 10th day of January, 1933, by said receivers because of information affiant had given concerning said logging and timber operations to the said E W Backus;

That a former auditor of said camps was thereafter placed in complete charge and supervision of all said logging and timber operations, that said bookkeeper was a man wholly without training and experience in the general logging and timber business, had never had a single day's experience as a cruiser and wholly without experience of any kind whatsoever relating to logging and timber operations other than as camp accountant

That said receivers in the winter of 1933 took out part of the timber and pulpwood which had been cut leaving a large part of said fallen timber remaining where it had been cut and also leaving large quantities of standing timber, all of which was adjacent to the railroad spur tracks, which the receivers caused to be removed; that the removal of said spur tracks before the cutting of the balance of said virgin timber and the removal of the balance of said fallen timber constituted a great waste and loss to the receivership estate; that the policy of the International Lumber Company had always previously been to contract for the purchase of privately owned stumpage on all lands adjacent to the spur tracks; that said receivership failed and neglected to contract for the purchase of said timber so privately owned thus cutting off to the said receivership a source of revenue which had always been realized by said International Lumber Company in its normal operations

That the said International Lumber Company held permit to cut timber on the West half of Section 25, Township 149, Range 28, Koochiching County, which permit expired on Sept 30, 1932 Affiant as superintendent of logging operations advised the receivership to arrange for the cutting of timber on the said West half of Section 25 before said permit expired; the said receivership wholly neglected to cut said timber before the expiration of said permit, all to the detriment and loss of said receivership

That by reason of said mismanagement and by reason of the loss sustained by said receivership on account of the disbandment of said camps and their subsequent reorganization, by reason of the loss occasioned in the salvaging of timber which had been covered by snow, rendering the removal thereof more difficult and expensive, by reason of the extra cost of logging down timber after the removal of the said spurs, by reason of the loss sustained by the receivership owing to the expiration of the permit to cut on said West half of Section 25, the total loss to said receivership occasioned by the removal of railroad spurs, which made the removal of remaining down timber and remaining stumpage prohibitive from the cost standpoint, the failure to buy stumpage on adjoining privately owned timber lands, the loss on Rainey Lake operations of pulpwood logs and boom sticks by reason of careless and negligent towing and storage, all of which has resulted in an aggregate loss to said receivership of a sum of approximately $270,000 00

That certain stumpage belonging to said International Lumber Company was burned over in the summer of 1933, which timber, if not salvaged during the operating season of 1933–34, will result, in affiant's opinion, in a loss of approximately $9,000 00.

That during the summer of 1933 the receivership has caused to be erected four new logging camps in the vicinity of Lake Kabetogema; that said receivers are also operating at full force six additional camps, three of which are the identical camps formerly under the supervision of this affiant; that affiant has investigated the operations of these ten camps and made as careful an estimate as he is able to make in the absence of access to the books and records of said Company, and states that the cost of operating all of said ten camps will be $210,000 00 for the season of 1933–34 in excess of the cost of such operations under practical, efficient management, that the total loss to this receivership by reason of the foregoing is and will be at the end of the operating season of 1933-34 the sum of approximately $489,000 00, practically all of which could have been saved to said receivership had said properties been managed in accordance with the best recognized principles of logging and timber cutting.

That in addition to the foregoing unwarranted expenditures and unnecessary losses to the receivership, the receivers ordered the destruction by burning of headquarters camp, known as camp number 29, consisting of a full and complete set of buildings sufficient and adequate to house a crew of one hundred and seventy-five men and stables for twenty-two pair of horses, all of which estimated loss, in affiant's opinion, was approximately $3,000 00, in rebuilding of same.

In addition to the foregoing the receivers ordered the destruction and rebuilding of a railroad bridge crossing the upper Big Fork River, which bridge was under the constant supervision and inspection of this affiant and which bridge was adequate for all purposes for a period of at least ten years to come The cost of reconstructing said bridge made necessary the abandonment of one mile of trackage and the laying of new tracks approaching the bridge at both sides of the river Said original bridge was inspected by this affiant, together with a competent safety engineer representing the Employers Liability and Insurance Company, the Company which provided the workmen's compensation coverage

for said railroad, and upon said inspection just prior to its destruction the said engineer declared said bridge to be safe for all uses to which it would be subjected.

That contrary to the advice of affiant, who had been in charge of the maintenance of what was known as the Deer River branch of the International Lumber Company's railway, the receivers ordered the ballasting and surfacing of thirty-two miles of said road-bed, all of which was entirely unnecessary and placed upon said receivership estate a wholly unwarranted expenditure That the total cost of said ballasting and surfacing, together with the destruction of the old bridge and the erection of a new bridge and the abandonment of a mile of railroad line, in the aggregate caused a wholly unnecessary expense to the receivership of between $30,000 00 and $50,000 00, the actual cost of which can only be determined by reference to the books and records in the possession of the receivers

Affiant verily believes that an examination of the books and records of said receivership would verify the estimates set forth in this affidavit

That affiant's statements above are based upon his actual personal knowledge of the properties, including all standing timbers owned by said receivership and included in the operations above described.

Subscribed and sworn to before me this 18th day of December, 1933

LOUIS HARMON.

ADELINE G. STIEF,
Notary Public, Ramsey County, Minnesota
My commission expires June 6, 1938
(NOTARIAL SEAL)

AFFIDAVIT OF MARK HESSEY, HEAD TIMBER CRUISER FOR MINNESOTA AND ONTARIO PAPER COMPANY

STATE OF MINNESOTA,
County of Ramsey, ss:

MARK HESSEY, being first duly sworn on oath, deposes and says:

That he is a resident of the State of Wisconsin and now engaged in the business of timber cruising and supervising large farm operations; that he has been engaged for over forty years in cruising timber, and supervising logging, river driving, and managing other operations incidental to cutting and transportation of logs and timber, that for a period of twenty-two years he was so engaged and in the employ of Minnesota and Ontario Paper Company and its subsidiaries including the International Lumber Company, and served as head cruiser in charge of all timber estimating, outside trespassing, checking and as adviser in connection with all their logging operations, that part of his duties consisted of the supervision of locating railroad right of ways, surveying for the same, building logging camps, and in furnishing cost estimates to the managing officers of said herein referred to companies relative to the cost of buying and removing and delivering timber

Affiant further deposes and says that he was for many years engaged in various phases of timber operations for himself, and was the owner of large timber holdings; that he was employed and served with similar responsibility and duties hereinbefore mentioned for various other large timber and logging companies of the United States; that he was employed and acted in such capacity for Jacob Mortinson of Chicago, Illinois for a period of seven or eight years, and was for a period of time employed by the Alexander and Edgar Lumber Company; that in connection with his duties for said employers he made personal surveys and appraisals of vast timber properties, and furnished said employers with valuations of timber, some of which timber estimates involved approximately 500,000,000 feet of timber in the State of Florida, 275,000,000 feet in the State of North Carolina, 400,000,000 feet in the State of Mississippi, 800,000,000 feet in the State of California, 200,000,000 feet in the States of Washington and Idaho, and approximately 275,000,000 feet in Minnesota, prior to his employment with Minnesota and Ontario Paper Company, that said Jacob Mortinson relied implicitly on judgment of this affiant and purchases of timber properties by said Mortinson were made only after the final approval of this affiant.

Affiant further states that he has personally inspected and cruised certain timber properties located in Cook County, State of Minnesota, owned by the

Minnesota Forest Products Company, a subsidiary of the Minnesota and Ontario Paper Company; that during the months of October, November, and December, 1932 and January, 1933, he cruised said timber properties, and furnished estimates in connection with a contract between said Minnesota Forest Products Company and the Northwest Paper Company of Cloquet, Minnesota, and that he had prior to said recent cruising of said timber examined said timber properties during the year 1929, with a view to determining the best plan for logging said timber properties, that as a result thereof, he is entirely familiar and acquainted with said timber properties, with the topography of the lands therein controlled and the facilities for logging operations on said timber lands, that in affiant's opinion the timber is in large part easily accessible and removable at reasonable costs and that the timber located thereon is in the main part sound and sturdy stock, and in normal times well worth the price paid therefore; that in affiant's opinion the pulpwood located thereon is very valuable, inasmuch as it is easily accessible for transportation by water on Lake Superior, and can be transported at unusually low cost in that manner, as is the experience of other timber operators who regularly ship similar pulpwood to Wisconsin points on the Great Lakes and other Eastern markets; that affiant verily believes the timber situate on said Cook County Lands are comparable in quality and value with other holdings of subsidiaries of Minnesota and Ontario Paper Company, practically all of which he appraised during his long period of employment;

Affiant further deposes and says that said Minnesota Forest Products Company is the owner of valuable timber located on Isle Royale, State of Michigan, that in his opinion the timber thereon is most easily accessible and can be logged and delivered at below average cost, that on about January, 1932, affiant conferred with R H M Robinson, one of the receivers for said Minnesota and Ontario Paper Company and advised him that it would be for the best interests of the estate to log certain portions of said timber properties, in that serious insect infection was present in parts of said timber, and that unless said such timber was removed, heavy losses would result; that he estimated at least 50,000 cords of timber per year should be removed and that since said advice and counsel was given, there has been sustained an estimated loss of approximately $350,000 00 through the failure to act on his advice Affiant verily believes that the estimate stated forth in this affidavit are conservative, that they are based on his personal experience in said work extending over a period of more than forty years

Subscribed and sworn to before me this 23rd day of December, 1933

MARK HESSEY

Notary Public, Ramsey County, Minnesota
ADELINE G STIEF,
My commission expires June 6, 1938
(NOTARIAL SEAL)

AFFIDAVIT OF EVERETT WYNNE, TIMBER CRUISER AND CAMP FOREMAN FOR MINNESOTA AND ONTARIO PAPER COMPANY

STATE OF MINNESOTA,
COUNTY OF RAMSEY—ss

EVERETT WYNNE, being first duly sworn, on oath, deposes and says: that he is a resident of the State of Minnesota, that he now is and has been engaged in work related to timber logging and Forest Products operations, for the past twenty-four years as a camp worker, compass man, timber cruiser and camp foreman, that for approximately three years he was employed by The Crookston Lumber Company as a timber cruiser, that for approximately seven years he was in the employment of the International Lumber Company, a subsidiary of the Minnesota and Ontario Paper Company; that from and after September, 1932, affiant was in charge of operations at camp number 144; that his duties were to supervise the cutting of the right of ways and laying of the tracks; the building of necessary bridges and of all other preparatory work necessary to the harvesting of the timber adjacent to said camp That on or about November 5th, affiant received instructions to close down said camp and was notified that there would be no further operations conducted therefrom That as a result of such orders being issued by R H M Robinson and C T Jaffray, Receivers for the Minnesota and Ontario Paper Company there resulted a tremendous loss in preparation costs including the cost of labor, supplies, and

material incidental to such preparations, all of which investment was almost wholly wasted, including therein the cost of transportation of men and horses to and from said base of operations and the wages, food and care for men and horses, during the period of non-operations. During this preparatory period a large amount of timber was cut and left lying on the ground, and on account of the heavy snow falls before operations were resumed, approximately one-third of all the timber cut prior to the abandonment of these operations was wholly lost Additional amounts of timber were lost by reason of culling the same by the receivers after the same had been cut and paid for That was not only the true situation at camp number 144, but the same was true concerning operations and the timber properties adjacent to the five other camps, in addition to the one he was in charge of, and that based on his knowledge of the operations of all these six camps and of the properties operated therefrom there have been huge and wholly unnecessary losses, through ill-advised and inexperienced management and operation policies, and through utter carelessness in conserving and utilizing the timber, the camp management, the railway spur track, the temporary skidways and landings, that the cash expended for transporting and caring of horses during the period; the cash expended in transporting men to and from camps and through the careless disregard of the value of such investment in the above preparatory work resulted in a loss to the company and its creditors in excess of One Hundred Eighty Thousand Dollars ($180,000 00)

Affiant states as one illustration of such losses that a large investment was made in vegetable supplies for camp 45 which was closed down and in which operations were not resumed Said vegetable supplies necessary for boarding a large crew of men in said camp were stored in a root cellar provided for that purpose, at a cost of approximately $590 00 and that when said camp was closed down on or about November 5th, said supplies were not removed and were not cared for with the result that the entire supply was allowed to rot and was a complete loss; that as another illustration, affiant pursuant to instructions, was ordered to burn the buildings at camp number 29 and replaced with new buildings; that said old buildings were in excellent condition and most suitable for the necessary purposes and that ill-advised orders of burning said camp buildings cost a loss of at least Three Thousand Dollars ($3,000 00)

(Signed) EVERETT WYNNE

Subscribed and sworn to before me this 23rd day of December, 1933
ADELINE G STIEF
Notary Public, Ramsey County, Minnesota

My Commission Expires June 6, 1938
(NOTARIAL SEAL)

II ANSWER OF MR BACKUS TO $7,000,000 00 FRAUD SUIT BROUGHT AGAINST HIM AND OTHERS BY RECEIVERS ROBINSON AND JAFFRAY

The answer of Mr E W Backus and the other defendants named in the suit brought by the receivers charging unlawful abstraction of funds from the Minnesota and Ontario Paper Company, is hereinafter set forth The first 38 paragraphs thereof are devoted to technical pleadings Hereinafter is set forth verbatim the defense which will reveal that this action is wholly without merit, and brought solely with the malicious intention of discrediting Mr Backus with bondholders of the Minnesota and Ontario Paper Company, designated in the answer as "M & O"

Thirty-ninth: Further answering, defendants allege that M & O and its various subsidiaries in the Bill of Complaint and hereinafter in this answer referred to, were created and organized as a part or incident in the carrying out of a single comprehensive plan embracing widely diversified and important industries of both national and international character. That such industries were conceived, organized and developed by defendant, E W Backus, and all thereof financially supported and carried to consummation by the defendants Backus Brooks and E. W Backus That the single comprehensive plan in contemplation antedated the formal organization of M & O was continued subsequently to its organization and its general purposes and policies consistently observed and followed at all times during the history of the operations of M & O with the consent and approval of all parties in interest and without variation from the definitely determined purposes above stated That

throughout practically the entire operations and history of M & O. it was dependent upon the resources and credit of the defendants Backus Brooks and E W. Backus, which last were made available at all times during the expansion of its properties and the development of its constantly increasing field of enterprise. That during the period last stated there was no time during the history of the operations of M. & O that it was not legally indebted to the defendants, Backus Brooks or E W. Backus in relatively large sums of money and that it continued to be so indebted at the date of the receivership in this cause That the objective purpose in the organization and creation of M. & O was the policy of consolidating and merging the enterprises of Backus Brooks, hereinafter more fully referred to, in M & O as an operating subsidiary of Backus Brooks and that each and every step had and taken subsequently to the organization of M & O was directed to the consummation and carrying out of this single and at all times, well defined and understood purposes That in the gradual development of the properties finally brought into M & O and which constituted substantially its entire resources at the date of the receivership herein, the properties themselves were acquired by the defendants E W Backus and Backus Brooks and carried by them during their development period, for the benefit of M. & O upon the understanding and agreement that when developed and operating, they should be taken over and acquired by M & O on a stipulated appraised basis. That many of such properties acquired by defendants, E W. Backus and Backus Brooks were acquired with the latter's resources and turned over to M. & O upon consideration of the latter's issuance to the transferor or its or his appointee or appointees, of its capital stock That in many instances, properties so acquired and developed in the interest and for the benefit of M & O. were financed by Backus Brooks and E W Backus and the obligations resulting from such acquisition and development on the part of M & O. carried and extended for the latter's benefit over relatively long periods of time

That throughout the history of its operations, M & O was the gratuitous recipient of facilities, benefits and advantages derived from its affiliation with Backus Brooks and enterprises controlled or owned by the latter, all of which contributed in varying degrees, to the ultimately successful operations of M & O previously to the advent of what is ordinarily and popularly termed, the world depression, with the latter's disastrous consequences in all industrial lines, especially the newsprint industry and building trades, in which M & O was engaged That all moneys paid by M & O. to any of the several defendants herein, were paid to Backus Brooks or Kenora in the carrying out of the general purpose and policy in this subdivision mentioned and all thereof was paid for or on account of indebtedness and obligations, which had previously been legally assumed and at the date of such respective payments, were legally due and owing by M & O to the last named defendants That the methods observed and followed in carrying out the single objective plan and purpose in this subdivision referred to and responsive to which, the ultimate obligations of M & O were assumed and any and all payments made by M & O, in fact paid, will appear from the matters hereinafter stated, as follows, viz·

(a) The defendant Backus Brooks resulted from the acquisition by the defendant E W Backus of the interest of both partners in the early part of the year 1884, of the firm of Lee & McColloch, then engaged in the lumber business The initial capital investment in which firm was $6,000. The firm name was thereupon changed to E W. Backus & Co In 1892, without the investment of added capital, the capital structure of the last named company had increased to approximately $600,000 The firm last indicated was succeeded in 1894 by E W Backus Lumber Co, a Minnesota corporation, which took over the assets of the former partnership In the year last mentioned, the defendant Backus, organized an affiliated syndicate and incorporated the Minnesota Logging Co, which corporation acquired large interests in standing pine timber in northern Minnesota comprising approximately 2,000,000,000 feet and purchased and reorganized the Brainerd and Northern Minnesota Ry Co (now the Minnesota and International Ry Co), which, during the same year, built approximately sixty miles of main line standard railroad, tapping the timber area The interest of E W Backus Lumber Co, in the projects last mentioned was approximately one-third During the same period (1893 to 1896), through the efforts of the said Backus Co, and its affiliates, the above mentioned railway was extended from Brainerd to Bemidji, Minnesota In 1899, William F Brooks became a member of said Backus Co,

under a working interest agreement and shortly thereafter, the corporate name of the company was changed to Backus Brooks Co In the same year and early in the year 1900, the corporation acquired a controlling interest in the Koochiching Company (now Koochiching Realty Company), making it approximately an 80 per cent owned subsidiary of Backus Brooks Such Koochiching Company, at the date of its acquisition, owned water power sites and adjoining lands at International Falls, Minnesota, on the international boundary At about the same time, the defendant, E W Backus, opened negotiations with the government of the Province of Ontario, Canada, to secure the water power site and adjoining lands controlling on the Canadian side of the international boundary, which were essential in the development from shore to shore, with the object of developing the water power from shore to shore and ultimately to establishing pulp and paper mills on both sides of the boundary, as well as saw mills and other wood-working industries to utilize the vast tributary timber resources At about the same time, in furtherance of the same objective, the corporation acquired large industrial acreage, including Townsite, Railway terminals, Storage space for logs and lumber on the Minnesota side of the boundary and acreage sufficient for mill sites on the Canadian side In 1902, the defendant Backus, organized the defendant Backus Brooks Company under the laws of Maine

This corporation succeeded the Minnesota corporation and acquired all of the latter's properties and rights The financial structure of the Minnesota corporation had then grown to approximately $3,000,000, with practically no outstanding obligations In 1903, the defendant, Backus Brooks Company, in conjunction with affiliated interests, organized the Rainy River Lumber Co, Ltd, a Canadian corporation and the Namakan Lumber Company, a Minnesota corporation The former of the two last mentioned organizations plays no particular part in the subsequent operations and development, in this answer referred to The latter (the Namakan Company), however, acquired large timber holdings in Minnesota, which entered into the later operations During the period last referred to, as well as in later years, the Backus Brooks Company of Minnesota, and its successor, acquired large timber holdings in northern Minnesota, in contemplation of future developments at International Falls and Fort Francis In 1905, the defendant Backus Brooks Company, organized the International Lumber Company, a wholly owned subsidiary of the defendant Backus Brooks Company, with a capital of $600,000, fully paid in, afterwards increased to $4,000,000 In the same year, the company organized the First National Bank of International Falls and the International Telephone Company In that same year, Defendant Backus having previously acquired the water power property on the Canadian side, organized the Rainy River Improvement Company, a Minnesota corporation, originally capitalized for $100,000, and Ontario and Minnesota Power Company, Ltd., a Canadian corporation, with authorized capital of $3,000,000 of common stock and $5,000,000 first mortgage bonds, the latter afterwards reduced to $3,500,000 The capital stock in the above organization was fully paid and wholly owned by Backus Brooks Company. Immediately following the matters last stated, and during the years 1905–1907 construction work on the development of the water power at Fort Francis and water power and mills at International Falls, was carried on by defendant Backus Brooks and its subsidiaries

(b) In 1906, the Keewatin Lumber Co, Ltd., was organized by the defendant Backus-Brooks Company, under the laws of the Province of Ontario, with a capital stock (authorized) of $500,000 00, of which $250,000 00 was paid in. This was a wholly owned Backus-Brooks subsidiary Its manufacturing plant was completed and put into operation during the same year This company was intended to handle the logs acquired from the Mather Syndicate timber limits and the interest of Backus-Brooks in the logs of Namakan Lumber Company Supplementary development in the affairs of the Canadian Company last indicated included a tie mill and a box factory at Keewatin and a box factory at St Boniface Contemporaneously with the acquisition of the Mather Syndicate timber limits, an option was secured on the Norman dam at the outlet of the Lake of the Woods in the Winnipeg River by the defendant, Backus-Brooks Company. In the same year (1906), the Big Fork and International Falls Ry Company was organized by Backus-Brooks Company and construction work was started immediately and completed in the fall of 1907, the property having been sold in the meantime to the Northern Pacific Railway Company This was made necessary by change in the proprietorship in the Minnesota and International Ry Co., which had declined to extend the latter

line from the Big Fork River to International Falls The last named development was imperative to provide transportation facilities for the completed plant at International Falls. In 1907, the pending construction work at International Falls and Fort Francis ceased temporarily by reason of the failure of the contractors in charge of the work. A still further delay was entailed by reason of the vote by President Roosevelt of a bill passed by the Congress of the United States authorizing the work The bill last indicated was passed over the veto of the President and the development work resumed in 1908.

(c) In 1908, following the matters last above indicated, the preliminary steps were taken for financing the development projects at International Falls and Fort Francis Negotiations were opened by the defendant Backus with the firm of Peabody, Houghteling & Company, Investment Bankers, of Chicago, Illinois, to underwrite the financing of the joint water power development at the points last indicated and the pulp and paper mills planned to be constructed at International Falls and to become the fiscal agents of the defendant Backus-Brooks Company and its subsidiaries At the time of these negotiations, development of the pulp and paper industry on the Canadian side of the border was impracticable for the reason Canadian newsprint was subject to an import duty in the United States of $6 00 per ton Pending the negotiations above mentioned, one of the partners of Peabody, Houghteling & Company personally inspected the properties involved, examining the water powers at International Falls and Fort Francis as well as making an extensive investigation of the tributary pulpwood resources covering a large area on both sides of the boundary During the period last stated, defendant Backus laid before the aforesaid representative of Peabody, Houghteling & Company, the broad development plan he had in contemplation, embracing the entire area contiguous to International Falls, Kenora, Port Arthur-Fort William and Fort Francis, including the development of the water powers, the construction of pulp and paper mills, saw mills, planning mills, box factories and other wood-working industries to utilize the vast timber resources tributary to the region mentioned The subject of the ownership by the defendant Backus-Brooks Company and its operations of Keewatin Lumber Company, the outstanding option on the Norman Power dam and the projected construction and development of the pulp and paper industry on the Canadian side of the border, whenever the customs duty into the United States would permit, were fully discussed as were the initial steps which had been taken to the last stated end, including the extended negotiations said Backus had had with the Province of Ontario, for an extensive pulp, wood and timber concession at the head of the lakes in the territory tributary to the point of contemplate manufacture The plan proposed by said Backus to the representative of the said Peabody, Houghteling & Company during such negotiations, was to first continue the development of the International Falls property, then under construction, this work to be started immediately

This to be followed by the development at Fort Francis, conditioned, as aforesaid, on the adjustment of the import duties into the United States and finally, the development at Kenora and Great Lakes at Port Arthur-Fort William, the last conditioned on the defendant Backus securing the government concession already referred to Protracted negotiations between the defendant Backus and Peabody, Houghteling & Company followed with the result that as a condition to the initial financing, the said banker required of said Backus, a stipulation and agreement on the part of himself as well as on the part of the defendant Backus-Brooks Company, that they would neither develop or operate independent properties in the area of such contemplated development which would compete with the parent operating company either with respect to raw materials or the sale of manufactured products in the same market The further condition was attached by said bankers that a parent operating company should be organized in the inception of the undertaking and before the initial financing thereof, which should take over the water power and adjoining lands on both the Minnesota and Canadian sides of the border and that upon the completion of the water powers and the completion of the paper mills at International Falls and placing the same in operation, such parent operating company should acquire and take over the International Lumber Company together with all the timber holdings of the defendant Backus-Brooks Company in northern Minnesota The further condition and stipulation was attached by the bankers that when and as the several properties then contemplated to be acquired and developed by Backus-Brook, were acquired and developed, the initial plan should be expanded in such wise that all such several properties would be brought in to the parent organization on the basis of their respective

appraised value. The conditions thus stated were acceded to by the defendants Backus and Backus-Brooks Company. As a final condition to the initial financing, above referred to, the investment bankers required that the entire proposed bond issue of $5,000,000 00 should carry the guaranty of the defendant Backus-Brooks Company on the bonds themselves and that defendant Backus should execute to the fiscal agent, to be held by them for the benefit of whom it might concern, his independent personal guaranty of the entire issue The guaranties last mentioned were given in closing the final steps for the contemplated financing. The agreements and stipulations with the bankers in this subdivision alleged, were at all times known to all parties in interest and from the date of the initial financing and the preliminary steps for consolidation, as hereinafter alleged, were followed and observed during the entire history of the operations of the M. & O. and its subsidiaries

(d) The negotiations last mentioned led to the organization, on or about the 8th day of October, 1908, of the Minnesota and Ontario Power Company (now Minnesota and Ontario Paper Company, termed in the Bill of Complaint herein as M & O). From the date of the organization of this corporation, two of the partners of the aforesaid Peabody, Houghteling & Company were continuously members of its board of directors for approximately nine years when they resigned by reason of having secured control of a competing paper manufacturing industry The capitalization of the corporation thus organized was $5,000,000 00 of common shares, $2,000,000 00 of participating 6% preferred shares and $5,000,000 00 of first mortgage and collateral 6% serial bonds Of this issue, the bankers underwrote $3,000,000 00 of the bonds and $1,000,000 00 of the preferred stock, the proceeds of such underwriting made immediately available for the development work then in progress, including the power dam from the American to the Canadian shore and the mill construction at International Falls, Minnesota In carrying out this transaction, defendant Backus-Brooks Company transferred to the newly organized corporation, the entire capital stock and bonds of the Ontario and Minnesota Power Company, Ltd, (characterized in the Bill of Complaint herein as O & M), the entire capital stock and bonds of the Rainy River Improvement Company, hereinabove referred to, and the mill sites acquired on both sides of the International boundary In consideration of the transfers thus indicated, the newly organized corporation issued to the defendant Backus-Brooks Company, the entire issue of its common stock ($5,000,000 00), and one-half ($1,000,000 00) of its issue of participating preferred stock, coupled with the agreement of the newly organized corporation to advance and pay $400,000 00 in cash, such sum to be appropriated to the recall and retirement of an equivalent amount of the outstanding Ontario and Minnesota Power Company bonds, which had previously been sold In the public offering by the bankers of the securities of the newly organized corporation, it was found that such sale would be facilitated by an offering of common stock as a bonus and the defendant Backus-Brooks Company thereupon donated approximately $500,000 00 of its common stock, which was received and used by the fiscal agents in consummating the sale by them of the securities Each and every step in the negotiations and transactions thus detailed, including the organization of the aforesaid Minnesota and Ontario Power Company as the operating subsidiary of the defendant Backus-Brooks Company, were had and carried out as a preliminary step and incident of the broader and more comprehensive plan above alleged, of consolidating and merging the various forest products and wood and paper manufacturing industries of the defendant Backus-Brooks Company as the same were successively acquired, developed and placed in operation by the defendant Backus-Brooks Company in such newly organized corporation Following the conclusion of the fiscal arrangements above alleged, the various developments of water power, pulp and paper mills and saw mills at International Falls and the water power development at International Falls and Fort Francis continued throughout the years of 1908 and 1909 and the manufacture of newsprint paper was commenced early in the year 1910

(e) In 1910, in accordance with the previous agreement with the bankers above alleged, the defendant Backus-Brooks Company sold to the newly organized operating subsidiary (M & O), the entire issue of capital stock of International Lumber Company, and later the increased capital stock of that company, and also, all of the standing timber owned by the defendant Backus-Brooks Company in northern Minnesota The obligation thus assumed for the purchase and transfer last indicated amounted, in the aggregate, to several million dollars and the same was carried by defendant Backus-Brooks Company over a series of years, not being finally liquidated until about the years 1925 and

1926. Shortly following the acquisition of International Lumber Company, as above alleged, and in furtherance of the pending program of development, defendant Backus organized the Minnesota, Dakota and Western Ry. Co, International Bridge & Terminal Co, Ltd, and Wattrose Island Boom Company. The development thus mentioned constituted part of the program for establishing communication between International Falls and Fort Francis It was taken over in part by the International Lumber Company and the newly organized operating subsidiary (M & O). The investment in this development aggregated approximately $1,750,000 00, and the same was financed through bank loans on the credit of the defendant Backus-Brooks Company and the personal guaranty of defendant Backus

(f) In 1911 the Fort Francis Pulp & Paper Company, Ltd, was organized. Shortly following the date of its organization, the erection of mills at Fort Francis was started and the same completed in 1914. Simultaneously, storage dams at the outlet of Namakan Lake were built and put into operation in 1914. The last mentioned corporation was wholly owned subsidiary of the aforesaid Ontario and Min in 1914 The last mentioned corporation was a wholly owned subsidiary of the aforesaid M & O The initial capitalization of the newly organized company was $50,000 00, which was later increased to $3,000,000 00. The development itself was financed on behalf of the two proprietary companies, through the credit of the defendant Backus-Brooks Company and the defendant Backus One loan of $1,000,000 00 was financed through the deposit of an equivalent amount of the M & O Preferred and Common stock loaned to that company by the defendant Backus-Brooks Company. The terms of the loan provided the holders of the note should reserve the privilege of option of converting the same into the stock deposited.

(g) In 1913, the defendant Backus purchased for the aforesaid International Lumber Company the assets of the Shevlin-Mathieu Lumber Company. The property thus acquired, included a saw mill plant and appurtenances, town site, etc., located at Spooner, Minnesota, on the lower Rainy River, also, all of that company's timber holdings in northern Minnesota; also, all of its lumber and logs. The purchase price involved in the transaction thus indicated was approximately $3,000,000 00. The purchase itself was made at the recommendation and with the approval of the fiscal agent above mentioned Of the initial payment required in this transaction, the defendant Backus-Brooks Company advanced approximately $650,000 00, which was carried by it for the M & O. over a series of years and was not finally liquidated until the new financing of M & O in the year 1925 Other advances made by the defendant Backus-Brooks Company and its subsidiaries incidental to carrying out and developing the various properties and rights of M & O aggregated several millions of dollars, carried by it for the benefit of M. & O in the same manner and which has never been paid

(h) In 1913, pending the developments last above alleged, the defendant Backus secured from the government of Ontario, Canada, the Lake of the Woods pulpwood concession, embracing some 1,800 square miles. The condition of this concession was an agreement on the part of the defendant Backus, to build a pulp and paper mill at or near Kenora. The carrying out of the latter project required the conclusion of the option agreement by defendant Backus-Brooks for the purchase from the John Mather Syndicate of the Norman dam controlling the water power at the outlet of the Lake of the Woods, hereinabove referred to. The conclusion of this option, involved the purchase of the entire capital stock of Keewatin Power Company, Ltd, comprising $750,000 00 of common shares and $250,000 00 of preferred shares for a consideration of approximately $600,000 00.

(i) In 1913, the properties of the Shevlin-Mathieu Lumber Company were acquired, as hereinabove alleged This transaction included a preference for the purchase of the timber byproducts of Crookston Lumber Co, a Shevlin organization having large timber holdings in northern Minnesota. The products covered by this preference were principally cedar and tamarack, including poles, railroad ties, pulpwood, etc Incidental to this transaction, the defendant Backus, in 1914, with two individual associates, organized the American Cedar Company. The Backus interest in the transaction was one-third and this interest held for the benefit of the aforesaid International Lumber Co The enterprise was financed through the credit of defendant Backus-Brooks Company and defendant Backus, individually, by whom the bank loans were guaranteed.

(j) In 1914, the defendant Backus caused the International Insulation Company to be organized with a capital stock of $50,000. The objective purpose

of this enterprise was the use of the by-products of wood pulp under a patented process The use, however, of the product grew to such proportions it was found necessary to manufacture the raw material direct from wood to secure the wood fiber. The invention to which reference is thus made, was the original development in the production of wood fiber insulation board. The company was organized as a subsidiary of M & O ; was afterwards renamed the Insulate Company and with its subsidiaries, has grown to an investment of over $5,000,000. In 1929, its net profits were approximately $1,000,000

(k) In 1917, preparatory to the large development in contemplation at Kenora, the defendant Backus Brooks Company purchased for the Keewatin Lumber Company, the properties of the Rat Portage Lumber Company and other independent operations in that district, to protect and insure the supply of raw material for the contemplated manufacturing plants. These transactions entailed an investment of approximately $100,000 In 1920, preparations for the actual development of the Kenora Properties were made in contemplation of starting actual operations early in 1921 Anticipating this large plan of development, the defendant Backus secured from the Ontario government, another valuable pulpwood and timber concession, embracing approximately 3,000 square miles At about the same time, the defendant Backus acquired from the Ontario government, a large undeveloped water power and also purchased from the City of Kenora, its municipal water power plant The development project thus undertaken, included completely hebuilding and modernizing the municipal power plant; increasing the discharge area of the Norman dam at the outlet of the Winnipeg River, the installation of water wheels, electrical generators and transmission lines of both the Kenora and Norman Plant, and the construction of pulp mills and paper mills with a capacity of 250 tons daily. These projects entailed the investment by the defendant Backus Brooks of many millions of dollars The active development work began early in 1921 and was continuously carried on thereafter until the entire project was completed in 1925.

(l) In connection with development projects previously to that last referred to, the defendant Backus had met with many obstacles owing to the failure of contracture, unsatisfactory work and excessive cost As an initial step in the last above mentioned development, he concluded to establish for defendant, Backus-Brooks Company, a complete engineering and construction department to plan, supervise and execute the projected work. The plan last stated was made effective in 1921, at which time, the Backus Brooks Company construction Department was organized under an efficient staff of specially employed engineers and construction managers and the best and most efficient machinery, tools, and other necessary apparatus provided In the inception of the plan thus mentioned, it was the intention of the defendant Backus-Brooks to enter into the business of general contracting but, in the interim expansion plans of M & O. and subsidiaries developed and in deference to the requirements of the projects of these companies and others in contemplation, remunerative contracts obtainable from the outside were refused and the operations of the newly created construction organization exclusively confined to those being carried on in connection with and as part of the comprehensive plan above alleged, in which the defendant Backus Brooks, through its subsidiaries, was primarily interested.

(m) During the progress of the widely spread and variously differentiated projects already alleged, having, as previously alleged, the single objective purpose in view, all of the various undertakings and the subsidiary organizations through which they were carried on, were at all times treated to all practical intents and purposes, as parts of a single enterpise, with the controlling management vested in the defendant Backus Brooks Company as the proprietary or parent organization

(n) Early in 1924, pursuant to the original understanding and agreement had in 1908, as heretofore alleged and under which it was provided that M & O. should become the parent operating organization of all the varied Backus Brooks forest products operating companies, located in the areas mentioned, as the respective developments thereof reached an operating stage, the subject of additional financing was taken up with new investment bankers with whom, as a result of extended preliminary negotiations, defendant Backus had arranged for the necessary financing preparatory to the consolidation or merger of the Kenora and Keewatin properties above described with the general undertakings and properties of M & O Notwithstanding all the development work that had been undertaken and carried on in the interest and for the

benefit of M & O that company had made only comparatively moderate advance to the defendant Backus Brooks Company, anticipatory to taking over the vast properties referred to All such advances were offset and more than offset by the large advances due to the defendant Backus Brooks Company and its subsidiaries by M. & O which have not been liquidated up to the present time.

(o) The details for the financing last referred to were confirmed as of November 30th, 1924, and carried out as next stated. In February and March, 1925, defendant Backus Brooks Company caused to be incorporated two Canadian holding companies, viz Kenora Development Company, Limited, with an authorized capital of 10,000 no par value shares and Kenora Paper Mills, Limited, with an authorized capital of 500,000 no par value shares and $8,500,000 first mortgage bonds, dated April 1st, 1925, and payable on demand Following the completion of the organizations last stated, the defendant Backus Brooks Company and defendant Backus transferred and conveyed to Kenora Development Company the entire capital stock of Keewatin Lumber Company, Limited, and Keewatin Power Company, Limited, the English River Pulp and Timber Limits, the pulp and paper mills constructed and in the process of construction and the undeveloped water power secured from the Province of Ontario in 1920. In exchange for the properties thus conveyed, defendant Backus Brooks Company received the entire capital stock of Kenora Development Company, Limited Following the conveyances and transfers last stated, the said Kenora Development Company transferred and conveyed to Kenora Paper Mills, Limited, the entire capital stock of Keewatin Lumber Company, Limited, and Keewatin Power Company, Limited The conveyance was coupled with an agreement by Kenora Development Company and the defendant Backus Brooks Company, for the completion of the power development at Norman dam and increasing the capacity of the newsprint mills of the companies whose stock had been thus transferred, reserving however, the construction plant and organization and the undeveloped water power previously referred to. The consideration for this conveyance was the entire authorized stock of Kenora Paper Mills, Limited, and the $8,500,000 of bonds of that company above mentioned Following the transaction last mentioned, Kenora Development Company, Limited, transferred to M & O the stock and bonds of Kenora Paper Mills, Limited, together with the agreement of Kenora Development Company and the defendant Backus Brooks Company, covering the completion of the development work as above stated In consideration for this transfer, M & O issued to Kenora Development Company, Limited, 17,500 shares of its regularly issued preferred stock, 43,920 shares of its regularly issued common stock and $8,500,000 in cash The issue of the common shares last mentioned was conditioned on the agreement such shares were to receive no dividends until the original 50,000 shares of common stock, issued by M & O had received 6 per cent dividend from date of issue to November 30, 1924

During the negotiations and in the procedure of consolidating these properties (on one side the properties of M & O and its subsidiaries and on the other, the properties of the Keewatin and Kenora companies, respectively, subsidiaries of defendant Backus Brooks Company), experts were designated to appraise the physical properties of both sides and to inventory and appraise the value of all other properties involved The appraisal was had accordingly. The minority stockholders of M. & O were permitted to designate and appoint a prominent and experienced paper mill owner as their representatives to confer with the defendant Backus and fix the basis of valuation on all of the various properties entering into the consolidation As a result, the valuation of such properties was mutually agreed upon and accepted as the basis of the consolidation In the same connection, it was agreed that as the defendant Backus Brooks could not deliver control of the capital stock of Great Lakes Paper Company, Limited, that the minority interest in that company should continue to be held by the defendant Backus Brooks Company and that if and when the defendant Backus Brooks Company could deliver control of the said Great Lakes Company and the latter's paper mill in operation, the same was to be turned over to M & O on the same basis of valuation as employed in the M. & O. consolidation then under consideration and the basis and valuation for which had been arrived at in the manner hereinabove alleged.

(p) The transactions last alleged, brought into the merger or consolidation, the management of the various enterprises located at Kenora, Keewatin and Norman through Kenora Paper Mills, Limited, a wholly owned subsidiary of M. & O. Shortly previous to the transfer of these properties to M & O the

defendant Backus had received an offer of $20,000,000 in cash therefor, from an outside independent competing interest This consolidation provided the basis for the financing of M & O effected through its trust deed and mortgage to The Minnesota Loan and Trust Company, as Trustee, under date of April 1, 1925, securing an issue of $16,000,000 first mortgage and collateral bonds, a copy of which mortgage is attached to the Bill of Complaint herein, as will more fully appear from such attached copy, the security conveyed and pledged under this mortgage included the various physical properties brought into the consolidation through the Minnesota and Ontario Company (M & O.) and International Lumber Company, stocks of the various constituent subsidiaries and the bonds of Rainy River Improvement Company; Ontario and Minnesota Power Company, Limited, and Kenora Paper Mills, Limited

(q) As hereinabove alleged, in the preliminary stages of the negotiations contemplating the establishment at Fort William or Port Arthur in the Province of Ontario, of facilities for the manufacture of paper and other miscellaneous commodities, the expediency as well as business necessity of the ultimate control of this enterprise by M & O was agreed to by all parties concerned, including the first above alleged fiscal agents In 1921, as a part of the initial step in this enterprise, defendant Backus secured from the Ontario government, the Negagami pulp limit estimated to contain 5,000,000 cords of pulpwood and timber of other species Transcontinental Development Company, Limited, a wholly owned subsidiary of defendant Backus Brooks Company (now owned by Great Lakes Paper Company, Limited) was organized to hold the limits thus acquired During 1922 and 1923, defendant Backus acquired 600 square miles of timber land in fee simple, to hold which, the Transcontinental Paper Company, Ltd, was organized with a capital of $5,000,000 of which 95 per cent was owned by the defendant Backus Brooks Company (now owned by the Great Lakes Paper Company, Limited).

(r) During the period last referred to, 1922–1923, the defendant Backus, in affiliation with outside parties, organized the Great Lakes Paper Company, Ltd, capitalized at 500,000 shares of no par common stock and $2,000,000 of 6 per cent preferred stock. In the inception of this organization, the defendant Backus Brooks Company held a minority interest, but notwithstanding, provided all the funds to finance the construction of the initial ground-wood pulp mill; to acquire industrial sites; to acquire sites for employees' homes and for the ultimate location of terminals and docks In 1927, the Backus Brooks Company acquired the entire stock ownership of the Great Lakes Paper Company, Ltd, and immediately upon such acquisition, began the erection of paper mills, the construction of which was continuously carried on until fully completed in 1929, the ground-wood pulp mill having been in operation since 1924 and the first newsprint unit in early 1929. The timber limits previously acquired for this project were estimated to contain 18,000,000 to 20,000,000 cords of pulpwood and located in proximity to Fort William, Ontario, where the mills were constructed.

(s) In 1927, negotiations were opened by the defendant, Backus, with the investment bankers who had underwritten the M & O financing in 1925, and handled the subsequent issues of securities by M & O contemplating the immediate acquisition of the Great Lakes project by M & O without the necessity of independent financing by Great Lakes At or about the date of the financing under the trust deed last referred to, the basis of valuation of the properties to be acquired on such consolidation, had been settled between the defendant, Backus, and the representatives of approximately 80% of the M & O minority stockholders.

This agreement provided in substance that the same basis should be employed for the purposes of the Great Lakes consolidation that was employed when the Kenora properties were taken over. The plan of immediate consolidation was not approved by the investment bankers, underwriters of the M & O. securities, as aforesaid, but in lieu thereof, it was proposed the Great Lakes enterprise should, in its initial stages, be independently financed through a bond issue of its own creation and that the ultimate taking over of the property by M. & O. should be postponed until the development work was completed and the mills in operation and showing satisfactory earnings. There was no change in the original plan and understanding herein above alleged, that the property should be developed for M. & O. and be made a part of the entire unitary organization. In 1930, Great Lakes Paper Company, Limited, made satisfactory showing notwithstanding the partial operation of its mills; the prevalence of what may be termed "cut throat" competition in the paper

industry and the general commercial depression In deference to the last mentioned conditions with the attendant difficulties in respect to any newly proposed public financing, it was decided the consolidation should, for the time being, be deferred, that the said Great Lakes Company should immediately take over the Transcontinental Paper Company, Limited, and Transcontinental Development Company, Limited, that it should increase its common capital stock to 750,000 no par shares and its 6% preferred stock to 100,000 shares, and that Backus Brooks Company should deliver to M & O. a sufficient number of such preferred shares, at par, to cover substantial advances made by M. & O. to the defendant, Backus Brooks Company, during the period of the development construction and operation of the Great Lakes project That the stock so to be transferred was that alleged in the Bill of Complaint and that such stock at the date of such transfer was fairly and reasonably worth par and more Pending the arrangements for completing the contemplated consolidation, it was agreed and understood that the Great Lakes Paper Company, Ltd, should be handled and conducted as a part of the unitary organization, that its manufactured product would be sold to M & O and the latter should withhold part of the payments coming to Great Lakes Company, but should remit amounts necessary to defray Great Lakes operating costs The amounts then withheld by M & O aggregated at the date of the receivership in this cause approximately $2,500,000. During the development periods of both the Kenora properties and the Great Lakes Company, the M & O company bought all of the ground-wood, pulp and paper produced as originally agreed in 1908, thereby obviating any competition in the purchase of raw material or in the sales market for the manufactured products pending the ultimate consolidation of these properties, as above alleged.

The contemplated plan and understanding for the consolidation of the Great Lakes with M & O was that the defendant, Backus Brooks Company, should transfer to M & O 750,000 shares of the no par value common stock and 100,000 shares of the preferred stock of the said Great Lakes Company, together with the latter's affiliated properties, including its undeveloped water powers. Backus Brooks was to receive in cash approximately $7,500,000, less advances previosuly made by M. & O and preferred and common stock in M & O in amounts to be determined by method of appraisal already mentioned

(t) The basis of consolidation last mentioned, wholly apart from the circumstance that its carrying out would have been a step or incident of the general plan of unitary organization hereinabove referred to, was fair, equitable, legal and to the advantage and for the benefit of M & O and the latter's consolidated operations and properties. Following the initial financing of the said Great Lakes through the flotation of a bond issue of $10,000,000 00 and while the Great Lakes was a subsidiary of the defendant Backus Brooks, as aforesaid and during the final completion of the paper mill development and before the said Great Lakes Company had acquired additional outside holdings of a value in excess of $10,000,000 00 which were taken over by the last named company in December, 1930, defendant Backus Brooks was offered $25,000,000 00 in cash for the equity in Great Lakes by a competitor of M & O. in the newsprint manufacturing and related industries

(u) During 1933, the defendant Backus, as hereinabove alleged, caused the Seine River Improvement Company to be organized and capitalized with $3,000,000 00 common stock The said Backus had previously secured leases from the Ontario government to develop the water powers at Sturgeon Falls, Calm Lake and Moose Lake The objective purpose in the acquisition of the last named property was to provide for the construction of transmission lines to both Fort William on the East and Fort Francis on the West, for the delivery of power to Great Lakes Paper Company, Limited, and Fort Francis Pulp and Paper Company, Limited It was intended to operate these properties independently through an independent power service corporation It developed later, however, that the industries of M & O at Fort Francis and International Falls lacked adequate power and that the shortage could not be provided for from any other source than that of the development first hereinabove mentioned. In deference to this situation, the decision was finally reached between all of the interested parties that the defendant Backus should turn the leases over to Seine River Improvement Company and that the company's capital stock should be turned over to M & O and the latter's subsidiaries

Previously to the arrangement last indicated, M. & O had no interest in Seine River One of the conditions of the transfer of the Seine River Stock and one of the considerations upon which such transfer was made, was that Kenora

Development Company should be given the contract to develop the three water powers in this subdivision referred to and that the construction plant and organization of Kenora Development Company, Limited, and Backus Brooks Company should develop such water power and supervise and construct the additional expansion construction then contemplated by M & O and its subsidiaries Fort Francis Pulp and Paper Mills, Ltd, and Kenora Paper Mills, Limited, all such construction and engineering to be carried out on the basis of cost plus 15% The aforesaid consideration was in all respects fair and reasonable. The understanding and stipulation last indicated was mutually agreed upon by all parties in interest and the construction and engineering carried out accordingly by the defendant Backus Brooks Company and the latter's subsidiary, Kenora Development Company, Limited Many of the operations and dealings between the various interrelated companies were informally handled throughout the entire history of their widely expanded and diversified operations Whether formal contracts covering the understanding and agreement for construction and development in this subdivision alleged were made and entered into at the time the work was undertaken, these answering defendants allege they have no knowledge or information sufficient to form a belief but that it was at all times the understanding of the Executive Department of the defendant Backus Brooks Company and of its subsidiary, Kenora Development Company, Limited, that such contracts had been formally prepared and executed by the respective parties in the inception of the undertaking In 1929, the Executive Department of the two last stated companies was informed by the Comptroller of M & O that in the absence of formal contracts only memorandum construction charges had been made and that to carry the latter to the regular books verification of the memorandum charges should be provided by formal contract; the defendant Backus thereupon instructed the Comptroller of M & O that if such memorandum or memorandums of agreement covering the construction in this subdivision mentioned, had not previously been made, the same should be prepared and executed and that in accordance with these instructions, the respective memorandums attached to the Bill of Complaint herein, and therein designated as respectively Exhibits "A" and "B" were prepared and executed under the directions of the defendant Backus

(v) In 1926, defendant Backus Brooks organized the National Pole & Treating Company with a capital of $30,000 00 of preferred shares and $30,000 no par value common shares This company was organized to take over the properties of National Pole Company, the American Cedar Company and Northern Tie & Treating Company, the last named company controlled through ownership of stock by International Lumber Company, which also owned a one-third interest through stock proprietorship in the American Cedar Company The outstanding interests in the first above named company were purchased by Backus Brooks The reorganization thus affected vested in International Lumber Company, a subsidiary of M & O as aforesaid, approximately 90% of both classes of stock of the National Pole & Treating Company

(w) In 1928, following the organization by M. & O. of the Insulite Company, a wholly owned subsidiary of M & O and the development of an extended product or commodity commercially known as insulite, investations of the facilities and opportunities for establishing a similar industry in Europe were conducted with the result of selecting Finland as the locality for this development by reason of a variety of circumstances including the availability of timber resources, the presence of developed and undeveloped water powers, low labor costs and world market. These investigations resulted in the acquisition by M & O of various properties in the country mentioned and the organization of the Insulite Company of Finland, a wholly owned subsidiary of M & O In connection with the same project, The Insulite Company of Finland acquired a half interest in the Abborfore Power Company of Finland, with the objective purpose of acquiring the necessary power for the contemplated manufacturing operations. Actual construction of the manufacturing plant was commenced in the early part of 1930 and carried to completion during the same year, when the manufactured product of the new enterprise was placed on the European market During the years 1930 and 1931, the investment in this enterprise aggregated approximately $3,000,000 00

Fortieth: These answering defendants further allege that previously to the conference had with the bankers in New York City the day before the institution of the receivership proceedings herein, as hereinabove alleged, no apprehension had existed upon the part of the executive management of M & O. or

of the defendant Backus with respect to the financial status or solvency of M. & O or its ability to finance its 1931 maturities; as indicated from the circumstance approximately $3,000,000 00 of new capital had been invested in expanding its enterprises in 1930–1931; that in the late summer of 1930, the executive management of M. & O approached the fiscal agent of the company with a view of anticipating the requirements for such maturities in the Spring of 1931, that at this time, the executive management was assured by the fiscal agent that the necessary financing could be taken care of, but that it was too early to then consider the subject, that the matter was accordingly permitted to remain in abeyance in accordance with the latter suggestion until early in October, when the fiscal agent suggested separating the developed water powers of M & O from its other properties, as a basis for a separate bond issue, which said fiscal agent agreed to underwrite The latter plan was developed by the end of the year, but then abandoned on account of apparently insuperable legal technicalities. Early in 1931, the commercial bankers of M. & O agreed with defendant Backus to provide the necessary funds for meeting all maturities in that year on the notes of M. & O with its series "D" bonds, as collateral, in February of that year, the defendant Backus called a conference with such bankers and fiscal agent in New York City to consummate the last mentioned arrangement; at such conference the commercial bankers, for the first time, informed defendant Backus that in the then prevailing financial conditions, any new financing was impossible; the defendant Backus was further informed that default in the obligations of M & O maturing three days later was inevitable and that the salvation of the enterprise could only be accomplished by a moratorium through a receivership; that in the same conference, it was further stated by the bankers that such receivership could be effected by making the defendant Backus the sole receiver, thus continuing his managerial capacity of the various industries and properties, which had been built up and developed under his personal supervision and direction.

That the conference brought out the desirability of a co-receiver or co-receivers, with the result that the parties characterized in the Bill of Complaint herein as the original receivers, were appointed; that apart from the assurances thus held out and given by the bankers, the defendant Backus would not have consented to the receivership, that during such conference, the bankers inquired of the defendant Backus as to the then cash situation of M & O. and upon being informed the last named Company had cash on hand in the amount of over $1,100,000 00, the bankers required that such moneys should be forthwith paid over to or appropriated by them for application and credit on outstanding obligations of M & O then held by them respectively; in response to the suggestion of the defendant Backus that the proposed preference would necessarily result in the cessation of all active operations for lack of the necessary cash resources; the bankers assured the defendant Backus, the necessary funds for the receivership operations would be provided by them through the receivership That all cash on hand was thereupon appropriated by the bankers. That as a result, the bankers substituted for their position as general creditors of the enterprise The preferred lien status of holders of receivers certificates in a relatively nominal amount.

Forty-first: Further answering, these answering defendants allege upon information and belief, that at the time the assurance last mentioned were given by the bankers to defendant Backus, there was no intention upon the part of the eastern bankers that the same should be carried out; that the fact the development of the vast properties involved had been made the life work of the defendant Backus and that the latter's entire fortune was in the equities of such properties and thus, in their salvation and rehabilitation, did not fit in with the scheme of such eastern bankers, that such eastern bankers have been, since the early stages of the receivership herein and still are conniving and conspiring to wreck M. & O. and turn its properties over to a competiting industry, of which such eastern banks are creditors for large amounts; that the plan and scheme of such bankers has been and is to bear and depreciate the properties and enterprise involved and that to the consummation of such scheme, it was essential the defendant Backus should be destroyed and removed, so far as possible, from the picture, that for the accomplishment of this end, it was essential that the parties really interested should ostensibly be brought together through the customary discredited banker's scheme of organizing creditors' and bondholders' committees; that with their knowledge of the fictation of the securities and the holders thereof, which knowledge was not possessed by the executive management of either M. & O. or the defendant

Backus-Brooks, the bankers were in a position to circularize the large number of widely scattered creditors individually interested and influence the latter in committing their interests to committees of the banker's selection and designation; that this step was taken with the result that in the course of the receivership administration such eastern bankers through their chosen committees have assumed to represent the majority of creditors and thus dominate and dictate the policies of the receivership; that no list or schedule of such claims has ever been presented to the court or otherwise made a matter of recore in this cause; that the failure of disclosing such claims has been accomplished through the medium and device of repeated extensions of the time to file claims in this cause, which has not as yet expired, that the receivership herein has been pending since February, 1931, during which period no record has been made of the creditors individually interested and that notwithstanding default in the outstanding trust deed or mortgage was made shortly following the date of the receivership, no steps have been taken by the trustees or the creditors secured by such mortgage, for the purpose of realizing upon or enforcing their security

Forty-second: Further answering, these answering defendants allege upon information and belief, that the steps thus had and taken and the methods followed, as hereinbefore alleged, have been directed and motivated from the outset, first by the purpose of destroying the defendant Backus, and second leaving the property and the interests of the creditors therein, to the tender mercies of the popular pastime or game of a bankers reorganization in the interests of a certain competing newsprint organization; that in furtherance of these purposes, shortly following the inauguration of the receivership, the representatives of the eastern bankers (the aforesaid so-termed "protective committee") demanded the resignation of the defendant Backus as receiver of the properties herein involved, that such resignation in the first instance was declined by the defendant Backus but thereafter assented to upon the understanding that he should be retained as a consultant and adviser of the receivers of the properties involved and the estate in process of administration receive the benefit of his knowledge and business experience in the various industries involved, following the matters last stated, complainant Robinson, with absolutely no experience in the newsprint or other allied industries, with no knowledge of the widely diversified properties involved in the present receivership, a total stranger to the several locations where the various properties were located and the various operations of such properties were being carried on, was selected and designated by the eastern bankers and their representatives (the aforesaid committees), with full knowledge on the part of said Robinson of the parties by whom he was designated and the objective purpose of his appointment as an incident in carrying out the scheme above alleged, that at the instigation of such bankers and their respective committees, the court having jurisdiction in this proceeding, was prevailed upon to appoint said Robinson and to fix his compensation in a sum wholly disproportionate to the value of any services he could render the receivership administration and out of all reasonable proportion to any thing justified by consideration of the equities of the receivership administration, that in addition to such designation of plaintiff Robinson as last above stated, the same interest and influences prevailed upon the court to designate the said receiver as the managing receiver or by characterization of similar import; that as an ostensible concession and with the intention of concealing and diverting attention from the effect and purposes of the last mentioned appointment, a local co-receiver was consented to and designated by the court, who has never discovered what the matter is all about; has assumed no independent jurisdiction and taken little or no appreciable part in the active administration of the receivership estate

Forty-third: Further answering, these answering defendants allege on information and belief there was no intention or purpose upon the part of such eastern bankers or their representatives, the so-termed protective committees, of carrying out the arrangement above indicated for retaining the defendant Backus in such consulting and advisory capacity of the various enterprises committed to the active conduct and operation of the receivership, that as the first step in the accomplishment of this purpose, the authority of the defendant Backus was gradually taken away and his advice in matters of policy and expediency either wholly disregarded or not sought, the method last indicated was continued until the commencement of the present action, when the defendant Backus was removed from all authority and connection with the

receivership administration, his resignation as a director and officer of various of the subsidiaries of M. & O. required and he, himself, discharged, by the present receivers.

Forty-fourth · Further answering, these answering defendants allege on information and belief that under the administration of the present receivers, owing to inexperience, inefficiency and ineptitude, the receivership estate has incurred heavy losses running into millions of dollars without notice to or knowledge of the creditors primarily interested therein or opportunity upon the part of such creditors to protect their several interests, except as such notice or knowledge may have been had by the aforesaid bankers committees, who have ostensibly assumed to be acting in behalf of and in the interest of such creditors, that pending the administration of the receivership estate by the present receivers, such estate has been mulcted in excessive costs and expenses far exceeding anything incurred by M. & O. during the period of its successful operation for administrative and operating expenses; that the objective purpose of plaintiff Robinson, one of such receivers, is effecting a plan of reorganization, in which, through the connivance of such Eastern bankers and their respective committees, said plaintiff will be permanently retained in active control of the properties involved, that the present suit has been instituted with no regard to the interests of the creditors or expectation of realization of any recovery therefrom but solely as a part of the scheme hereinabove alleged, of destroying the defendant Backus, of dissipating, breaking down and destroying a vast industry, to the building up and establishment of which, the defendant Backus has devoted practically his entire life; the throwing out of employment of hundreds and perhaps thousands of employees, all for the purpose of the selfish aggrandisement of such eastern bankers and the latter's endeavor to constitute a monopoly, the profits of which will be derived for themselves and the expense and loss of which will fall on the innocent investors, and of turning the property over to a competitor on the latter's terms to the great and irreparable loss of such investors

Wherefore, These answering defendants demand judgment that a decree be entered herein, adjudging that they may be hence dismissed and that they may have and recover their costs and disbursements herein and for any other and further relief which is consistent with equity and the facts herein alleged.

MORTIMER H BOUTELLE,
ADRIAN H DAVID,
Solicitors for Answering Defendants,
1500 Rand Tower, Minneapolis, Minn

III LIBEL SUIT BROUGHT BY E W BACKUS AGAINST RECEIVERS ROBINSON AND JAFFRAY FOR $2,000,000 DAMAGES

State of Minnesota, county of Hennepin, District Court, Fourth Judicial District. *E W Backus, Plaintiff,* vs *R H M Robinson,* and *C T. Jaffray, Defendants.* Complaint

Plaintiff complains of defendants, and each of them, and alleges ·

I

That all times herein complained of, the defendants were and now are the duly appointed, qualified and acting Receivers of the Minnesota and Ontario Paper Company, a Maine corporation, with its principal place of business in the City of Minneapolis, Hennepin County, Minnesota, and that said defendants were and now are administering the affairs of said receivership estate under and by virtue of the power and authority vested in them by order of the United States District Court for the District of Minnesota.

II

That at all times herein mentioned, plaintiff was and is the President of said Minnesota and Ontario Paper Company, now in receivership as aforesaid; that he was, and is, President of Backus Brooks Company of Minneapolis, Minnesota, and the Kenora Development Company, Ltd, of Kenora, Ontario, which latter two companies own over ninety per cent (90%) of the voting stock of said Minnesota and Ontario Paper Company, that plaintiff was the founder and

builder of the vast News Print paper and timber enterprises owned or controlled by said Minnesota and Ontario Paper Company, all built through his energy and devotion over a period embraced in the past forty (40) years, that at the time of the receivership, said enterprises had a book and actual value in excess of One Hundred Million Dollars ($100,000,000 00); that said enterprises had a regular and highly rated experience of earnings over a period of many years, all due to and made possible by the long experience and sound business judgment used by plaintiff in directing the affairs of these vast enterprises, located in the United States, Canada, and Europe

III

That at the time said defendants qualified as receivers of the aforesaid estate, there was the agreement and understanding between defendants and plaintiff that defendants would seek the counsel and advice of this plaintiff with respect to management of said estate, because of plaintiff's long experience in directing said business; that the resignation of prior receivers and the recommendation that the present receivers be appointed was based on such understanding, as herein stated; that very shortly after the defendants qualified as receivers, said defendant, Robinson, in particular, ignored and pointedly brushed aside suggestions, advice, inquiries pertinent to the business of said estate, and in all manner possible, repudiated said former understanding, and refused to be guided by counsel or advice of this plaintiff That said repudiations, as aforesaid, were the first step in a conspiracy to wholly displace this plaintiff from the position of trust and responsibility he had thereby enjoyed in his own business affairs, and through which he became recognized as one of the largest News Print paper manufacturers on the North American Continent.

IV

That legal proceedings filed by defendants as receivers against plaintiff as hereinafter set forth, set out a pretended cause of action charging plaintiff with having unlawfully and fraudulently exercised his control over said Minnesota and Ontario Paper Company, and its subsidiaries, in such a way as to have unlawfully abstracted from said companies, for plaintiff's and others' use, large sums of money, that said charges are wholly false and untrue, and not based on fact, that the principal transactions as alleged in said legal proceedings were concluded a considerable period of time prior to institution of the receivership of said estate, and were based on bona fide contracts between corporation with established separate entities, that defendants' pretended cause of action was brought on the theory of ultra vires and breach of trust, that it was not essential to defendants' pretended cause of action to allege "fraud" and "abstraction," which allegations they well knew to be false and untrue, that such charges of "fraud" and "abstraction" were inserted by defendants in said pretended cause of action for the sole purpose of discrediting plaintiff's character, ruining his business standing and rendering it wholly impossible for this plaintiff to go forward with plans of reorganization of said Minnesota and Ontario Paper Company

V

That on or about September 30th, 1933, these defendants, in the City of Minneapolis, Minnesota, did maliciously compose, publish, circulate and deliver through mail and other channels, a certain written Report, as of said date, setting out a summary of the business and fiscal condition of said estate, that there was contained in said printed Report certain false and milicious statements of and concerning plaintiff in words as follows:

SUIT BY RECEIVERS AGAINST FORMER OFFICERS AND STOCKHOLDERS AND COMPANIES OWNED BY THEM, FORT FRANCIS PULP AND PAPER COMPANY, LIMITED, BEING JOINED AS A PARTY THEREIN

"On September 18, 1933, the Court, upon application of the Receivers granted leave to sue Edward Wellington Backus, Mrs Elizabeth H. Backus, Seymour Wellington Backus, Kenora Development Company, Limited, Backus Brooks Company, and Fort Francis Pulp and Paper Company, Limited. In pursuance of such leave, suit was instituted upon that date

"This suit is predicated on the claim that for a period of years preceding this receivership control over the business and affairs of Minnesota and Ontario Paper Company and of its subsidiaries, was fraudulently and unlawfully exercised by E W. Backus, S. W Backus, and Backus Brooks Company through stock ownership and domination of directorates and officers, by means of which large sums of money were abstracted from Minnesota and Ontario Paper Company and from certain of its subsidiaries for the use of defendants, E W Backus, S W. Backus, Backus Brooks Company, and Kenora Development Company, Limited, resulting in an indebtedness owing by said defendants of approximately $7,000,000 by the end of the year 1930, and that said defendants fraudulently and unlawfully undertook to discharge said indebtedness by a series of transactions which included the transfer through Fort Francis Pulp and Paper Company, Limited, to Minnesota and Ontario Paper Company of approximately $5,000,000 par value of the preferred stock of Great Lakes Paper Company, Limited, which stock had little or no value, for a credit of approximately $5,000 000, and the cancellation of approximately $2,000,000 of obligations owed by Backus Brooks Company and Kenora Development Company, Limited, by setting up and using as offsets thereto pretended credits in their favor claimed by them as lawful charges in connection with the construction of plants and properties of the Minnesota and Ontario Paper Company and certain of its subsidiaries, both in the United States and in Canada. The Receivers seek to set aside these transactions and to recover from the defendants other than Fort Francis Pulp and Paper Company, Limited, the amount of the aforementioned advances aggregating about $7,000,000, together with lawful interest thereon"

VI

That the defendants maliciously caused said written Report to be widely circulated, published and delivered to diverse and sundry persons and corporations throughout the United States and Canada.

VII

That the false and malicious language as hereinabove quoted, was conceived and planned wholly with a view to destroying confidence in and discrediting plaintiff, and that the mailing, publishing and circulating of said libelous matter was done with the intent and knowledge by said defendants and with the designed purpose that such libelous matter would be republished and recirculated by its recipients and that the same was so republished and recirculated

VIII

That the defendants intended, through said libelous publication, to convey the thought and to charge that plaintiff had conducted the affairs of said Minnesota and Ontario Paper Company and its subsidiaries in a wholly unlawful and irregular manner, for his own private gain and benefit; that his acts were fraudulent, and that he had, in fact, so unlawfully abstracted money from said Minnesota and Ontario Paper Company and its subsidiaries as to constitute embezzlement; and, that the same was so understood by the recipients thereof. That said libelous statements were false and known to be false by said defendants, that said words were maliciously intended to so damage plaintiff as to cause many thousands of bondholders and other creditors of said estate to lose all confidence in the integrity and business judgment of plaintiff, and so thereby greatly lessen or make it wholly impossible for plaintiff to obtain the future necessary consent of said bondholders and other creditors to a plan designed to rehabilitate the affairs of said Minnesota and Ontario Paper Company.

IX

That defendants, and each of them, aspire to the future control and management of the properties involved in said receivership and that the pretended cause of action as alleged in said complaint is, in fact, based on desires and schemes of said defendants, and particularly of defendant, Robinson, and big Eastern Banking interests who wish to obtain control of the vast properties

involved in said estate, on such a basis as to constitute a brazen disregard of the rights and financial interests of approximately 15,000 bondholders and of equity owners, and that in order to prosecute such schemes and chicanery, defendants have launched a comprehensive plan and scheme to place plaintiff in bad repute and disfavor with said bondholders, and which in fact has resulted, and as a part of said scheme maliciously caused the publication and circulation of the statement concerning the plaintiff hereinabove set forth.

X

That the defendants maliciously connived and obtained the widest publicity of the libelous statements set forth in paragraph V herein throughout the entire United States, Canada, and even reaching into Europe, causing great damage to the good name, fame, reputation and character of plaintiff. That it was maliciously intended by defendants to have such effect, was intended to and did impute crime and wrong doing, lack of integrity and character to plaintiff, and particularly to deprive the plaintiff from participating in the further management and affairs of said Minnesota and Ontario Paper Company, or to receive consideration of bondholders and creditors in a reorganization plan That said language and all of the same blackened the name and standing of plaintiff to his friends and the public generally, and to bankers, bondholders, and to any and all others having either a claim or slight interest in the affairs and business of said estate, and held him up to hatred, ignominy, contempt, ridicule and disgrace, and totally destroyed plaintiff's previous high credit rating, business integrity and repute, all to plaintiff's special damages in the sum of One Million Dollars ($1,000,000 00), and to plaintiff's general damages in the sum of One Million Dollars ($1,000,000 00).

Wherefore, Plaintiff prays judgment against defendants, and each of them, in the sum of Two Million Dollars ($2,000,000 00), together with his costs and disbursements herein

(Signed) DAVIS & MICHEL,
Attorneys for Plaintiff,
419 Metropolitan Bank Bldg,
Minneapolis, Minnesota

MORTIMER H BOUTELLE, and HOUGEN and HOLTEN, Of Counsel,
Rand Tower, Minneapolis, Minnesota.

STATE OF MINNESOTA,
County of Hennepin, ss:

E. W. BACKUS, being duly sworn, says that he is the plaintiff in the above entitled action; that he has read the foregoing complaint and knows the contents thereof, that the same is true to his own knowledge, except as to those matters therein stated on information and belief, and as to those matters he believes it to be true.

(Signed) E W BACKUS

Subscribed and sworn to before me this 5th day of January, 1934
[NOTARIAL SEAL]

(Signed) HARRIET M RENSHAW,
Notary Public, Hennepin County, Minn.

My commission expires March 31, 1936

STOCK-EXCHANGE PRACTICES

TUESDAY, APRIL 3, 1934

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

The committee met at 11:06 a.m. in room 301 of the Senate Office Building, Senator Duncan U. Fletcher (chairman) presiding.

Present: Senators Fletcher (chairman), Gore, Costigan, Goldsborough, Townsend, Walcott, Couzens, and Kean.

Present also: Ferdinand Pecora, counsel to the committee; Julius Silver and David Saperstein, associate counsel to the committee; Frank J. Meehan, chief statistician to the committee.

The CHAIRMAN. The committee will come to order, please. Senator Kean, do you have something that you wish to present?

Senator KEAN. Referring to my request calling for the record of sales of the aviation stocks on the New York Stock Exchange, as outlined in that statement, one of my objects was to show the thoroughness of the management of the New York Stock Exchange and their ability to show who bought and sold stocks of any given security. I think this has been fully demonstrated.

My next object was to give to the press and to the people connected with the committee who were investigating various financial phases of operations of banks and other financial institutions the opportunity to show their efficiency.

They have now had 3 weeks in which to examine these accounts, and they say they will need $100,000 to do this work. The stock exchange did the work for the committee for nothing. I do not believe that the value to the public would be sufficient to justify the expenditure of $100,000, and therefore in the interests of economy withdraw my request for this investigation.

I offer the following resolution:

Resolved, That the investigation authorized heretofore into the transactions in air-mail companies' stocks be discontinued, and that the general counsel, Mr Pecora, is requested to report the general results of the investigation to date in regard to these stocks

(The resolution was adopted.)

Mr. PECORA. May I say with reference to the resolution that has just been offered by Senator Kean and adopted by the committee that a liberal compliance or any substantial compliance with the duties and responsibilities covered by the resolution previously adopted by the committee which instructed me as counsel to investigate the transactions in those aviation company stocks would have required a complete exploration of thousands of such transactions, because there were thousands of them enumerated in the data pre-

sented to the committee by the officers of the New York Stock Exchange.

The resolution of Senator Carey to which I have already referred——

The CHAIRMAN. Senator Kean.

Mr. PECORA. I thought it was Senator Carey. The resolution instructing me to proceed and ascertain and report to the committee the motives that prompted those persons who bought or sold those aviation company stocks would have necessitated getting in communication with every person who had such a transaction within the period of time covered by the data furnished to the committee by the New York Stock Exchange, and those persons, according to the data, were scattered all over the country, from east to west and from north to south. There were absolutely no indications on the face of the data submitted by the New York Stock Exchange which afforded any clue or lead or indication as to the motives that prompted any of the transactions so reported.

I have not been in the least unwilling to proceed with the fulfillment of that task, or its accomplishment, but it could only have been consummated at great expense, and would have involved the services of many assistants, would have required a great deal of time, and I have no idea what results might have been forthcoming.

Senator COUZENS. Are we going into executive session on the stock exchange bill or are we having open hearings?

The CHAIRMAN. Executive session. This is a matter that ought to be dealt with in open session.

That covers this question then. Mr. Pecora has explained what would be involved in the further investigation, in the matter of time and expense.

Senator KEAN. I think it would be a waste of money.

The CHAIRMAN. It seems to me it would not be justified. Anything that Mr. Pecora has gathered now that he thinks worth while to report to the committee he can report later.

Mr. PECORA. I will, sir. (See subsequent hearings of Apr. 18, 1934.)

The CHAIRMAN. That concludes the business in open session this morning. The committee will now go into executive session and take up the bill.

(Whereupon, at 12:20 p.m., Tuesday, Apr. 3, 1934, the committee went into executive session.)

STOCK-EXCHANGE PRACTICES

THURSDAY, APRIL 5, 1934

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

The committee met at 10:30 a.m., following adjournment on Tuesday, April 3, 1934, in room 301 of the Senate Office Building, Senator Duncan U. Fletcher (chairman) presiding.

Present: Senators Fletcher (chairman), Wagner, Bulkley, Gore, Costigan, Reynolds, Bankhead, McAdoo, Adams, Norbeck, Goldsborough, Townsend, and Carey.

Present also: Senator King, of Utah; Ferdinand Pecora, counsel to the committee; Julius Silver and David Saperstein, associate counsel to the committee; and Frank J. Meehan, chief statistician to the committee.

The CHAIRMAN. The committee will come to order, please. Mr. Untermyer is able to be present this morning. The members of the committee know very well, I think, about his great interest in this subject. He has been active more or less, and certainly concerned, about the subject for over 20 years. We know of his services with the Pujo Committee; we know of his services here when we had a bill pending in 1914; and he has a thorough understanding of this whole situation.

Now, Mr. Untermyer, we will be very glad for you to just discuss this bill. Have you examined the revised bill and the bills that are pending before this committee?

Mr. UNTERMYER. I have examined the revised bill after a fashion, within the limited time at my disposal. I have examined the original bill very fully.

The CHAIRMAN. All right. We will now be very glad to have your views.

STATEMENT OF SAMUEL UNTERMYER, ATTORNEY AT LAW, NEW YORK CITY

Mr. UNTERMYER. Mr. Chairman and gentlemen of the committee, I tried to fix up something on the way over. I trust that the committee will not get the impression from anything I may say by way of criticism of the pending bill that I am lacking in enthusiasm or appreciation of the necessity for the enactment of comprehensive legislation for Federal regulation of stock exchanges.

Perhaps I may be pardoned in that connection——

(Thereupon Senator Bulkley, of Ohio, came into the committee room and was congratulated by members of the committee.)

Senator KING. Mr. Untermyer, here is the new bridegroom, and we have to interrupt your statement in order to congratulate him.

Mr. UNTERMYER. Well, Senator Bulkley, I also congratulate you.

Senator BULKLEY. I thank you.

Mr. UNTERMYER. Now shall I resume?

The CHAIRMAN. Yes.

Mr. UNTERMYER. Perhaps I may be pardoned in that connection for referring to the fact that I have been for at least a quarter of a century actively agitating for such legislation, both in the Congress of the United States and in the State of New York, and am the author of a number of bills looking to that end, beginning with the bill recommended in the Pujo Committee report, and followed in 1913 by a bill which was before the Senate Committee on Banking and Currency, of which Senator Owen, of Oklahoma, was then chairman, and known as the "Owen bill", and ending with the submission of a bill last year that was prepared by me at the request of the President.

I am profoundly imbued with the necessity for such legislation and deeply interested in the subject.

Before outlining my objections to the present bill, permit me to refer to the omission of a number of particulars that may be regarded in a sense as of comparative minor importance but which seem to me of considerable importance. In what I have to say on this subject I have more particularly in mind the form of the constitution and the regulations of the New York Stock Exchange, after which the others are largely patterned.

First. For 40 or 50 years the membership of the New York Stock Exchange was limited to 1,150 members. At least I think that was the number. That was true, alth ough the business of the exchange had increased, perhaps, fiftyfold. It was not until after the boom of 1929 or thereabouts that it was increased by 25 percent, or 375 seats. Those were issued as in the nature of membership dividends, the sale and distribution of which was vested in the board of governors of the New York Stock Exchange, so that the present membership is about 1,450.

Those seats, I understand, were sold at an average price of approximately $500,000 each, yielding enormous cash dividends of over $175,000,000 to the members of the exchange as a result of their monopoly of the right to sell securities thus built up and for which the public has had to pay in the form of commissions.

I suggest that the Federal Trade Commission be given supervisory control over the exchange membership, and that the proceeds from the sale of future seats be treated as a trust fund for the public benefit instead of a sinecure for the members.

One of the regulations of the exchange that has been very drastically enforced has given to exchange members on the insolvency of a member or firm a priority over all other creditors to the extent of the value of that seat, and every member to whom the insolvent member is indebted will get 100 cents on the dollar, although defrauded creditors may not get more than 1 cent or 5 cents on the dollar, which has frequently been the case. It seems to me that rather runs up against the law of the land, and that upon bankruptcy, and many of them have become bankrupt, the seat should be an asset of the estate and all creditors should share in the value or the realized

sum from that seat. The members should not be preferred creditors to the extent of the value of the seat.

Second. The commission rates on the purchase and sale of securities have been practically doubled in recent years. They now range, I believe, from $20 per 100 shares to $50 per 100 shares, of which one half is payable by the seller and the other half by the buyer.

While section 46, page 18, of your bill would give the Federal Trade Commission the right to prescribe uniform rates of commission, it does not otherwise authorize the Commission to fix rates, which it seems to me it should do and would do by striking out the word "uniform." That would permit the Commission to fix rates.

The volume of the business transacted on the exchange has increased manyfold. Great fortunes have been made by brokers through this monopoly. The public has no access to the exchange by way of membership except by buying a seat and paying a very large sum for it. Therefore it is a monopoly. Probably it has to be something of a monopoly. But after all it is essentially a public institution. It is the greatest financial agency in the world, and should be not only controlled by the public but it seems to me its membership and the commissions charged should either be fixed by some governmental authority or be supervised by such authority. As matters now stand, the exchange can charge all that the traffic will bear, and that is a burden upon commerce.

Third. The power of the exchange to expel and suspend members is now supreme, and so remains under the terms of this bill. A former president of the stock exchange testified as long as 22 years ago before the Pujo committee that the most grievous offense a member could commit would be to split commissions or to reduce the prescribed commissions. Although many of the great capitalists of the country who deal largely on the exchange in the purchase and sale of securities never act as brokers, yet they are able to have their orders executed at less than 10 percent per share of the cost to the public by reason of holding a membership.

Senator COSTIGAN. Mr. Untermyer, is it your suggestion that the prices at which seats on the exchange are sold should be fixed by an external governing authority?

Mr. UNTERMYER. No. My suggestion is that the proceeds from such monopoly, and the increase of seats, should go into some sort of trust fund and not into the pockets of members of the exchange. This $175,000,000 I referred to was simply distributed among the members of the New York Stock Exchange.

Senator MCADOO. Mr. Untermyer, you would suggest that it go into a trust fund for whose benefit?

Mr. UNTERMYER. Well, I suppose it could be used to some extent toward the administration of the act.

Senator GOLDSBOROUGH. Mr. Untermyer, did I understand you correctly that if a deed of trust be filed or a petition in bankruptcy by a member of the New York Stock Exchange, the proceeds arising from the sale of his seat on the exchange would not go to his general creditors?

Mr. UNTERMYER. It would not. It goes to the members of the New York Stock Exchange.

Senator MCADOO. Well, they have a prior claim on it under the rules of the New York Stock Exchange; is that it?

Mr. UNTERMYER. Yes. Under the rules of the New York Stock Exchange they have a prior claim on it. But is there any reason for such a rule?

Senator GOLDSBOROUGH. I quite agree with you, but my understanding was that the situation was quite the contrary. I am glad to be advised of the true situation, and now understand from you that it is the other way.

Mr. UNTERMYER. Yes.

Senator MCADOO. It has always been as Mr. Untermyer suggests. They have always had a preference, and I think Mr. Untermyer is right in saying that no such preference should be given.

Senator GOLDSBOROUGH. Well, I did not know that that was the situation, and I am glad to be set right on it.

Mr. UNTERMYER. I happen to know because I have had many experiences along that line.

Senator GOLDSBOROUGH. Oh, I have no doubt of your knowledge. I am quite sure that you are right about it.

Mr. UNTERMYER. And I know of instances in which the estate has yielded 1 percent to other creditors, while stock exchange members have received 100 cents on the dollar.

The CHAIRMAN. You may proceed with your statement, Mr. Untermyer.

Mr. UNTERMYER The expulsion or suspension of a member not only exterminates him in a business sense but destroys his reputation. It seems to me such a decree should be subject to judicial review. I do not mean by this that the operation of the judgment of expulsion or suspension should be stayed pending such review, but that the right to appeal to the courts should exist. It is an arbitrary and undemocratic power that should not be vested in any body of individuals. It is likened unto a private club, and for many years they took the position in the courts that they were in effect a private club. The courts have sustained that contention, or practically have sustained that contention, so that no member could get a review. A member cannot get a review as things now stand.

Senator COSTIGAN. In other words, the consequences are in effect those of disbarment of any member of the legal profession.

Mr. UNTERMYER. Oh! They are worse almost, it seems to me, and there is no opportunity for a judicial hearing anywhere. Now, it would disrupt the business of the exchange if a man could operate, could stay the operation of such a judgment. I do not think that should be permitted, and while I think the judgment should go into effect, yet if the man should feel that he wants to clear his reputation he ought to be given the opportunity to do so.

Senator GORE. If he were allowed to stay in the exchange as a member. I mean after a judicial proceeding, could the rest of the members boycott him so that it would be in the end equivalent to expulsion even though he were cleared?

Mr. UNTERMYER. Well, I don't know about that. I should say not if you have a regulatory power over the exchanges, such as I have been contending for now for a quarter of a century.

Senator GORE. I thought the other brokers might, out of respect for the decree of the management or the board of governors, even though a court held a man should not be expelled, just refuse to trade with him.

Mr. UNTERMYER. Well, he would still have his customers, would have the people who believed in him, after a court should vindicate him. My idea was that he should not remain in the exchange and continue to deal pending his appeal, but that if he should be vindicated by a court then I think he should be reinstated.

Senator MCADOO. Is it your idea that, in case of vindication by the courts, he would have an action against the exchange for the damages he had suffered?

Mr. UNTERMYER. No. I do not think so.

Senator GORE. Wouldn't his orders have to be executed by some other broker, I mean on the other side of the transaction?

Mr. UNTERMYER. Yes; they would have to be executed by a broker on the other side of the transaction, but so long as you have a regulatory body, why, its duty would be to see that orders are executed if they are bona-fide orders.

Senator GORE. What I was wondering about was this: If John Doe were a member who, it was undertaken, should be expelled, and if he gave an order to Richard Roe, would Richard Roe execute that order?

Mr. UNTERMYER. Well, Senator Gore, sufficient unto the day is the evil thereof. The question is whether a man should have his day in court on a subject of that kind. Many of these expulsions in years gone by have simply been because of reducing the commissions to a large customer, or splitting commissions. They have not been, as a rule, for fraud.

Senator MCADOO. Nor for moral turpitude, I take it?

Mr. UNTERMYER. No. Some of them, I should say many of them, have not been cases of members guilty of moral turpitude. And others who have been guilty of moral turpitude have stayed in the exchange until they were sent to prison, such as this man Booth, who kept no books. The exchange told him he should keep books, but he kept none. He got rid of millions of dollars of the people's money. Now, I believe, he is up in prison.

Mr. PECORA. I think he is out by this time.

Mr. UNTERMYER. Is he out by this time?

Mr. PECORA. Yes! I think so.

Mr. UNTERMYER. Well, he ought to go back.

Senator WAGNER. Well, I believe there is a review in a case where the board of governors may act arbitrarily in the matter of expulsion.

Mr. UNTERMYER. No, sir.

Senator WAGNER. Well, then, I did an illegal thing when I attempted to review, as a judge, the famous Miller case.

Mr. UNTERMYER. I remember the Miller case very well. But after you had reviewed it and examined the authorities you found there was nothing you could do, didn't you? You did not reinstate him.

Senator WAGNER. No; but I declined on the ground that there was evidence to sustain the action of the board of governors in expelling him. There the charge was a very serious one.

Mr. UNTERMYER. But the precedents are all against that. I do not know of any case in all the history of the New York Stock Exchange where a fiat of the board of governors has been reviewed and reversed, or the courts have taken any jurisdiction. I have had some of those cases myself.

The CHAIRMAN. I think we have spent enough time on that angle. That is a matter of practice or of the internal operations of the exchange among its members. I do not see the relation to the public interest there as being so vital.

Mr. UNTERMYER. It has the relation of the rights of individuals.

The CHAIRMAN. Yes.

Mr. UNTERMYER. It is not everything that people agree by contract to do in a public body of that kind that ought to be enforced, because they have been more solicitous for their commissions and for maintaining their standard of commissions, in which I think they are perhaps right, than they have been about any other subject.

The CHAIRMAN. I am glad to have the point, but I do not think we need to take much more time on it.

Mr. UNTERMYER. All right; the next suggestion I make is this: I urge that there be included in the bill the necessary machinery to enable holders of bonds and debentures that are listed on the exchange, to communicate with one another for mutual protection, and that no such security should be listed or should be retained on the list that does not provide for such protection.

As matters now stand, the trustee for the bonds through which the interest coupons are paid is the only one who has the means of ascertaining the real owners where they are bearer bonds, as most of them are, and bearer coupons. The trustees should be required to furnish the company with these lists from time to time, and the latter in turn should be under the duty of supplying them to the bondholder. The result of the present situation is that it is well-nigh impossible for protective committees on defaulted bonds or other contesting bodies of bondholders to communicate with one another, and their protection against the powers that be in the corporation is almost impossible.

We have recently had the last of many object lessons in this connection, one in which I am concerned, or was concerned, for the protective committees in the case of Kreuger and Toll, and the International Match Co., where there were two protective committees, of which Messrs. Bainbridge Colby and ex-Governor Silsby, of New Jersey, are the respective chairmen.

The firm of Lee, Higginson & Co., of Boston, and the issuing houses, great trust companies and banking houses connected with them, were responsible for the perpetration of colossal swindles on the securityholders of these companies. I do not mean to say that they perpetrated these swindles. I do not mean to say that they knew of the swindles. But they were so grossly negligent in not examining into the affairs of those companies and their names were so great that people relied so implicitly upon them, that I regard them as responsible for those swindles. And yet the issuing houses connected with that banking firm, or their representatives, were able to corral the bulk of the bonds almost to the exclusion of the committees organized to protect the holders, because of the inability of the protective committees to ascertain the names and addresses of securityholders; whereas the inner circle had access to that information There was $350,000,000 lost to the securityholders of this country in that transaction. They are going to get practically nothing.

Senator GORE. You think much of that could have been saved to the security holders by the plan you suggest?

Mr. UNTERMYER. Well, I don't know that the plan I suggest could have saved them, but the plan I suggest would have given them a chance to get together and endeavor to protect themselves.

Senator GORE. And make an effort?

Mr. UNTERMYER. Yes. Instead of which these security houses had the access to the lists of bondholders and nobody else could get them. I think out of 150 million dollars of bonds our protective committees were able to get by advertisment less than 10 million dollars in bonds, because we could not reach these people, did not know where they were. They were in every corner of the earth. The average investor or the people of this country in those securities had as an investment less than $2,000 apiece. Every little hamlet in the country, the supersalesmen all over the country, just scouring the country and selling these bonds, whilst they worked on the stock exchange, manipulated the prices there so as to keep these bonds up a little above par until their hundreds of supersalesmen that floated them on the public got through and then they took the pegs from under them, and I think they are about $5 a bond now.

We will come to that later when we talk about this provision about allowing these syndicates to peg securities with the consent of the Commission. That is just another form of manipulation.

There is another effect that prevents stockholders of nondividend-paying corporations from joining for their protection. As counsel for the Transit Commission of New York I called this to the attention of the transit commission and the stock exchange a few years ago. It arose while we were endeavoring to get in touch with the stockholders of the Interborough Road, which had not paid dividends on its stock for some years.

Senator TOWNSEND. Mr. Untermyer, would you mind being interrupted there?

Mr. UNTERMYER. Not at all.

Senator TOWNSEND. You spoke of the pegging of the price of those bonds. Would you mind elaborating on that?

Mr. UNTERMYER. I am coming to that a little later.

Senator TOWNSEND. All right.

Mr. UNTERMYER. The stock of the Inter-Borough was being kicked around the street, as is usual in such cases, in the names of brokers who had at one time or another held it as collateral for loans, many of whom had not for years owned or had any interest whatever in the stock and in the certificates that stood in their names, and had no idea where they were. They used to give proxies on that stock until I had the exchange pass a regulation somewhat ameliorating that condition.

In such cases there was and is no way of ascertaining the names of those who own this stock or of the brokers who at the time may hold it as collateral. The brokers have been in the habit of issuing proxies on this stock that stood in their names, but as to the ownership of which they had no idea. The great banking houses in New York and in other cities have been in the habit of controlling publicly owned corporations through such practices, although in most cases they have little or no interest of their own in the corporation. I tried to induce the stock exchange to pass a regulation requiring

every brokerage house that held such stock on margin to have it registered in its name within 10 days after it came into its possession, but the exchange refused that request on the ground that it would interfere with speculation in the stock.

Now, they did pass a regulation at my suggestion prohibiting brokers from giving any more proxies on stock that they did not have, although it stood in their names. But they did nothing to make it possible to find out for the city and the transit commission who owned this stock, and we cannot find out today.

All I can see is that it interferes not with speculation but with evading the transfer tax by passing the certificates from hand to hand. Its effect is to leave stockholders helpless in corporations that do not pay dividends. Of course, where they pay dividends is another situation. Then the books of the company show to whom the checks are mailed out. But a great preponderance of the common stock on the New York Stock Exchange I should say do not pay dividends. Every listed stock should be required to be registered in the name of the owner or of the broker who owns it, so that the stockholders can get together for mutual protection.

Now, my sixth suggestion: I respectfully submit that the provisions of section 13 (a) of your revised bill, page 52, line 21, with respect to proxies, they are the opposite of what they should be. The ability of security holders to join for their mutual protection against the management of corporations that are now largely controlled by those with no substantial financial interest in the corporation and to communicate freely with one another to that end and to protect one another should be encouraged rather than discouraged or made difficult.

Why should it be considered necessary or desirable in the public interest in the solicitation of proxies to continue or dislodge an existing management. Before being permitted so to do—I quote from the bill—to solicit or to permit the use of his name to solicit any proxy for consent or authorization in respect to any security, to apply to the Commission and to file with it a statement of his purpose or his relations to and interest in securities. The bill says "The names and addresses of the persons from whom similar proxies, consents, or authorizations are being solicited."

Senator ADAMS. Mr. Untermyer, what would be the effect of the section as it now stands on the corporate operations and contests over corporate control?

Mr. UNTERMYER. Well, as it now stands, anybody who wants to contest corporate control instead of being encouraged to do so and to have his voice heard, has got to go before the Commission and make a disclosure to the Commission and get the consent of the Commission to deal with his own property. Why? Who put that in and why was it put in? I am trying to find out some reason for it. It is difficult enough for people who want to buck up against these managements to do so. What is the purpose of making it more difficult? Why not leave the stockholders where they are. If they want to contest the management or an election or an act that is to be done by a corporation, why not permit them to do so?

The CHAIRMAN. I imagine the purpose was to prevent a group of stockholders from corralling all the stock by obtaining proxies secretly and quietly for that purpose.

Mr. UNTERMYER. Well, in the first place, haven't the stockholders the same right to give them the stock, to vote to give it to the management? Why should the management have such an advantage as that over the ordinary stockholder that is trying to dislodge him?

The CHAIRMAN. The idea was to prevent that advantage to the management. The idea was to give the stockholders a chance.

Mr. UNTERMYER. It does not give him any chance at all. It does the contrary. It embarrasses him. It requires him to make a whole lot of disclosures to the Commission before he can go and approach his fellow stockholders and ask their authority to act.

Senator GORE. What is your suggestion as to facilitating this communication?

Mr. UNTERMYER. My suggestion is to facilitate the assertion of the rights of stockholders who are not controlled by the management, to give them a chance to come into their own.

Senator GORE. Yes.

Mr. UNTERMYER. Now, we all know that the bulk of the great corporations of the country are controlled by people who have not any interest in them.

Senator ADAMS. That is in line with your suggestion which you made just preceding this, that the lists of bondholders and stockholders be made available?

Mr. UNTERMYER. Yes; it is all in the same direction.

Senator GORE. Isn't that one of the fundamental troubles in our whole economic structure, that the management is divorced from ownership?

Mr. UNTERMYER. That is because the stockholders are willing to divorce management from ownership. If they choose to give their proxies to managements that have no ownership, that is their affair, but why embarrass people who want to change that sort of management?

Senator GORE. What is your concrete suggestion as to how to close the circuit and bring them into contact?

Mr. UNTERMYER. Well, my suggestion is to leave it alone as it is now; not to make it more difficult. That is all.

Senator MCADOO. You would eliminate this provision?

Mr. UNTERMYER. Yes; I would.

Senator GORE. You think that makes the present situation worse?

Mr. UNTERMYER. It does make it worse.

Senator GORE. And the present situation is bad enough?

Mr. UNTERMYER. Well, it is bad enough—very bad—because of the power of these brokers who have the stock registered in their names and these great corporations permit them to get these proxies. That is the way they get them. They get them through brokers.

Senator MCADOO. There is not any doubt there is a great abuse there, Mr. Untermyer, that ought to be corrected. I think the purpose of the bill was to correct them. Now, if it is to be made worse for the unprotected stockholders, I think we ought to have a concrete suggestion. We would be glad to have a concrete suggestion. You haven't any amendment prepared?

Mr. UNTERMYER. We do not need a concrete suggestion. Let them alone.

Senator GOLDSBOROUGH. You mean you would take out the entire section?

Mr. UNTERMYER. I would take out the entire section.

Senator MCADOO. That is what I was getting at.

Mr. UNTERMYER. Unless you want to prevent brokers from giving proxies on stocks that stand in their names. You have tried to prevent it in other places, and we have tried to prevent it, and we have had some amendments passed to that end, looking in that direction, but they are not sufficient for the purpose. They do not accomplish the purpose.

Mr. PECORA. Mr. Untermyer, what is the objection in your mind to requiring anybody, whether it be a minority stockholder or a group of minor stockholders, or whether it be group of stockholders who may be minority stockholders in fact but who by virtue of their relationship to the corporation as officers and directors might manage or control the corporation—what would be the objection to any such person who desired to solicit proxies from their fellow stockholders setting forth in a statement to be filed with the Federal Trade Commission the specific purposes for which they are seeking those proxies? Doesn't that information acquaint every other stockholder with the avowed purpose or object for which his proxy is being sought?

Mr. UNTERMYER. Yes; it acquaints the management, too, and puts them on guard, so that the stockholders are much more embarrassed, and then it requires certain disclosures and it seems to me that it puts every stockholder who wants to protect his corporation and get a change of management in the position of a sort of a striker.

Now, somebody has evidently persuaded—someone connected with the drawing of this bill—that there are a lot of strikers around and that every fellow who wants to change a management is a striker.

Mr. PECORA. Speaking for myself and such others as I conferred with in the connection with the preparation of this bill with regard to section 13, what we had essentially in mind was putting every stockholder in a corporation, whether he was a large or small stockholder on an equal footing with every other, if such a stockholder desired to associate with him other stockholders for what purpose he had in mind, and making it thereby possible for every stockholder from whom a proxy is solicited by any other stockholder to know definitely what the purpose was of the person soliciting the proxy.

Mr. UNTERMYER. Why?

Mr. PECORA. Well, I think so a stockholder could intelligently decide whether or not to give his proxy.

Mr. UNTERMYER. He is not a babe in arms. He can decide.

Mr. PECORA. In the past stockholders have been solicited to give their proxies by other stockholders without really knowing what use was going to be made of their proxies.

Mr. UNTERMYER. They never did.

Mr. PECORA. What purposes were sought to be effectuated by those solicited proxies? Under this bill if enacted a stockholder whose proxy is solicited by any other stockholder would have specific information given to him concerning the purpose for which the proxy is sought and what use is intended to be made of it. Don't you think that that gives every stockholder an opportunity of better determining whether or not he shall give his proxy when it is solicited?

Mr. UNTERMYER. No; because every committee of stockholders—and I have represented some hundreds of them at one time or another—every committee of stockholders explains in a circular to the stockholder why he wants his proxy. The proxy itself contains the particular features of the specified respects in which he wants to act. He has got all that information. What has the Commission got to do with it?

Mr. PECORA. Mr. Untermyer, very often the requests for these proxies specify the purpose that the solicitor seeks to effectuate in such very general language that the stockholder receiving it and sending in his proxy really does not know the extent of the grant and power that is given the attorney-in-fact named in the proxy.

I have at the moment specifically in mind an incident, proof of which was presented to this committee within the last two or three months, where the officers in control of the corporation had done certain acts during their year of administration and desired to get a blanket ratification of all of their acts from the stockholders. They sent out solicitations for proxies which in very general language contained a statement of that sort. The annual meeting or the special meeting of the stockholders that was called for the purpose of giving ratification to the acts of these officers, the only person attending the meeting was the representative of the officers who had all the proxies that had been turned in. No one else sought any proxies.

The result was that at this special meeting the officer of the corporation, the only stockholder present, voted nearly all the outstanding capital stock by virtue of these proxies in a resolution dictated by the officers who had done acts that well might have merited criticism, which was adopted ratifying those acts. And I venture to say that not a single one of the stockholders of that corporation who gave their proxies under those circumstances knew what acts they were going to be asked to ratify through the medium of the proxies that they gave.

Mr. UNTERMEYER. That abuse has existed from time immemorial, and it is an abuse by management, understand. This does not change it.

Mr. PECORA. It does to this extent, I believe, that this requires the management, or anyone—let us say the management—seeking proxies from fellow stockholders to state definitely what use they intend to make of the proxies, what purposes they have in mind to attain through the voting of the proxies; and when they do that, the moment they solicit proxies, it gives the right, this bill gives the right, to any other stockholder to go to the Federal Trade Commission, and by having access to the statement of purposes this Act requires the management to file, will be able to acquaint himself with those purposes and will in turn be thereby enabled to seek proxies from those same stockholders for the purpose of counteracting the aims and purposes of the management.

Mr. UNTERMYER. Mr. Pecora, you know and I know, from 50-odd years of practice of corporate law——

Mr. PECORA (interposing). Yours is an experience of 50 years. Mine is not.

Mr. UNTERMYER. Yes. Well, at any rate, we know the abuses of this proxy system. You are adding to them by this provision. If you want to provide that every proxy shall state the specific purposes for which it is to be used, you understand, and it shall not be used for any other purpose applicable to all proxies, that is one thing, and that is what they have not done. They have had blanket clauses in their proxies under which all the acts, all the illegal acts of the directors and officers, have been ratified, and when we have gone to the court we have met those ratifications and they have been very difficult to overcome. We have not been able to overcome them.

But those are offenses of the management. Now, this law does not require anything of the management in that direction.

Mr. PECORA. It requires it of every one seeking proxies.

Mr. UNTERMYER. No; it does not require anybody. The statement of the purposes—why, that does not mean anything, unless you provide that the proxies—if you are going to go into that subject and have the commission deal with it instead of letting the security owners deal with it, as they can deal with it if you do not embarrass them, why that is one thing. This embarrasses them. I know it embarrasses them, because I have represented so many and I have represented so many corporations on the other end of this thing.

Mr. PECORA. You know, Mr. Untermyer, from your vast fund of experience, that persons constituting the management of a corporation in a great many instances in reality are very, very small stockholders.

Mr. UNTERMYER. Yes.

Mr. PECORA. This bill would require them to say in the statement to be filed with the Federal Trade Commission as a condition to their soliciting proxies from fellow stockholders not only the purposes for which those proxies are being sought and are to be used, but also to specify their actual individual interest in the corporation and their relation to it.

Now, I venture to say that in the past many stockholders who have given their proxies upon solicitation to the management of a corporation had been led to believe that the management seeking those proxies were large stockholders, and hence through their stockholding interests of a substantial volume could be regarded as being imbued with a desire to promote the best interests of the corporation; whereas, if those stockholders had known of the very slight interest which in many cases the managers of corporations actually have through the ownership of stock, they might not have been persuaded so easily and readily to send in their proxies.

Mr. UNTERMYER. That is all right theoretically, but that is not the way it works out in practice. The way it works out in practice——

Mr. PECORA (interposing). We do not know how this will work out in practice because the practice has not been initiated.

Mr. UNTERMYER. Well, yes; I can see how it will work out in practice, because the managements would come in, they would marshall all the stockholders they can get, and they would come in and they would say, "We represent so many stockholders and we are making this application in behalf of so many." Have you gone over it yet with the phraseology of this thing?

Mr. PECORA. We have, sir.

Mr. UNTERMYER. It is a burden upon the minority stockholder.

Mr. PECORA. I think it makes the way open to every stockholder to be informed specifically the purposes for which his proxy is being solicited by any other stockholder, be the other stockholder connected with the management or merely acting as an individual.

Mr. UNTERMYER. Let us see if it does anything of the kind, Mr. Pecora. Let us see what page it is.

Mr. PECORA. Page 37 of the printed bill, H.R. 8720.

Mr. UNTERMYER (reading):

It shall be unlawful for any person, by the use of the mails, to permit the use of his name to solicit any proxy or consent or authorization with respect to any security registered on any national securities exchange unless (1) at such time prior to such solicitation as the Commission shall by rule or regulation prescribe the persons named to exercise such proxy, consent, or authorization shall file with the Commission a statement setting forth the purposes of the proxy, consent, or authorization

Now, then, that means you have got to tell your whole story in your circular.

Mr. PECORA. Isn't the stockholder entitled to that information when someone seeks his proxy?

Mr. UNTERMYER. Oh, they both ought to have to tell their story. The management should also tell its story.

Mr. PECORA. Neither one has to tell his story.

Mr. UNTERMYER. All the management says is "We are asking for a proxy to reelect our board." That is all. The man who is contesting, though, has got to show some reason why the board is not to be elected. He is the fellow who has got to make a disclosure, not the management. This does not impose anything upon the management.

Mr. PECORA. The management is required to conform to this section just as well as any other stockholder

Mr. UNTERMYER. Yes; but he is in control.

Mr. PECORA. And he wants to perpetuate or continue control

Mr. UNTERMYER. All this says is that he is asking for a proxy to reelect his board, that is all.

Mr. PECORA. Another stockholder desiring to bring about a defeat of that board may solicit proxies from the stockholders, from the other stockholders, and this would require him specifically to so state, and I think any stockholder is entitled as a matter of right, reason, and equity to know what uses are going to be made by anyone who solicits a proxy from him of that proxy.

Mr. UNTERMYER. He never gives a proxy against the management unless it is accompanied by a full explanation from a reputable committee.

Mr. PECORA. Then the explanation could be embodied in the statement.

Mr. UNTERMYER Now, but why should he? The management is going to send out a proxy. All they have got to do is to say that they want a proxy to reelect the board, and they want a proxy, if you please, to take care of all that has happened and have it all approved and ratified. That is all they say.

Mr. PECORA. He is trying to get proxies.

Mr. UNTERMYER. A man out of power has no chance of getting a proxy. Why should he apprise customers that he wants to go out with his proxies at the same time that the management goes out?

He does not want to go out after the management. Most stockholders just sign their proxies, anyway, and send them in. They do not even know there is a row on. Why not let these people alone? They have got their rights now.

Mr. PECORA. I think all stockholders should be put in a position where, if anyone solicits their proxies, they must inform the stockholders what use is intended to be made of them, what purposes are intended to be effectuated by the use of the proxies

Mr. UNTERMYER. See how that lines up.

Mr. PECORA. I think it would line up by making it possible for every stockholder to learn in advance of his giving a proxy what the proxy is sought for, whether the request for the proxy comes from the management group or whether it comes from a minority group who want to use the proxy. It enables every stockholder to act intelligently with regard to the giving of his proxy, instead of putting him in position where he gives his proxy through the process of signing a blank check.

Mr. UNTERMYER. He does not give a proxy blindly. He gives his proxy to a broker.

Mr. PECORA. Under this bill he would not.

Mr. UNTERMYER. Yes; he would.

Mr. PECORA. Brokers are prohibited from doing it now, under this bill, without the written consent of the actual owner of the stock.

Mr. UNTERMYER. Yes; but they always get it. This bill does not add anything. That is so now. He has got to get the written consent of his customer now.

Mr. PECORA. Under a rule or regulation of the exchange.

Mr. UNTERMYER. Yes; which I had passed. He has got to get written consent; and where a man has a lot of stock on margin there is not much question about his consent He consents to whatever he is told to do.

Mr. PECORA. There is nothing to prevent the stock exchange from repealing or modifying its rules and regulations tomorrow.

Mr. UNTERMYER. I am not discussing that. I am going to discuss that a little later. I think it ought to be a little more specific; but that is the regulation as it exists today. The broker has got to have the written consent of his customer, and he never fails to get it. He gets it when he makes a loan. He gets two consents: he gets one by which he pockets the interest. Instead of the customer getting it, the broker grabs that, and the customer does not get the interest, nor does the customer get a proxy, because it is sort of a blanket proxy. I want to get that changed by a word or two so that there will have to be a written consent in each case.

But coming back to this question of proxy, I think you are embarrassing the rights of the minority stockholders by the proxy provision in the present bill. May I have just another minute or two on this? There is a regular stereotyped form that comes from the management. It provides as a rule for ratifying everything that the directors and officers have done. Now, suppose a minority stockholder or a committee of stockholders wants to contest that. The present system is ample and has worked very well. He goes to the stockholders, if he can get a list of them—and sometimes he cannot, because of the hocus-pocus that exists—he gets a list of stock-

holders, and if he has a real grievance he has got to state his grievance in detail.

Mr. PECORA. He does now. Such a minority stockholder would have to state it now.

Mr. UNTERMYER. Yes; and he does state it in great detail.

Mr. PECORA. This bill would put him under no greater burden or obligation than exists now.

Mr. UNTERMYER. Yes; it would. He has got to show who is connected with him, who is associated with him, what other proxies he has got. He has got to uncover men who may not want to be uncovered in their fight for control——

Mr. PECORA. Not necessarily.

Mr. UNTERMYER. Yes. He has got to do it under this act. He has got to give all his cards away and the management sits by——

Mr. PECORA. Would he not have to do it anyway if he wanted successfully to combat the efforts of the management in the battle for proxies?

Mr. UNTERMYER. No; the man behind the scenes does not need to be disclosed; and if he thinks his financial life is of any value to him he generally does not disclose himself.

Mr. PECORA. You called attention to what you happily phrased as the present hocus-pocus that makes it sometimes impossible for a stockholder seeking to contest the continuation of a management group from getting a list of his fellow stockholders.

Mr. UNTERMYER. Yes.

Mr. PECORA. Under this bill, if the management group sought proxies in order to continue themselves in management and control as they always have, they would be required to file with the Federal Trade Commission a list of the names and addresses of the other stockholders whose proxies were solicited.

Mr. UNTERMYER. Where?

Mr. PECORA. With the Federal Trade Commission.

Mr. UNTERMYER. But where, in the bill? I do not see it.

Mr. PECORA. It provides for filing with the Commission a statement setting forth the purposes of the proxy, consent, or authorization, the persons to exercise it, their relations to and interest in the security, the names and addresses of the persons from whom similar proxies, consents, or authorizations are being solicited. Now management groups seeking proxies for the purpose of continuing their management or control would be required, under this bill, at the time they sought those proxies, to file with the Federal Trade Commission a statement which would include the names and addresses of the stockholders whose proxies were solicited, and that immediately makes that list available to any other stockholder who might seek to obtain proxies from stockholders in order to combat the management group.

Mr. UNTERMYER. But that list is available now, under the law. We need no law for that.

Mr. PECORA. You mentioned the hocus-pocus which has existed in the past and which has operated to prevent stockholders from getting access to such lists.

Mr. UNTERMYER. What I said was that these lists consist largely of brokerage houses who have long parted with the control of the stock that stands in their name, and if you get a list you get a list of

these brokerage houses which have nothing to do with the stock except that they have been getting proxies on stock that they had nothing to do with at all. You would get no further information under this bill than you can get now and which is available to you at the moment. Not the slightest. You are just requiring people who are contesting the control of corporations to bring themselves under the jurisdiction of the Federal Trade Commission and such regulations as it may pass. That is just embarrassing. It does not help you in the control or the management. It is something tending to make it more difficult.

Senator GORE. It seems to me that both sides of this issue have been presented, if I might be allowed to say go.

Senator MCADOO. I think we might be allowed to proceed with the next point, Mr. Chairman.

The CHAIRMAN. Yes.

Mr. UNTERMYER. I say that subdivision (b) of section 13 is a mere reenactment of the existing regulation of the stock exchange which requires a written authorization from the customer before his broker can give a proxy; and I suggest, if written authorization of the customer is required as to each proxy thus given, the words "specific authorization from such customer" be substituted for the blank authorization such as is now in use.

The CHAIRMAN. Where is that?

Mr. PECORA. Lines 12 to 18, page 38 [reading]:

> It shall be unlawful for any member of a national securities exchange,

And so forth—

> to give a proxy, consent, or authorization in respect of any security registered on a national securities exchange and carried for the account of a customer without specific written authorization from such customer

Mr. UNTERMYER. "As to each such proxy."

Some of the above suggestions were called by me to the attention of Mr. Pecora in a communication to him on March 2, from California, before the revised bill was introduced. I have no disposition to discuss, and I am sure that you have no time to listen to any discussion of the question of the constitutionality of this bill in its present form. You and your counsel have doubtless given that subject the consideration to which its importance entitles it. That question was fully discussed in a brief submitted to the Senate Banking Committee by my deceased partner, Mr. Louis Marshall, and myself in 1913, for the committee, and by the late John G. Milburn for the stock exchange, in which I contended that regulation of the exchange could be accomplished under the post-office section of the Constitution and through the telephone and telegraph systems.

Senator GORE. To what committee was that brief submitted?

Mr. UNTERMYER. That was submitted to Senator Owens' committee. There was grave doubt as to whether it would be possible to regulate stock exchange transactions as within the purview of interstate commerce; but subsequent decisions of the United States Supreme Court in the cases of *Stafford* v. *Wallace*, *Board of Trade* v. *Olsen and Tagg Brothers and Morehead* (280 U.S.) have to a considerable extent strengthened the argument that these transactions may be regarded as interstate commerce, although the question is not free from doubt. Regulation under the post-offices section has, how-

ever, always seem to me to be ample to insure the constitutionality of this legislation.

Addressing myself now to a friendly criticism of a more important provision of the bill, I beg respectfully to submit the following suggestions, which will be taken up in the order in which they appear in the bill:

On page 8, paragraph (13), and page 13, section 6 (a), the failure to include tax-exempt obligations of the States and political subdivisions among the exempted securities by specifying those of the United States Government——

Senator ADAMS. That has been done. This committee has already adopted an amendment of that kind.

Mr. PECORA. State and municipal bonds or bonds issued by any political subdivision.

Mr. UNTERMYER. I am very glad to hear that. It adds a great deal.

Senator MCADOO. That is already accomplished.

Mr. PECORA. After I received the letter from you that you were kind enough to send me last month, we discussed every suggestion of yours, and find that many of them have been adopted.

Mr. UNTERMYER. Some have not; and those are the ones that I am going to talk about.

Mr. PECORA. I mean, like the one you are now addressing yourself to.

Mr. UNTERMYER. I did not know that. It is not in the revised bill.

Mr. PECORA. No; it is not in printed form as yet.

Mr. UNTERMYER. That is very gratifying and it saves a lot of discussion. I felt that that would be a dangerous thing to do.

Senator MCADOO. It is not in the last print we received, Mr. Pecora.

Mr. PECORA. I beg your pardon, sir?

Senator MCADOO. That provision that we agreed on is not in the last print. It will be embodied subsequently.

Mr. PECORA. Yes.

Senator WAGNER. Is it not in the confidential print?

Senator ADAMS. No; that was adopted, Senator Wagner, when we were having a meeting over in the Capitol when we had the Chairman of the Federal Trade Commission present at a meeting of the committee. I think Mr. Pecora was not at that meeting.

Senator WAGNER. Do you also include securities of municipal agencies of one or more States?

Senator ADAMS. Yes; that is also included. That covers the port of New York.

Senator WAGNER. We have got to have a special provision for that.

Senator ADAMS. It is already in.

Senator WAGNER. We do not include it here. Using the words "political subdivision of a State" does not include the port authority, because that is an instrumentality of two States.

Senator ADAMS. That was specifically included in the amendment.

Senator WAGNER. I suggested that amendment; I remember that.

The CHAIRMAN. That was all threshed out over there.

Mr. UNTERMYER. In hurriedly going over this at about 1 o'clock this morning, I think I misread section 4 on page 10.

The CHAIRMAN. Section 4 refers to transactions on unregistered exchanges.

Mr. UNTERMYER. I am not sure about this, Mr. Pecora. I may be mistaken, and you may correct me if I am. As I say, I dictated this hurriedly. Section 4 makes it unlawful for any broker or dealer, directly or indirectly, to buy, sell, or deal in any security on an unregistered exchange under the all-embracing definition of the word "exchange" as described in section 3 (a) of the bill. That seems to me to be a handicap upon the marketing of a vast proportion of the corporate securities of the country. There are many hundreds, probably thousands, of high-class bonds and stocks of companies privately owned that have not been and are not desired by the owners to be distributed to such an extent as to entitle them to listing, but which the owners may from time to time desire to sell through brokers. Why should that rule limiting distribution be denied to the owners of these properties? This is especially true as to bond issues. It happens about daily, or almost daily, that the owner of a comparatively small but perfectly sound property or business may want to market bonds or sell stock. The natural agency for such a transaction would be a banking house or a brokerage house. This provision seems to prevent him from using the mails to that end, does it not?

Senator GOLDSBOROUGH. What page is that, Mr. Untermyer?

Mr. UNTERMYER. Page 10.

Senator ADAMS. Mr. Untermyer is reading from page 10, section 4, H.R. 8720, the printed revised draft.

The CHAIRMAN. A modification of that was suggested. We propose now to leave that to the Federal Trade Commission.

Mr. UNTERMYER. I do not think so, Mr. Chairman. You mean under this bill as printed?

The CHAIRMAN. I think we have suggested a modification of that.

Mr. UNTERMYER. I do not see why there should be any interference whatever.

Senator GOLDSBOROUGH. I have a copy of the new draft here, Mr. Untemyer [handing document to the witness].

Mr. UNTERMYER. I understand that you have stricken that out and substituted something else for that.

Senator ADAMS. The House has made a suggestion which is in this new print.

The CHAIRMAN. Your point is well taken. I think it has been corrected.

Mr. UNTERMYER. I think that covers the situation. We might pass that, then. That seems to prevent the disbarring of sales of bonds.

Section 6 (a) makes it unlawful for any member of a national securities exchange, or any broker or dealer who transacts business through such a member, directly or indirectly, to lend on any securities not listed on the exchange. This I regard as one of the most serious prohibitions in the bill, especially with regard to loans on gilt-edge bonds, mortgages, and similar collateral. It seems to me to be an unnecessary restriction in the wrong direction, the effect of which will be to destroy the market value of many of the highest classes of securities, such as stocks of banks, insurance companies,

and the like. If all unlisted securities are to be made unavailable as collateral, their marketability is wellnigh destroyed.

Has that been taken care of?

Mr. PECORA. It has; yes. The Commission is given the power, under the bill, to classify certain unlisted securities as exempt securities, taking them out of the operation of this prohibition. It has already been specifically done with regard to Government, State, and municipal bonds and bonds issued by any policial subdivision of a State or States or any agency or instrumentality of a political subdivision of a State or States.

Mr. UNTERMYER. Yes; but, Mr. Pecora, the question of whether or not they are going to be included rests with the Commission from day to day, and if it is uncertain whether they can be dealt in at all, there value is going to be affected.

Mr. PECORA. This prohibition does not run to banks making loans on such unlisted securities.

Mr. UNTERMYER. It did originally.

Mr. PECORA. The original draft was put out so long ago, and we have been working on so many different provisions, that I will not at this moment trust my recollection as to just what was in the original. I would rather charge my mind with what is now before us. But I think that has been taken care of. We had before us your letter at the time it was gone into.

The CHAIRMAN. That section has been modified.

Mr. PECORA. We gave most earnest consideration to it.

The CHAIRMAN. We have changed that entirely.

Mr. PECORA. I think you will find that that objection has been taken care of and met by revision.

The CHAIRMAN. The Federal Reserve Board now has charge of that matter.

Senator MCADOO. Are you talking about margin requirements?

Mr. UNTERMYER. No, sir.

Senator MCADOO. That is in this section.

Mr. UNTERMYER. But another subdivision.

Senator MCADOO. But that is the section that you are dealing with, is it not?

Mr. UNTERMYER. I am dealing with subsection (a).

Senator MCADOO. That is the 40-percent margin requirement?

Mr. UNTERMYER. No; that is not the one.

Senator MCADOO. That is subsection (a).

Mr. UNTERMYER. In other words, that prevents loans upon any collateral that is not listed—as it stood, I mean.

Mr. PECORA. By the broker only.

Mr. UNTERMYER. The broker makes a loan to his customer. He gets the money from the bank, but, after all, it is the broker's loan. He borrows it at a lesser rate as a rule because he adds his own responsibility But it is a broker's loan all the same. The banks never make loans on stock exchange collateral directly to the owner of the collateral. They make them to the broker and he carries the account and he goes to the bank.

Mr. PECORA. The broker is enabled to lend to his customer because he, in turn, gets credit from the bank.

Mr. UNTERMYER. But it is a loan from the broker to the customer.

Mr. PECORA. But if the bars as to unlisted collateral were to be thrown down entirely and these margin provisions are to be made effective and enforceable, a broker could very easily evade the purpose and intent of the act, or that portion of the act relating to margin requirements, by assigning an arbitrary value to unlisted securities whose market value is a matter always of considerable doubt and uncertainty.

Mr. UNTERMYER. But his broker would not take it.

Mr. PECORA. The broker might take it in order to enable him to evade the provisions of section 6.

Mr. UNTERMYER. There is one thing that a broker never does: He never knowingly takes inadequate collateral. He sometimes hooks it and converts it, but he does not take inadequate collateral.

Mr. PECORA. Brokers as a class are today opposing this bill because, among other things, of its margin requirements which they think are too high; so that that is some evidence of the fact that legal evasion, if such a term is proper, could be effected I think it would be effected by throwing down the bars now found in section 6 (a) against brokers making loans on unlisted collateral unless such unlisted collateral be in exempt securities. The bank is left free; and a bank always has better knowledge and information about security and about a customer.

Mr. UNTERMYER. Suppose my margin has declined and I have got a piece of property that is free and clear and that is worth a million dollars——

Mr. PECORA. Provision has been made, but has not yet been brought to public notice, covering such a situation.

Mr. UNTERMYER. Then I am only too pleased. But as it stands in this revised bill I do not think it is a good thing.

Senator ADAMS. As to this matter there are some amendments to cover. The committee has not been advised of them as yet.

Mr. PECORA. They will be brought to the committee's notice.

Mr. UNTERMYER. I do not think it ought to be in that form. I hope it has been changed. But you gentlemen have something else to do than to listen to me.

The CHAIRMAN. What suggestion would you make as to a change, Mr. Untermyer?

Mr. UNTERMYER. As to subdivision 6 (a)?

The CHAIRMAN. Yes.

Mr. UNTERMYER. I should make it "or on any nonregistered collateral approved by the Federal Reserve Board" or "unlisted collateral deemed sufficient by the Federal Reserve Board." I do not know whether you realize the burden you are putting upon the Federal Reserve Board. They will not be able to do any other business for many years.

Senator MCADOO. We may have to consider having a special commission to deal with this whole problem here, this and the securities act. We have not acted on that yet.

Senator KING. Mr. Chairman, I wanted to ask Mr. Untermyer a question. I hope that Mr. Untermyer, before he leaves the stand, and before he leaves the city, will have an opportunity to express his views, if he cares to, on this interdepartmental report, which sets up an independent committee or commission for the purpose of handling

all these questions, instead of leaving it with the Federal Trade Commission.

Mr. UNTERMYER. With representation of the stock exchanges on it? I am opposed to it. I do not know why they should have any representative on any board that is regulating them. It would be the first regulatory body I know of that had a representative on it from the interests that were being regulated.

Senator KING. That was not an essential in the bill.

Senator MCADOO. The committee might consider the point I suggested a moment ago, because the suggestion made during the discussions here is that an independent commission, not nominated by the stock exchange or anybody else, but appointed in the public interest, might be provided for, instead of conferring these powers upon the Federal Trade Commission or the Federal Reserve Board.

Mr. UNTERMYER. The Federal Reserve Board is the ideal agency, if it has the time, or if it could be enlarged, and have a couple of members added to it who would devote themselves to it, because it is a part of the financial business of the country.

Senator MCADOO. I do not say that the committee is going to adopt any such suggestion. I only mention the fact that the suggestion has been made to the committee, and it will be considered, of course.

Senator GORE. I introduced Senate bill 3234. It may not have come to your attention. It creates a board consisting of the Secretary of the Treasury and the Governor of the Federal Reserve Board as ex officio members, and three other commissioners to be nominated by the President, with the advice and consent of the Senate Your suggestion to add two members of the Federal Reserve Board would be just one less than the membership provided for in my proposal.

Senator MCADOO. That was Mr. Untermyer's suggestion.

Senator GORE. You probably have not seen that bill.

Mr. UNTERMYER. No; I have not.

Senator GORE. It is based upon the so-called "Dickinson report."

Mr. UNTERMYER. I do not favor the Dickinson report. I think that the Federal Reserve Board is the logical financial agency to take control of this situation, except as to the business end of it, and as to that I quite agree that the Federal Trade Commission is the right agency. In that respect I am in full accord with the bill.

Senator GORE. The bill I introduced follows, in a good many details, the bill submitted to the Pujo Committee by you.

Mr. UNTERMYER. I do not remember that.

Senator GORE. There was a bill included in their report.

Senator ADAMS. Mr. Chairman, may I suggest one inquiry? We have this confidential committee print. Have the parts in italics been adopted by the House committee or just submitted?

The CHAIRMAN. No; I do not think so. They have been trying to keep up with our hearings and they have suggested this printed form. The print shows the difference between the revised bill and the changes to be made in the revised bill. That is merely a matter to come before the committee for action.

Senator ADAMS. I was inquiring as to what action, if any, had been taken by the House committee.

The CHAIRMAN. They have not taken any action on it.

Mr. UNTERMYER. May we skip section 6 (a) on the theory that I will examine that and look at it?

Senator WAGNER. In my absence you have discussed the margin feature of it?

Mr. UNTERMYER. No. I am going to now.

Section 6 (b) is, of course, the most widely discussed and highly controversial provision of the bill. That is the marginal provision. It prescribes a rigid, uniform percentage basis of the extent to which listed securities may be made available for stock-exchange loans, regardless of the character of the collateral. It is immaterial whether the security for the loan be high-grade bonds or nondividend paying common stocks, which are subject to wide fluctuations.

The margin of security in all cases must be the same minimum. I submit, with all due respect, that this is a false basis for determining the margin of safety for a loan. A loan secured by a 10-percent margin in bonds of the State of New York, which are unlisted, at their market value, may be, and is, far less subject to fluctuation, and has a wider market, and is far more conservative than a 60-percent margin on any number of listed common stocks. Every collateral loan on listed securities necessarily depends for its safety upon the character of the securities in that loan. No hard and fast rule can be laid down that will not take from the all-around security of such loan. On this proposition, strange to say, I find myself in agreement with the stock-exchange authorities, that the marginal requirements as to each class of security should be left to the determination of the Federal Reserve Board. Those requirements will necessarily be shifting from day to day. The desire that prompts this drastic requirement is one with which everyone outside of the financial district will sympathize, but it does not accomplish that purpose. It seems to me that it is bound to reduce and restrict speculation, which we would all like to see, within reasonable limits. But I am not in favor of preventing it. If you had no speculation in the market, either for the rise or the fall; if you had no short or long accounts, the differences in quotations would be wide and the market would be very much restricted. So that I feel that you have to have a certain amount of speculation. You have to encourage a certain amount There has been the grossest, most excessive, dishonest speculation There is no doubt about that. But I hope that is not going to mislead this committee into making unwise provisions in this law.

It seems to me that it is bound to have the contrary effect of deflating the market value of the highest class of securities by placing them on a par with the most speculative ones as to their availability as collateral, which is far from the purpose you have in mind.

I am aware that this view is contrary to that which you have well-nigh agreed upon, or are said to have well-nigh agreed upon, but I feel that notwithstanding that fact I should register a protest against what seems to me an unsound and unreasonable method. It is bound to militate against the very highest classes of securities, and in favor of the most speculative class.

In this connection I have not lost sight of the provision of subdivision (d) of section 6, on page 17, of the bill, which gives to the Federal Reserve Board a certain discretionary power to permit accounts to be carried for a limited period under specified conditions on different margins, but the board will naturally be reluctant to allow such exemptions, and the banks will be equally reluctant to loan in these exceptional cases, in view of the declaration that the

specific marginal requirements are to be generally strictly adhered to, as the considered policy of Congress. If the law is passed in this form, it is reasonably certain that the requirements which are laid down will have to be followed in the making of most loans.

With all due respect, gentlemen, I think it is the wrong principle. As I have said, take a State bond of the State of New York. It has not fluctuated 2 points in price throughout all the depression.

Mr. PECORA. But, Mr. Untermyer, those bonds have been taken care of, as we indicated before, by putting them all in the exempt class.

Mr. UNTERMYER. I am only using using that as an illustration. Take certain first-mortgage railroad bonds——

Mr. PECORA. The Commission has the power, under the bill, to exempt those securities, too.

Mr. UNTERMYER. You mean the Federal Reserve Board has the power?

Mr. PECORA. The Federal Trade Commission.

Mr. UNTERMYER. That means that whenever a man has high-grade first-mortgage railroad bonds that are selling on a 4 or 4½-percent basis, before he can use them as collateral he has got to go to the Commission.

Mr. PECORA. It would also mean that the Commission itself would, in advance, make rules and regulations exempting securities of that class.

Mr. UNTERMYER. In the face of a declaration to the effect that it is the announced policy of Congress to adhere to this specific, rigid marginal requirement?

Mr. PECORA. That statement appears in connection with the powers given to the Federal Reserve Board over margins, but the power to exempt securities from the operation of the provisions of this bill is lodged in the Federal Trade Commission, and is a pretty broad power.

Mr. UNTERMYER. I am not speaking of the power to exempt them from the operation of the bill. I am speaking of the extent to which they are available as collateral.

Mr. PECORA. If they are made an exempt security, then they are not tied down by any of the restrictions of this bill as to their availability for purposes of collateral.

Mr. UNTERMYER. If that is so, it goes very far, but the principle is wrong all the same.

Senator MCADOO. You mean the fixing of any specific, rigid, marginal requirement by statute?

Mr. UNTERMYER. By statute; yes.

Senator ADAMS. If I get your theory, there may be securities which ought not to be exempted entirely from regulation, but as to which the margin requirements are too high.

Mr. UNTERMYER. There are so many thousands of securities on the list, and there are so many inactive securities that have, for 40 years, paid their interest, never defaulted, and there is no chance of it.

Senator COSTIGAN. Mr. Untermyer, what tests would you have the Federal Reserve Board apply in determining the appropriate margin requirement?

Mr. UNTERMYER. Its own judgment at the time, because times change.

Senator COSTIGAN. Would the objection be to prevent excessive speculation?

Mr. UNTERMYER. Yes.

Senator COSTIGAN. Or would there be some other?

Mr. UNTERMEYER. No. The objective would be, first, to make loans absolutely secure and to prevent excessive speculation. Take the active stocks on the market. The active stocks are those of these great corporations. Sometimes, in active times, they go up to half a million shares in a week. Some times they fluctuate 10 or 20 or 30 points in a week. A great many of them do not pay any dividends. A lot of them are not worth 40 percent of what they were worth, and the margins would be exhausted as to those. I think it is much better to leave that to a body that has its hand on the throttle.

Senator MCADOO. You mean to subject them to regulatory power by a competent authority, either the Federal Reserve Board, the Federal Trade Commission, or whatever body may be constituted for that purpose?

Mr. UNTERMYER. Yes. That would check speculation.

Senator GORE. Is it not one of the infirmities of this sort of regulatory measure, where you commit to the hands of an administrative official control over such a wide field of activities, that you have to reduce those activities to routine? They must largely be committed to the hands of subordinate officers and employees, and the activities you commit to those people must be reduced to routine. You cannot give them any wide discretion.

Mr. UNTERMYER. There is a great deal in what you say. As long as you are going to try to control and prevent excessive speculation, you have to give the power to somebody. As soon as you start on a policy of a rigid marginal requirement and try to look into the future, with all its possibilities, you are going to break your neck before you get through.

Senator GORE. Montesquieu said that excessively good laws produce excessive mischief. I sometimes think there is a grain of truth in that.

Mr. UNTERMYER. When you try to be too specific.

Senator MCADOO. You are talking a lot about excessive speculation, which we want to restrain, and, of course, that is one of the objectives of this bill. What is troubling me a great deal about it is how you are going to define or determine what is excessive speculation. Have you any formula for it?

Mr. UNTERMYER. Nobody has a formula.

Senator MCADOO. Exactly. How are you going to interpret it?

Mr. UNTERMYER. But when the time comes we will have a formula. That is the function of the Federal Reserve Board, to determine when there is excessive speculation, when too much of the funds of the country are being directed toward Wall Street and the security markets. In 1929 everybody who had any sense at all knew that there was wild and excessive speculation. Every fellow who knew what he was about got out from under.

Senator MCADOO. Do you think that can be controlled effectively merely through the marginal requirements on loans?

Mr. UNTERMYER. That is one feature. That is a pretty good check.

Senator MCADOO. How are you going to reach those vast amounts of private and corporate funds which are lendable in the market at

all times? You might restrain the banks, but one of the things that is troubling me is how you are going to reach those vast amounts of money that come into the market that are not subject to governmental jurisdiction.

Mr. UNTERMYER. That never comes in unless there is excessive speculation, because the rate does not attract it.

Senator MCADOO. How are you going to control it?

Mr. UNTERMYER. You are going as far as you can. You cannot control everything.

Senator MCADOO. We think we can.

Senator GORE. It seems to me that is the only point in favor of this specified margin.

Mr. UNTERMYER. But it will do untold harm.

Senator GORE. In 1929 could not the Federal Reserve Board, by raising the rediscount rate, probably have put some check or brake on the runaway market?

Mr. UNTERMYER. No. People would pay anything for money then. They did not care what they paid for money.

Senator GORE. I think you are right about that. It was just a stampede.

Senator MCADOO. The trouble about the rediscount rate, Senator Gore, is that many people are not touched by the rediscount rate. If you have ample resources without rediscounting in the bank, it is immaterial what the rediscount rate may be, and those who have funds that are not subject to regulation, as the banks are, are not affected by it one way or the other. But I do think that a provision which we put in the banking act last year, which gives the Federal Reserve Board, so far as banks are concerned, the right to increase the reserve requirements of the banks above the legal limit, is the most effective check that can be put upon it.

Mr. UNTERMYER. If I were drafting this legislation, and I felt that Congress had the power, I would not let these corporations put their money in Wall Street.

Senator MCADOO. How could you stop that?

Mr. PECORA. This bill contains a restriction along those lines.

Mr. UNTERMYER. There ought to be some restriction. They can put it in their banks. The banks got together in the biggest monopoly we have today, the Clearing House Association, and said, "We will not pay any interest. We collect interest, but we will not pay any." I tried to get the Clearing House Association regulated, just as I did the stock exchange, by a bill that is attached to the Pujo report. It needs it just as badly.

Mr. PECORA. I recall the effort you made before the New York State Legislature.

Mr. UNTERMYER. I tried there again, but I just did not get anywhere.

Senator ADAMS. In the matter of paying interest, you know there was a bill which went out of this committee and through Congress, which played right into the hands of this banking control by forbidding the payment of interest. That was done by a bill that went through this committee.

Mr. UNTERMYER. I wonder why.

Senator ADAMS. I wonder why myself.

Mr. UNTERMYER. They are drawing interest. They are lending it out at interest. Why should they not pay interest. I remember when they paid as much as 3 percent.

Senator MCADOO. There are a good many reasons for it, which I have not time to present to the committee here. I do not think it is altogether germane, but if you will take the record of the hearings you will get the explanation of it.

Mr. UNTERMYER. I have yet to learn it.

The CHAIRMAN. Let us go on.

Mr. UNTERMYER. Let us go on with this business. The subject is so vast——

Senator WAGNER. Your final recommendation is to fix no limitations, but leave it to the Federal Reserve Board?

Mr. UNTERMYER. Yes. That is the one respect in which I agree with this document.

The CHAIRMAN. Proceed.

Senator WAGNER. I think you forget that I introduced that bill to which you referred in the State Legislature of New York.

Mr. UNTERMYER. I know you did.

Senator WAGNER. That was a good while ago. We tried then.

Mr. UNTERMYER. Yes; we tried, but the powers that be were too strong for us.

In subsection (e) of section 6, beginning on page 17, there is an exemption of a loan to a dealer to aid in the financing of the distribution of securities to customers not through the medium of an exchange. That seems to me unjust, in that it discriminates in favor of new and untried securities as against those that have been tested in the security market. There is greater danger in such loans, and more care should be required in the fixing of margins with respect to such securities than with respect to those that have undergone test on a free market.

I would like to know why that exemption has been made. I can not quite see that. That is just in order to assist in the distribution of securities, is it not? We will have something to say about that in a few minutes, if you have the patience to listen. They do not need any more encouragement in the distribution of securities. In fact, they have too much encouragement now. I do not see why they should be taken out from this bill.

Senator MCADOO. Excuse me a moment. How long are you going to be here? I have to leave.

Mr. UNTERMYER. I do not know how long these gentlemen will have the patience to listen to me.

Senator MCADOO. How long do you expect to be in town?

Mr. UNTERMYER. I wanted to take the 5 o'clock train.

Senator GORE. Mr. Chairman, I shall have to leave to go on the floor of the Senate. There is a matter coming up in which I am greatly interested.

The CHAIRMAN. We will proceed for a little while, and then, I think, when we adjourn we will meet in the Military Affairs Committee room in the Capitol.

Mr. UNTERMYER. I must say that I cannot see the reason for that exemption.

The CHAIRMAN. Let us finish the main statement, if we can.

Mr. UNTERMYER. Shall we pass on?

The CHAIRMAN. I think so.

Mr. UNTERMYER. That is section 6 (e). I do not think there should be any exemption in favor of new securities against those that have been tried.

The CHAIRMAN. We will note that.

Mr. UNTERMYER. Section 6 (f) reads:

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.

And so forth.

Mr. Pecora, I think somebody must have put this over on you. Let us see if he did not.

Mr. PECORA. If anyone has, I would like to have the hoodwink removed from my eyes.

Mr. UNTERMYER (reading):

any loan, renewal, or extension thereof made on any security or securities prior to the enactment of this act

They are exempted from the effect of the bill for almost 5 years, until January 31, 1939. That would seem to exclude from the operation of the bill the many hundreds of millions of loans now outstanding on securities of pools and syndicates held in the banks. Some of them have already been carried along for years I regard this as a distinctly vicious exemption. It means that the banks may be cluttered up for another 5 years with this vast amount of unmarketable securities on which the margins have been exhausted or impaired, instead of forcing the banks either to demand additional collateral from the underwriter, as required by the bill, or to liquidate the loans within one year, which is ample time for the purpose, and thus release for commercial purposes the funds of the bank that are thus tied up in these loans.

Of course, all of us who live in the financial district, or who have lived in the financial district and had to do with it, know that in the great boom, up to 1933, they just ground out pools and syndicates. You have dealt with some of them yourself.

The CHAIRMAN. Some 250 of them, I think.

Mr. UNTERMYER. That does not cover all of them by any means.

Mr. PECORA. I have not dealt with any pool. I have merely brought evidence to the committee of pools.

Mr. UNTERMYER. You have dealt with them very effectively, in my opinion; and I am very much gratified to see it. There is no reason for tieing those unliquid loans up for 5 years.

Mr. PECORA. May I explain the reason for it?

Mr. UNTERMYER. Certainly.

Mr. PECORA. Considerable argument was heard by the committee with regard to the original provisions of subsection (f), section 6, the argument being, in substance, that were the bill to remain in its original form with regard to this provision it would require or compel a liquidation of all existing margin accounts where the margins were less than those fixed by this bill, by the time the bill went into effect, and that that would have a decidedly injurious deflationary effect.

Mr. UNTERMYER. That is true, too.

Mr. PECORA. This modification was made in order to meet that objection or criticism, which did seem to be reasonable. The condi-

tion to which you refer, of banks being loaded up for some time with securities pledged with them by pools and syndicate accounts, is still within the control of the banks. There is nothing in this bill to prevent a bank from selling out or from liquidating any such loan accounts, or requiring the furnishing of additional collateral.

Mr. UNTERMYER. Except that they themselves are in it up to their necks.

Mr. PECORA. The banks may further be required to do it through the operation of the examiners, whether State or Federal. Their pressure is of no inconsiderable quality in such a situation, as you know.

Mr. UNTERMYER. But I do not see why, Mr. Pecora, 1 year is not ample time for them to call on the underwriters either to increase their margins, if they want to carry these unliquid loans indefinitely, or take them up. But why should there be 5 years allowed for it? That just excludes them from the operation of this bill and puts them in a favored class.

Mr. PECORA. There was no desire to do anything but afford a period of time for the liquidation of existing margin accounts that would enable such liquidation to be effected without producing any deflationary effects on the market.

Mr. UNTERMYER. I am sure that is so, so far as you are concerned. I know something about the inside of some of these loans. They are as rotten as they can be. They have not got any margin, and the banks themselves are interested in them.

The CHAIRMAN. Why not compel them to close out right now?

Mr. UNTERMYER. Not now. I suggested 1 year.

Mr. PECORA. The only question was whether the 5-year period was too long.

Mr. UNTERMYER. I think there ought to be 1 year, at least. But in the meantime they can call on their underwriters to take up these loans or to give them liquid collateral. This collateral is dead. A lot of it is upon ventures that could not come through because they were caught. A good deal of it is based upon most exaggerated values.

Mr. PECORA. The hope is that the banks will be prodded into taking proper and appropriate action with regard to furnishing additional collateral in those instances, through the examiners.

Mr. UNTERMYER. The way to do it is to give them a year in which to do it. Then they will find a way. But do not give them 5 years. Let me say this: I was somewhat concerned with the Federal Reserve bill which was the outgrowth of the Pujo investigation. We got all sorts of legislation, to do away with interlocking directorates, and a great many other things, but we gave them too much time, and they came down here, and the Federal Reserve Act today, as compared with what it was, is not a recognizable thing. It was lacerated to death. If you give these people 5 years, before you get through they will get 15 years. You will have a change of administration, and you will get them in the saddle. We have just now a people's government. We have had a high-finance government for a good many years. They run the country, with all due respect to some of the Republican members of this committee, and if you let them have 5 years for this thing, the banks will continue to carry them. There is no reason for it. If, at the end of 1 year,

they can show some good reason, let them come to Congress and show it. I would not give the many more than 1 year.

Mr. PECORA. I might say that Mr. Redmond, who attended the meetings of this committee on behalf of the New York Stock Exchange, made the argument on this 5-year provision, that it would not do a customer any good anyway. I do not agree with his argument, but I am merely showing you the diversity of opinion.

Mr. UNTERMYER. It would not with a bank that was independent, but it would with a bank that was not—and most of them are.

The CHAIRMAN. The committee will stand in recess until 2 o'clock, at which time we will meet in the Military Affairs Committee room in the Capitol.

(Whereupon, at 12:30 p.m., Thursday, Apr. 5, 1934, a recess was taken until 2 p.m. of the same day.)

AFTERNOON SESSION

The committee resumed its session at the expiration of the recess.

STATEMENT OF SAMUEL UNTERMYER—Resumed

Mr. UNTERMYER Before I go on with this résumé of comments upon the revised bill, may I make a suggestion, Mr. Chairman?

The CHAIRMAN. We would be glad to have it.

Mr. UNTERMYER It is in connection with section 6 as to the rigid margin requirements and the substitution of the Federal Reserve Board. I know how busy the Board is, and my suggestion would be that the Board be increased by three members. I speak of the Federal Reserve Board because it is more properly delegated, to my mind, with power to pass upon these questions of margin requirements. My suggestion is that there should be an addition of three members to the Federal Reserve Board and that the President assign three members of that board to that part of the administration of the act with which they would be concerned under the bill, so as to give proper attention to that subject.

I know there is a good deal of difference of opinion as to the Federal Reserve Board, and that a great many people think that they are rather closely allied to high finance, which may or may not be true; but that would not be true of the new members appointed by the President. I do not say it is true of the present board. That would avoid any such suspicion in the public mind, and it would do away with what I regard as a very dangerous provision in this bill in endeavoring to fix margin requirements by act and to have a sort of uniform percentage of security values regardless of the character of the securities in the loans. As I said before, a loan on one class of securities is better secured at 30 percent than another would be at 70 percent, because one is upon purely speculative securities and the other is upon stable securities.

The CHAIRMAN. We will consider that suggestion.

Mr. PECORA In other words, you feel, Mr. Untermyer, that if section 6 is to be modified so as to give to the Federal Reserve Board discretionary power over margin requirements instead of fixing indefinite limitations upon margin requirements in the bill, the Federal Reserve Board should be increased by three members to be ap-

pointed by the President, and that the President shall also be empowered to create a division of not less than three members from among the personnel of the Federal Reserve Board, with the special duty of administering the functions placed upon the Federal Reserve Board by this act?

Mr. UNTERMYER. Yes; that accurately sets forth my suggestion.

I refer now to section 7 (a) of the bill which I regard as one of the most novel and important and, I think, the most questionable revolutionary requirements of the bill. It prohibits any member of an exchange or any broker or dealer from borrowing on stock exchange collateral except from or through a member bank of the Federal Reserve System, subject to the power of the Federal Reserve Board to allow such loans to be negotiated in localities where there are no member banks to meet emergency needs.

Do I correctly understand that that has been changed so that State banks or institutions may be appealed to for these loans, or that it still rests with the Federal Reserve banks?

The CHAIRMAN. I think we modified that so as to allow leeway there for using other banks.

Mr. UNTERMYER. Why should not that be in the bill? Why should the bill be limited to Federal Reserve banks for the purpose of loans and the other be a mere matter of discretion? There must be some good reason, which I have been unable to visualize, why State banks and trust companies have thus been excluded from lending on securities listed on the stock exchange. There is no question that this drastic restriction will lessen speculation; but it will, on the other hand, create an exclusive haven in the Federal Reserve System of stock-exchange transactions and will affect the marketability of all listed securities, besides increasing the interest rate on stock-exchange loans and discriminate against the legitimate business of State institutions.

Take, for instance, the present situation in the city of New York where the bulk of these loans are made. The Clearing House Association, which is a rock-ribbed monopoly consisting of Federal Reserve banks, and State banks, and State trust companies and institutions—not all of them, but some of them have managed to do as they pleased with the borrowing public. If you are going to restrict borrowing through a certain clique or section, even of that association, you are going to let them charge any interest rate they choose and make loans or not make them as their own interests may require, and do a variety of other things that have brought discredit upon the whole financial system. I do not know whether you are familiar with the latest performance of the Clearing House Association in New York in connection with the Harriman Bank or not. Are you?

The CHAIRMAN. We have had some information about it.

Mr. UNTERMYER. It is a shocking situation.

Mr. PECORA. It is on the program to present some evidence about that, in detail, to the committee.

Mr. UNTERMYER. I hope so; the country is sadly in need of it.

Senator KEAN. The way this thing works in the clearing house is like this, that today I may have a credit of $8,000,000, and therefore I call so many brokers' loans. Tomorrow I may be debited at the clearing house $10,000,000. In one case I loan the money

out; in the other case I call it back. That is about the system that the banks use, is it not, in New York?

Mr. UNTERMYER. Except where they are dominated by private selfish interests.

In the case of the Harriman Bank, the bank was in temporary trouble, as many other banks were. It was a member of the Clearing House Association. They were going to be thrown into insolvency; and being a clearing-house bank, that might have precipitated a run on other clearing-house banks. So, to protect themselves, they said to the Comptroller of the Currency, "We guarantee the payment of depositors if you will put our man in as president." And they put in Mr. Cooper, of the Guaranty Trust Co., which was an influential institution in the Clearing House Association. They put him in as president, but the thing did not work out very well, and they had to go into insolvency. The Comptroller of the Currency, upon like representation that they were going to make good every obligation and take care of the depositors, appointed this same Mr. Cooper as the conservator.

Mr. PECORA. I think Mr. Cooper had been connected with the Manufacturers' Trust Co. and not the Guaranty.

Mr. UNTERMYER. No; I think it was the Guaranty. I do not think it was the Manufacturers' Trust. At any rate, what happened was this——

The CHAIRMAN. That whole business was investigated by the Judiciary Committee.

Mr. UNTERMYER. Not very much, Mr. Chairman. At any rate, they repudiated that obligation and are now being sued upon it. They claim that their own executive committee did not have the power to commit them to the obligation on the faith of which the Comptroller of the Currency put them in control. What are you going to expect of institutions that deal with the Government in that way?

Mr. PECORA. Dealing with section 7 and your comment upon it, you undoubtedly notice that the prohibition there is upon a loan to a broker or dealer who is a member of a national securities exchange; and in order to enable the Federal Reserve Board the more effectively to have control of bank credit for stock-market purposes, it was deemed advisable to put in the restriction that you have called attention to. I am merely stating that as the purpose.

Mr. UNTERMYER. Yes; I understand. But I do not think the reason is at all persuasive. Take the rest of the country, where there are perhaps some communities in which there are only two banks. One may be a Federal Reserve bank and the other a State institution. Are you going to take all the business away from the State institution, the business of loaning on securities, and give it all to the Federal Reserve bank? If you want to destroy State banking and want to drive all such institutions into the Federal Reserve System, that might be a way of doing it. That probably will be the most efficient way of doing it.

Mr. PECORA. That was another thing that was in our minds.

Mr. UNTERMYER. I can conceive of its being done for that reason. If that is the reason I will have no more to say. But I believe that State institutions really ought to be preserved.

The CHAIRMAN. One thought is that the Federal Reserve Board has some sort of supervision over Federal Reserve banks and member banks of the system, but they have not over State banks.

Mr. UNTERMYER. I know; but that is no reason why a man should not be able to go to a State bank and borrow money on listed securities.

Mr. PECORA. An ordinary borrower can. This bill only prohibits a broker from so doing.

Mr. UNTERMYER. Yes; but that is no reason why a broker should not be permitted to do so, because he is acting for a customer; he is not acting for himself.

Mr. PECORA. Then this might be, as you suggested, a persuasive force to induce State banks to come under the Federal Reserve System.

Mr. UNTERMYER. Yes.

Mr. PECORA. And help to bring about a unified banking system.

Mr. UNTERMYER. And it might be a blunderbuss.

Senator CAREY. What page is that?

Mr. PECORA. Subdivision (a), page 19, of the first revised bill.

The CHAIRMAN. It is page 30 in the other print.

Senator KEAN. Suppose a broker has been in business for many years and has accumulated quite a fortune, say, $100,000 or $150,000. This would prevent his using his capital or borrowing any money from a bank at all, would it not, outside of a Federal Reserve bank?

Mr. UNTERMYER. He could not borrow on this collateral, but I do not believe there would be anything to prevent him from personally lending money to a customer.

Senator KEAN. But if someone came in and wanted to borrow, he could not do it——

Mr. UNTERMYER. I think it is a little too rigid.

Senator CAREY. This would exclude borrowing from any bank but a Federal Reserve bank, would it not?

Mr. UNTERMYER. Yes; and why?

Senator CAREY. He could not borrow from a private bank?

Mr. UNTERMYER. No; a broker could not who is a member of the exchange when he is borrowing on stock-exchange collateral; and he cannot borrow on any other collateral. That is another thing.

Mr. PECORA. Unless it is exempted.

Mr. UNTERMYER. Yes; but the great body of securities are not exempted and are not going to be.

Senator GOLDSBOROUGH. It permits borrowing from a State bank which is a member of the Federal Reserve System?

The CHAIRMAN. Yes; any member bank.

Mr. UNTERMYER. Yes; but a State bank might have a good reason for not being a member of the Federal Reserve System.

Senator CAREY. He could not borrow from an individual either?

Mr. UNTERMYER. No, sir. Subdivisions (c), (d), and (e), section 7, relating to the hypothecation by exchange members of securities carried for customers' accounts, are similar to those prescribed by the New York State law, and now in practice on the stock exchange. Experience has proven that they do not accomplish their purpose.

Subdivision (c) prohibits the commingling of a customer's securities with those of any person other than a customer.

Subdivision (d) prohibits the commingling of such securities of one person with those of another person without the written consent of the customer, while subdivision (e) forbids the lending of pledged securities without his consent. While subdivision (d)—will you take note of this, Mr. Pecora?—requires written consent, subdivision (e) rather significantly provides only for consent. But I imagine this is an oversight. Did you notice that?

Mr. PECORA. Yes, sir.

Mr. UNTERMYER. Neither of these safeguards has proven effective. The customer is always required to sign an omnibus consent. The consent required should be specific written consent that the broker is permitted to commingle the securities. The customer has not heretofore profited by or received any of the fees that come to the broker from the lending on any such securities and which have heretofore constituted a large part of the revenue of the broker. A real safeguard to the customer concerning the hypothecation of his securities and one that I have suggested to the stock exchange would be a provision requiring that on the outside of the so-called "loan" envelope—I suppose you know that the broker hands in a loan envelope to his bank and on the outside he lists the securities—on the outside of the so-called "loan" envelope containing the securities delivered to the lending bank the broker should be required to list the amounts for which he holds the several securities, and that the bank be prohibited from lending or holding securities for a sum on a basis in excess of that amount.

Mr. PECORA. Mr. Untermyer, we have had it in mind, and this is a method that might meet your comment, to change subdivision (d) in section 7—this is a new draft which you have not got before you—so it will make it unlawful for any member of a national securities exchange or a broker or dealer through the medium of any such practice directly or indirectly to hypothecate or arrange for the hypothecation of securities carried for customer's account under circumstances that will permit such securities to be commingled with the securities of any person other than a bona-fide customer or that will permit such securities to be hypothecated for or subjected to any lien or claim of the pledgee for a sum in excess of the aggregate in debtedness of such customers in respect of such securities.

Mr. UNTERMYER. That is all right, except that that would prohibit a bank from making such a loan——

Mr. PECORA. The broker is prohibited from making any such loan. That would operate on any lender, too.

Mr. UNTERMYER. If you will add to that that on the back of the loan envelop the amount for which the broker holds such securities should be noted and that the bank should not lend in excess of that amount, it would be better.

Mr. PECORA. We have sought to effectuate the principle you have in mind by this proposed modification that I have just read to you.

Mr. UNTERMYER. In all the many failures of brokerage houses of which I know it has been found that the broker has borrowed on the securities of his customer in excess of the sum owed, and the customers have either had to pay an excess over the sum owed the bank or lost all their securities. Tens of millions of dollars have been lost in that way. There is no occasion for continuing that abuse.

It is a very simple matter to limit the amount that a broker may borrow to the sum owing him by the means above outlined.

Mr. PECORA. In this proposed modification we have also modified, or we propose to modify, subsection (e) so it would require the written consent of the customer.

Mr. UNTERMYER. As to each security?

Mr. PECORA. Yes. In other words, it would then read:

To lend or arrange for the lending of any securities carried for the account of any customer without the written consent of such customer

Mr. UNTERMYER (reading):

Without the specific written consent of such customer as to each security

Mr. PECORA. Yes.

Mr. UNTERMYER. Section 8, entitled "Prohibition against manipulation of security prices", is a virtual reenactment of existing laws of the State of New York and other States covering that subject. Except as hereinafter specified, they have never been sufficient to prevent manipulation and are not now adequate. There is constant syndicate manipulation by banking houses in marketing new securities. Subdivision (8) on pages 23 and 24, which authorizes the Commission to permit "pegging, fixing, or stabilizing the price of such property", which I assume is intended to permit of the distribution of new securities by syndicates, makes possible the continuation of this vicious form of manipulation. The operations of Lee, Higginson & Co. in the Kreuger & Toll International Match case fairly illustrate that method of distribution. Whilst they and their associate issuing houses were scattering their worthless securities broadcast over the country with the aid of many hundreds of high-pressure salesmen, they were pegging and lifting the prices of the securities on the exchanges through washing operations and creating an artificial appearance of activity to induce investors to buy the worthless stuff at around par. As soon as they had marketed the securities, the artificial pegs were pulled from under the market and the securities finally dropped to about 5 percent of the price at which they were sold to hundreds of thousands of victims who were led to believe that they were buying a high-grade, 5-percent investment bond vouched for by the most impressive list of great banking houses in the country. Such tactics are not necessary. They should be made impossible. Why that method of distributing securities should be encouraged with the concurrence of the Commission, as this bill provides, instead of being made a criminal offense, is a mystery to me.

Mr. PECORA. May I explain something about that?

Mr. UNTERMYER. Yes.

Mr. PECORA. When the original draft of the bill was before the House and Senate committees at public hearings there was considerable argument advanced to the committees by opponents of the bill with regard to this provision. It was pointed out that the Government in recent times, particularly, has resorted to stabilizing or pegging processes to stabilize the market in the issuance and distribution of Government securities, and the point was made that that proved that there is some benefit to the public in certain kinds of pegging processes or stabilizing processes. It was in deference to that argument, based upon the example of governmental activities, that this clause was written. You notice that it leaves it entirely

within the discretion of the Federal Trade Commission to say what kind of pegging or stabilizing operations may be permitted as deemed to be in the public interest.

Mr. UNTERMYER. Yes; but now we know what they will do, and they will do the most vicious thing. They have been doing it. Pegging is nothing but manipulation.

Mr. PECORA. Yes; there is no question about that.

Mr. UNTERMYER. What the syndicate banking house does is this. It has, for instance, a hundred million dollars of bonds or stock to dispose of, and it makes daily transactions—one set of brokers to sell and another set of brokers to buy. At the end of the day they generally have no more than they had at the beginning. Sometimes they have and sometimes they have not. But I do not see any difference between that kind of manipulation and others. They justify it on the ground that that is the only way in which they can distribute securities. But that is not true. That is not the British system at all. The British system, which we ought to have in our country, just as we ought to have had the British Securities Act, as I urged upon these gentlemen, instead of this hodge-podge we have got here now—under the British system a prospectus, which is pretty rigid, is published. The British public is educated to buying securities on the basis of the prospectus. The prospectus is offered for subscription, and generally the subscriptions open at 10 o'clock in the morning and close at the end of the day, and the stock that is not subscribed is turned over to the underwriters where it belongs, instead of being foisted upon the public through these deceptive methods.

I do not believe that pegging, which is manipulation, should be encouraged at all. Because the big fellow can get away with it, why punish the small fellow for doing it?

Mr. PECORA. Your criticism is not that it is too drastic but that it is too liberal?

Mr. UNTERMYER. My criticism of the bill is that it should not be allowed.

Senator KEAN. Do you think it should be stopped as to United States bonds?

Mr. UNTERMYER. I do not think we should disturb that. There is not much of that done.

Senator KEAN. Oh, there is a great deal of it just now.

Mr. PECORA. I made the point at a prior hearing, with reference to that, that if the Government does it, it does it for the public interest. When anybody else resorts to it, they do it for their own private interests.

Mr. UNTERMYER. They do it to unload them on the public. What happens is that when they have, through their supersalesmen, marketed these securities, they withdraw the peg and you are stuck and the stuff goes to its own level. It is all wrong.

Senator KEAN. It is bound to go to its own level.

Mr. UNTERMYER. The point they make—and I have discussed it with them—is that the difference between pegging by a high-brow bank and pegging by a low-brow banking house is that one is manipulation and the other is not.

I am pretty nearly through, gentlemen. Your patience will not be required much longer.

I will discuss next section 10 (e) with respect to specialists. These provisions should, in my judgment, be more drastic than those prescribed in section 10, subsection (e). It is an acute and long-standing evil.

No dealer or broker and no firm of which a dealer or broker is a member that registers as a specialist should be permitted, directly or indirectly, under any circumstances, to buy, sell, or deal in for his own account or for his firm any security in which he acts as a specialist. But I see no reason for restricting his dealings as a broker in other securities. That seems to me a sane and reasonable solution of the specialist proposition. He is a specialist every morning he gets from the other brokers their buying and their selling orders. He knows just how much stock he has got to buy and how much he has got to sell, and he has no right to deal in that security for his own account. In point of fact, they have made great fortunes by that corrupt method of dealing. I am not in favor of excluding the specialist from being a broker in anything except securities in which he is a specialist, because in normal times there is not enough business for a specialist purely as a specialist, and as long as he confines himself to other securities and does not try to be both a broker and a purchaser in the security it is all right.

Mr. PECORA. The original draft of the bill, as you probably will recall, provided for a complete segregation of the functions of broker and dealer, and would not have permitted any member of an exchange to trade for his own account. He could only be a broker.

Mr. UNTERMYER. That is the British system.

Mr. PECORA. Yes. That evoked very considerable opposition on the part of the exchanges all over the country. That is, perhaps, next to section 6, the section which has become the most controversial section of this bill. Special study was given to that particular question. We went to the floor of the stock exchange within the last 2 or 3 weeks. We were given the privilege of the floor, but not to trade—to observe and see and study—and we devoted a considerable part of 2 hours to the operations of the specialist.

The claim has been made that when the market is not active, if a specialist is deprived of the right to buy and sell for his own account you would have a much larger spread between the bid and asked prices of a given security, and that is to the detriment of the investor. We studied that and gave it very considerable attention and it seemed that there was some merit to that criticism.

Mr. UNTERMYER. I do not think so.

Mr. PECORA. The specialist argues that when the market is inactive he is under no inducement to make a market and keep the price range close or narrow, merely because he is enabled to execute orders on commission; that the only incentive to him to make a fair and orderly market with narrow quotations would be to trade for his own account, and that would be the only way in which he could make a narrow market or a fair and orderly market. With that in mind we thought that whatever benefits actually might accrue from the exercise by the specialist-broker of the right to trade for his own account could be preserved and the evils that you have called attention to could be eliminated by the adoption of rules and regulations by the Federal Trade Commission which would prescribe the extent to which a specialist-broker could trade for his own

account. That is what we have sought to do by the present provisions of section 10.

Mr. UNTERMYER. I do not think that that is nearly as simple or effective a way as to say to the specialist, "You cannot be a broker to sell other people's securities, or to buy securities for other people, and at the same time deal in your own securities." It might create a little wider divergence in an inactive market, but that is inevitable to honest dealing, because this is a falsely stimulated market for the benefit of the man who holds the cards on both sides.

Mr. PECORA. We appreciate the advantage to the specialist in holding those cards. He is playing the cards with the knowledge of what is in the hands of the public.

Mr. UNTERMYER. I should say so. He is just playing with marked cards.

Mr. PECORA. But we thought we might be able to preserve whatever benefits may actually accrue to the public from a close and narrow market that would flow from the exercise by the specialist of the right to trade for his own account, if we confined the extent of that trading to such limits as appear to be, in the discretion of the Federal Trade Commission, in the public interest.

Mr. UNTERMYER. You cannot control that.

Senator KEAN. Mr. Untermyer, do you not realize that on the stock exchange in one department there is a very large number of listed securities that are very inactive?

Mr. UNTERMYER. Yes.

Senator KEAN. And if these brokers did not make a market, it would make a very wide difference—I mean to say, a difference of 25 or 30 percent.

Mr. UNTERMYER. No.

Senator KEAN. Yes.

Mr. UNTERMYER. In the first place, you do not have specialists in those securities.

Senator KEAN. Excuse me, sir. You do.

Mr. UNTERMYER. Almost all the securities of which I know——

Senator KEAN. Are active.

Mr. UNTERMYER. They are sufficiently active for a man to devote all his time to them as a specialist?

Senator KEAN. Yes.

Mr. PECORA. Not only for one man, but they have competing specialists holding books on the same securities.

Mr. UNTERMYER. But in inactive securities they do not usually have specialists.

Senator KEAN. They do.

Mr. PECORA. There are a few brokers who make a specialty of those inactive stocks. There are some 200 or 300 in number. They all trade around one post.

Mr. UNTERMYER. I know the posts, and I know the system, but they do it because there is a lot of graft in it.

Senator KEAN. They make a market which otherwise would not exist.

Mr. UNTERMYER. They make a market, and add on their profit.

Senator KEAN. The point is that they make a market which otherwise would not exist at all.

Mr. PECORA. And that has a tendency to keep the quotations closer.

Mr. UNTERMYER. I do not believe they should be permitted to make a market——

Mr. PECORA. We have given some study to the English system, where they have the jobber in place of the specialist, and the evidence that has come to our notice with regard to the operation of the English system does tend to indicate that the market is much wider, and that the quotations are much wider under the jobber system.

Mr. UNTERMYER. I am very familiar with the British market. I have spent a good deal of time in England, and with the British system. The jobber and the broker there are absolutely divorced. The broker does not go on the exchange at all.

Mr. PECORA. We find that under the English system the jobber, when there is a period of public trading such that he cannot trade to his own advantage, just stays away from the floor. He will not function at all.

Mr. UNTERMYER. It would be better, I think——

Mr. PECORA. He runs away from the market, in other words, when perhaps his activities are the most needed for the public interest.

Mr. UNTERMYER. I think it would be better than to permit a specialist to take orders to buy and orders to sell, and then go and trade upon them for his own account. That is what he does. He says "I have an order here to buy a thousand shares of steel at 51, and I have an order to sell a thousand shares at 52. I will buy myself one thousand shares at 51." His customer will not get the shares at 51. He will probably get them at 51½ or 52, because he has absorbed the market.

Mr. PECORA. Under the present rules and regulations of the stock exchange, some of which have only recently been adopted, the specialist cannot do that.

Mr. UNTERMYER. He has to show his orders.

Mr. PECORA. Yes. I think the present rules of the stock exchange have gone forward in the right direction.

The CHAIRMAN. He has to offer the securities first to the public before he can buy.

Mr. UNTERMYER. Yes.

Mr. PECORA. I think that is a step in the right direction.

Mr. UNTERMYER. Yes. I think a better step would be if he could not deal at all in those in which he is a specialist. He has the rest of the market, in which he is on a par with everybody else.

Mr. PECORA. If he is a specialist he has to remain at his post. He cannot go around on the floor trading in other stocks. He would not have the opportunity to do it.

Mr. UNTERMYER. They do not remain all the time at their posts.

Mr. PECORA. I know it.

Senator KEAN. Pretty well.

Mr. PECORA. In the more active securities they have got to.

Mr. UNTERMYER. In the very active securities; but not in the comparatively inactive securities.

Senator KEAN. You mentioned Steel.

Mr. UNTERMYER. There are a number of specialists in Steel.

Senator KEAN. They have to be there all the time.

Mr. UNTERMYER. They have to be there all the time.

The CHAIRMAN. Mr. Untermyer, you spoke of the British system, and said that our Securities Act ought to follow that.

Mr. UNTERMYER. Yes.

The CHAIRMAN. Do you not think that we did follow it about as far as we could? Under the British law all corporations are under one control. Here we have 48 different kinds of corporations, and you cannot make our law absolutely fit in with the British law.

Mr. UNTERMYER. Not absolutely. I have agitated that subject here in Congress for quite a number of years. I wanted the British companies' acts enacted, and I wanted interstate corporations to be under Federal regulation or a Federal law. I have had some experience with the British companies' acts. I have organized a good many companies under those acts.

Senator KEAN. As the organization is now under the Securities Act, it places so much responsibility on everybody that——

Mr. UNTERMYER. Nobody will act. I do not want to discuss that. I would rather not discuss it.

The CHAIRMAN. I just thought I would mention that difference.

Mr. UNTERMYER. Huston Thompson, I think, drew the first draft, and when it was first submitted to me I said I thought it was too severe to be workable.

Senator KEAN. You think it ought to be modified?

Mr. UNTERMYER. Yes; I do.

The CHAIRMAN. Very well. You may proceed.

Mr. UNTERMYER. Let us go on.

The next is section 15 (a), referring to the beneficial owner of more than 5 percent of any class of equity security.

Senator KEAN. That is only securities listed on the exchange, is it not—or does it apply to any securities?

Mr. UNTERMYER. No. I think it is only securities that are listed.

Senator KEAN. It is confined to listed securities.

Mr. UNTERMYER. That is on page 39, Mr. Pecora.

Mr. PECORA. That relates only to registered or listed securities.

Mr. UNTERMYER. I can understand its wisdom if it were limited to a person in practical control of the company by the ownership of, say, 20 percent of the stock.

Mr. PECORA. This section, Mr. Untermyer, has been colloquially termed the "anti-Wiggin" section, which, perhaps, will explain the purpose of it.

Mr. UNTERMYER. Yes. In extreme cases make bad laws.

Mr. PECORA. The theory was that the ownership of 5 percent of the stock would practically constitute him an insider, and by virtue of that position he could acquire confidential information which he might use for his own enrichment by trading in the open market, against the interests of the general body of the stockholders. That is the main purpose sought to be served.

Mr. UNTERMYER. I understand the purpose, and I understand the wisdom of it.

Mr. PECORA. You approve of the principle?

Mr. UNTERMYER. I approve of the principle, but I do not approve of its application to anybody who owns 5 percent, who is not an officer or director, and has no fiduciary relationship.

Mr. PECORA. If you were to raise that limitation to 20 percent of a listed or registered security, you probably would have difficulty in having it apply to any individual, because it is a grave question

whether, in any listed security, there is any individual who owns 20 percent or more of the outstanding stock.

Mr. UNTERMYER. If he owns less, and is not an officer or director——

Senator KEAN. If he is a director or officer, I think it should apply.

Mr. UNTERMYER. I agree. I think it should apply. But if he is not—if he has no relation whatever to the corporation, except that he is an investor and owns that amount of security, I do not see why these penalties should be applied to him. They are too severe.

Mr. PECORA. We had evidence here last summer from Mr. Van Sweringen. He and his associates felt that if they could acquire a block of stock which amounted to around 10 or 15 percent of an important railroad line, they would thereby get a management control. He admitted that very blandly.

Mr. UNTERMYER. But with the prestige of Morgan. Otherwise they would not.

Mr. PECORA. I do not recall whether they succeeded in making that acquisition of that block of stock with the aid of J. P. Morgan & Co. As I recall the evidence, they financed it through some banks.

Mr. UNTERMYER. They were Morgan banks. I know the Van Sweringen outfit.

Mr. PECORA. The only point I want to make is that with that evidence in mind, that management control of an active stock could be obtained through control of 10 percent of the outstanding stock—and there was a large amount of stock outstanding—where an individual owned as much as 5 percent or more, he would be in a position, through that ownership of a block of stock of that size, to virtually be an insider, and he could very well dictate, with one or two others, elections to the board of directors.

Mr. UNTERMYER. So, you will not let anybody acquire over 5 percent.

Mr. PECORA. It is open to anybody to do it, but he cannot use the information to trade for his own account against the public interest.

Mr. UNTERMYER. But he cannot get any profit out of it. He is foreclosed from making anything out of it, and the result is that he will not buy it.

Mr. PECORA. He can profit from it provided his transactions are more than 6 months apart. It is designed avowedly to prevent insiders from utilizing their position to trade for their own account and against the interests of the general body of the stockholders. The only penalty against it, as you have observed, is that he has to disgorge his profits for the benefit of all the stockholders.

Mr. UNTERMYER. That is a penalty that will prevent him from buying any more stock, and you will hurt the market in the stock. He may have to buy to protect the stock.

Mr. PECORA. If he buys and does not sell again for another 6 months, he does not have to account.

Mr. UNTERMYER. But he may just buy for the purpose of protecting the sock, and he may want to sell it as soon as he can. He may not be an insider at all. There are many corporations owned or controlled by big banking houses that have not 1 percent of the stock. They know more about it. They have got more information than the follow who owns 30 percent of the stock. They know all about it because they are running it. To take one extreme case, like the

Wiggin case, and predicate legislation of this kind upon it is very dangerous because, as you know, Mr. Pecora, hard cases make bad laws.

Mr. PECORA. We do not know how many other cases of Wiggins there might be.

Mr. UNTERMYER. There are plenty.

Mr. PECORA. I am afraid that is so.

Mr. UNTERMYER. There are plenty.

Mr. PECORA. That is why the section was written.

Mr. UNTERMYER. I must say it is likely to do more harm than good.

The CHAIRMAN. You think that that 5 percent ought to be made 20?

Mr. UNTERMYER. I think so—15 or 20; some substantial amount.

Senator KEAN. Mr. Untermyer, would it not be satisfactory if you made it apply to the officers or directors?

The CHAIRMAN. That is another provision.

Mr. UNTERMYER. I think that 5-percent provision should apply to the officers and directors, but I do not think it should apply to anybody who wants to accumulate a larger amount than 5 percent of the stock.

Senator KEAN. Suppose you believed some security was going to go up, and that you accumulated some of that stock, and you thought you were going to be elected a director, and then the United States came along and said, "You cannot be a director in that company." For instance, take a bank. They have told me I cannot be a director in a bank—several of them. I have a letter in my pocket from them, and I have to resign from every bank of which I am a director.

Mr. UNTERMYER. The last suggestion I have to make is with regard to section 17 (c). I think you put this back where it did not belong. The limitation in section 17 (c) of the time for the commencement of an action to enforce a liability to 2 years after the cause of action accrues is unduly restrictive. Frauds and misrepresentations are generally not discovered until after that length of time. I do not think the time limit for the operation of the statute should begin to run until after the discovery of the cause of action, and I am hoping that the provision in the original bill in that respect will be restored. Was not that in the original bill?

Mr. PECORA. In the original bill the limitation provided was 1 or 2 years after discovery.

Mr. UNTERMYER. That is what I said.

Mr. PECORA. It was argued here that the discovery might not be made for many years after the violation occurred.

Mr. UNTERMYER. That is so in all equity actions now.

Mr. PECORA. That was the argument that was advanced.

Senator KEAN. I am the one who advanced it, and I think it leads to blackmail. I have known of a great many such cases.

Mr. UNTERMYER. So have I; but I have known of many cases where the management blackmailed the outside stockholders.

Senator KEAN. That may be, but we are trying to protect the public.

Mr. UNTERMYER. We are talking about the public. I do not think we need have very great fear of blackmail.

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Mr. PECORA. Mr. Untermyer, what do you think of the suggestion of providing a statute limitation of 2 years after discovery, but in no event more than 6 years after the violation?

Mr. UNTERMYER. I would approve of that fully.

Those are the only suggestions, gentlemen, that occur to me at the moment. I want to say this, if I may, in closing, that I should consider it nothing short of a catastrophe if this bill were not enacted.

Senator MCADOO. I did not hear that.

Mr. UNTERMYER. I should consider it nothing short of a catastrophe if this bill were not enacted. I think it is so important that if I were a legislator, notwithstanding all the objections I have urged, I would take it as it is rather than see it fail. I would like to see it improved very much, but above all things, we have gone all these years with a great financial institution, the greatest in the world, absolutely a law unto itself, without any sort of control whatever, and it is time it was controlled. Nobody can have his own way about any piece of legislation of this kind. I know the influences that are pressing upon Congress to defeat this legislation. I have met them myself. I think it is the greatest propaganda that was ever tried upon any legislative body.

Senator KEAN. I think the committee wants to enact the bill, if they can get it in shape.

Mr. UNTERMYER. Then let us get it in the best possible shape, and then enact it. But do not let it fail, and do not let this vicious propaganda destroy it. I do not want anything I have said by way of criticism of this bill to be regarded as anything except in the way of helpful, constructive suggestions. Some may be right and some may be wrong. Even as to those that are right, I would rather see those go down than to see the bill fail.

Thank you, gentlemen.

The CHAIRMAN. With regard to this propaganda which you mention, I have a letter from a man out in California, who says that one concern there is issuing 20,000,000 circulars against this bill. They are being signed by clerks and other people. They have frightened all the employees and have told them that they were going to lose their jobs, that the exchange was going to be closed, and all that. They got them to sign these circulars in that way.

Mr. UNTERMYER. I have been up against it too often not to know what it means.

Senator MCADOO. Did you get the name of that constituent of mine? I would like to have it.

The CHAIRMAN. All right; I will show it to you.

Mr. UNTERMYER. When they get through with that, then they will begin by trying to frighten the Members of Congress.

The CHAIRMAN. That is what they are doing. I have had letters threatening me. They have told me, "You will never come back to the Senate", and all that; but that does not bother me.

Mr. PECORA. I have gotten letters, Mr. Chairman, saying that I will never come back to the Senate. They do not know that I have never been there.

Mr. UNTERMYER. They are not good propagandists. They are not well informed.

The CHAIRMAN. They have come to this point, though, Mr. Untermyer—and it is quite effective. It is having its weight on Members of Congress and the public generally. They are claiming that this bill is going to check investments, is going to keep capital out of business, is going to disrupt business, is going to destroy the exchanges, and all that sort of thing. That, of course, is a serious thing, but that is the most effective point they have reached with their propaganda. The people do not want to destroy business.

Mr. UNTERMYER. Senator Fletcher, you remember what happened when the Federal Reserve Act was under consideration?

The CHAIRMAN. Yes.

Mr. UNTERMYER. You remember that every great banker, almost, in the United States went upon the witness stand and testified that its enactment would destroy the country.

The CHAIRMAN. Yes.

Mr. UNTERMYER. You remember that within a year or two after it was passed those same gentlemen said it was the salvation of the country—every one of them.

Senator MCADOO. Some of them even claimed credit for its enactment.

Mr. UNTERMYER. Yes, sir.

The CHAIRMAN. I remember that perfectly well.

Mr. UNTERMYER. I do not believe the public is going to take these gentlemen quite so seriously.

The CHAIRMAN. That is what I wanted to bring out. Can you see any such effect as destroying the exchanges, crippling business, and interfering with investments adversely?

Mr. UNTERMYER. I can see that the bill will restrict speculation. That is its purpose.

The CHAIRMAN. And that ought to be done.

Mr. UNTERMYER. It ought to be done.

Senator KEAN. Mr. Untermeyer, further than that——

The CHAIRMAN. Let me finish, please.

Senator KEAN. I beg your pardon.

Mr. UNTERMYER. No; you go on.

Senator KEAN. We had Mr. Potter, of the Guaranty, down here. He figured out these margins, and said that for his institution alone it would mean the liquidation of some $400,000,000 of market loans.

Mr. PECORA. Mr. Potter was addressing himself then to the original draft, Senator Kean.

Senator KEAN. Yes.

Mr. PECORA. I think much of his criticism would disappear if directed to the revised draft.

Mr. UNTERMYER. Frankly, I think that these specific, rigid marginal requirements are a great mistake, and that is the reason I have suggested the increase of the Federal Reserve Board and the allotting of three men to the execution of this law, and not endeavoring to deal with a delicate subject, such as this is, by hard and fast rules.

Senator KEAN. If anything like Mr. Potter's statement would be true, for his institution alone, that would mean the liquidation of over 1 billion dollars on the stock exchange.

Mr. UNTERMYER. He must have had in mind all the frozen loans he has there for syndicates and pools.

Mr. PECORA. And which would have had to be liquidated by October 1.

Mr. UNTERMYER. The answer to Mr. Potter might be to let the underwriters take up those loans.

Senator KEAN. It might be. I do not know what he had in mind. I could not read his mind.

Mr. PECORA. Senator Kean, his objection was to the original draft, which has been considerably relaxed in respect of the provisions which bear upon the banks.

The CHAIRMAN. Giving those people who have the present margins time in which to carry their securities.

Senator MCADOO. I just want to ask Mr. Untermyer one question. I agree with what I understand to be your position, that it is unwise to fix a statutory requirement, or fix any statutory margin requirement for loans when all these things vary so materially in point of security and other conditions that no general formula can be made to apply with advantage or with safety, perhaps, to the general interest.

Mr. UNTERMYER. That is my position.

Senator MCADOO. That can be accomplished, however, through regulations by the authority which is empowered to deal with those questions.

Mr. UNTERMYER. Yes.

Senator MCADOO. And the fixing of these margin requirements should be relegated to regulation, and not be committed to a statute.

Mr. UNTERMYER. I would not put the rigid marginal requirements in the statute.

Senator MCADOO. That is what I mean. Leave it to regulation.

Mr. UNTERMYER. I would leave it to regulation.

Senator MCADOO. By the competent authority which is going to administer the act.

Mr. UNTERMYER. That is my idea; but I would be very careful not to leave it to the regulation of people who are under the domination or control of high finance in New York.

Senator MCADOO. Certainly not. It will be regulated by the Federal Reserve Board, or the Federal Trade Commission, or whatever authority is established by the Congress to deal with it.

Mr. UNTERMYER. I would rather see a new deal in the Federal Reserve Board.

Mr. PECORA. Through the appointment of three new members?

Mr. UNTERMYER. Yes. Is there anything else, gentlemen?

The CHAIRMAN. Any other questions to be asked? I do not know whether you need to bring that up, it is not very important, but as long as you are here and your opinion is so valuable to us, we have gotten as far as section 2 of this bill, and the question is as to the importance of section 2, which simply outlines the purpose.

Mr. UNTERMEYER. I don't see any harm in it. It is a stump speech.

Senator KEAN. That is the objection to it?

Mr. UNTERMEYER. No; I don't see that that is any objection to it. I think it may guide the courts in determining what Congress had in mind when it was passing this legislation as affecting interstate commerce.

Senator COSTIGAN. That was the case in the Grain Futures case.

Mr. PECORA. Board of Trade against Olsen.

Mr. UNTERMYER. Yes.

Mr. PECORA. This section was somewhat based on that Grain Futures Act, which contained a recital of purposes, which also might be called a "stump speech", but was a statement of conclusions of fact.

Mr. UNTERMYER Yes.

Mr. PECORA. And which was of guidance and value to the court in construing the act and upholding its constitutionality.

Mr. UNTERMYER. Yes; stump speeches are sometimes very interesting when not delivered from the stump.

Senator KEAN. The motion, Mr. Untermyer, was to leave in everything, I think, that was constructive and to cut out the speech part of it.

Mr. UNTERMYER. Well, then there would not be anything left. [Laughter.]

Senator KEAN. I think that the finding of facts was all left in.

Mr. UNTERMYER. I read it two or three times, and I think pretty well of it myself.

Senator ADAMS. So do the authors.

Mr. UNTERMYER. Oh, yes; I am sure they do. I think it is pretty well constructed as that sort of a thing, and it may be a guide to the court. It cannot hurt. There is nothing about it that I have seen. I went through it to see if there is anything that might harm, if it contained any admissions against interest, and I could not find anything.

The CHAIRMAN. Any other questions you wish to ask Mr. Untermyer?

Mr. UNTERMYER. Gentlemen, I am obliged to you for your patience.

The CHAIRMAN. We are very much obliged to you for coming down.

Mr. PECORA. Might I make again the statement that the communication addressed to us by Mr. Untermyer and which contained many suggestions, most of which he has referred to in detail today, was very, very carefully and favorably considered, and I think it should be stated to Mr. Untermyer that many of them have been adopted.

Mr. UNTERMYER I am very intensely interested in this thing. The passage of this legislation I would regard as the culmination of one of my ambitions of a quarter of a century.

The CHAIRMAN. I am glad to hear you say that. I think it is very important, and I think now is the time to accomplish it if we are ever going to accomplish it.

Mr. UNTERMEYER Yes; I think so, too.

The CHAIRMAN. The country needs it We are very much obliged to you.

Is there anything else now? If not, we will meet again at 10:30 tomorrow morning.

(Accordingly, at 3:27 p.m., the committee adjourned until 10:30 on the following morning.)

WASHINGTON, D C, *Saturday, March 24, 1934*

PETITION ON BEHALF OF THE SPECIALISTS OF THE NEW YORK STOCK EXCHANGE

The Honorable Committee on Banking and Currency of the United States Senate, Washington, D C.

GENTLEMEN The undersigned members of the New York Stock Exchange respectfully invite your attention to the far-reaching effect which we believe certain provisions of the pending Stock Exchange Regulation Bill would have on the fortunes of twenty million investors in the United States

We refer to the provisions in Section 10 of the Bill for the practical elimination of the present market "specialist", who, as he now operates, is an indispensable factor in assuring the liquidity of investments and, in turn, the liquidity of commercial banks and other financial institutions throughout the country

The specialist, as the members of the Committee are doubtless well aware, is a member of the Exchange who deals exclusively in one or more stocks and is thus able to execute with the utmost diligence all orders entrusted to him for the purchase or sale of such stocks Any member of the Exchange may become a specialist if he so desires

Because of the active and varied operations on the floor of the Exchange, it is physically impossible for the broker who directly represents the commission house to execute all transactions committed to him In line with the intensive specialization which has taken place in every field of modern activity, the vocation of the specialist has been developed over a period of years to fill the obvious need of a man of expert knowledge and financial and moral responsibility who can give instant execution to orders entrusted to him for the purchase or sale of specified stocks The specialist is primarily a broker's broker

The specialist, however, under the present practice, is more than a broker's broker. He is also a dealer, and his activity as a dealer is indispensable to his effective functioning as a broker It is our understanding that your Committee, while recognizing the useful services performed by the specialist, seeks to impose certain limitations upon his activities in accordance with the Committee's general purpose of regulating the Exchange on behalf of the public interest

The members of the Exchange, as already reported to your Committee, are heartily desirous of co-operating in any measure that would make the Exchange a more effective market for public securities We feel, however, that the present draft of the bill before your Committee would essentially alter the character of the specialist as he actually exists and, in so doing, greatly diminish the facilities of the Exchange in its service to the public

The specialist of today is the custodian or trustee of thousands of orders originating in this and many foreign countries With a market order in his possession a specialist is barred from trading for his own account until that order is filled He cannot give his personal interest precedence over that of his customer No business is more carefully supervised, and there are no penalties in any other line of business endeavor more drastic than those meted out to a specialist if he violates the law of the Exchange or if, as stated in the Constitution of the New York Stock Exchange, he indulges in any practice "inconsistent with just and equitable principles of trade"

There seems to be a common belief that, because of the possibility of his acting either as a broker or dealer, the specialist has an opportunity to act contrary to the interests of the regular brokers and their customers and that he actually does so Nothing could be further from the truth

The greatest criticism directed against the specialist is that he works in a dual capacity, either as a broker for his customers or as a dealer for his own interests As a matter of fact, he can never serve these two interests simultaneously. Were he to do so he would be expelled from the Exchange Further, the minute a specialist steps into the capacity of a dealer, any trades which he may effect for his own account are, by the rules of the New York Stock Exchange, not binding except with the consent and approval of a representative of the firm with whom he trades In other words, a specialist in trading for his own account buys from or sells to a broker who represents the seller or purchaser, as the case may be. It is the duty and interest of this other broker to see to it that *his* customer makes the best possible trade If at any time such a trade is seen to be "inconsistent with just and equitable principles of trade" that trade is cancelled

The new Bill as now formulated provides two types of specialists. that of the dealer-specialist (one who trades for his own account and cannot accept commission orders) and broker-specialist (who executes orders for others and cannot trade for his own account) This means a division of the functions now performed by specialists If this dual capacity is broken up so that there are two categories, viz. dealer-specialists and broker-specialists, a situation will arise which will have a broker-specialist working for the interest of his customers and a dealer-specialist who has no responsibility except to himself.

The present specialist lives because of the fact that if he does not at all times make a just and ample market, the commission houses will speedily introduce a competing specialist in his field and his business will be cut down He, therefore, does everything in his power to make such a market. Let us assume for the moment that the broker-specialist operating as provided in the Bill cannot trade for his own account and a dealer-specialist may The dealer-specialist has no customers, is responsible to no one save himself, and it is inconceivable that he would have the same interest as the present specialist in the maintenance of a continuous fair market for securities

The specialist's success depends upon the efficiency and intelligence with which he serves his clientele, without that efficiency and intelligence he would shortly find himself without orders

The fact that the business of the specialist has been developed over a period of time and requires a high degree of alertness and specialized knowledge for its efficient functioning, and the fact that it involves the livelihood of several thousand people, including the necessary staffs, cannot, of course, be a primary concern of your Committee But your Committee is rightly concerned with the maintenance of a liquid, or immediately accessible, market to the investor, which in turn means an opportunity for the nation's industry to finance its development We believe that the specialist performs an essential function in that branch of national economy

If the liquidity of he market is at any time impaired it will unquestionably mean that collateral would necessarily be more difficult of disposal Banks would accordingly be reluctant to accept stocks as collateral for loans which might be needed for productive enterprise The effect, in truth, would be to impair a capital market on all exchanges in the United States where securities may now be either obtained or sold, with the inevitable consequence that other world markets would be utilized

The end and aim of commercial banks is, at all times, to have such a degree of liquidity that they may accommodate the short term needs of business Destroy the liquidity of the market and the ability of the banks so to function would be proportionately curtailed There are many examples today of the inability to liquidate in other lines of business

We believe the intricate and complex functions of the specialist should not be disturbed as they now exist, and we respectfully submit the suggestion that the members of your Committee visit the Exchange to observe these functions in actual operation

The corporate structure of American business has resulted in the issuance of hundreds of millions of shares of stock held, it is said, by over twenty million people These are the people who, in the last analysis, "make the market" If the prospective legislation is followed to its logical conclusion, the functions now performed by the New York Stock Exchange would be seriously curtailed This would not only impair the savings of millions of people but also throw many thousands into unemployment

Therefore, it is respectfully petitioned that Section 10 of the Bill be amended in accordance with the recommendation of Richard Whitney, Esq, President of the New York Stock Exchange, made to the Committee on Interstate and Foreign Commerce of the House of Representatives at a public hearing on Thursday, the 22nd of March, 1934

Section 10, as thus amended, would read as follows

"Section 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 six 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 a reasonable time not exceeding ten 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"

Respectfully,

BLAIR S WILLIAMS, 308 Lexington Ave, New York City
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JOHN H AUERBACH, 778 Park Ave, N Y
CHARLES K COOK, 40 Fifth Ave, New York City
BENJAMIN H BRINTON, Chestnut Street, Englewood, N. J.

N B The specialists of the New York Stock Exchange are assisted in their labors by 1,290 employees who support 2,481 dependents The annual salaries of the employees total $2,166,708 The specialists pay in real estate rentals and clearances $1,846,999 per annum.

WASHINGTON, D C, *Saturday, March 24, 1934.*

PETITION ON BEHALF OF THE FLOOR TRADERS OF THE NEW YORK STOCK EXCHANGE

The Honorable Committee on Banking and Currency of the United States Senate, Washington, D C

GENTLEMEN The undersigned members of the New York Stock Exchange, representing some sixty members engaged in trading exclusively for their own account on the floor of the Exchange, respectfully invite the attention of the Committee to a provision in Section 10 of the pending National Securities Exchange Bill, the effect of which would in our opinion be the virtual paralysis of the activities of floor traders and substantial injury to the interests of the entire investing public of the United States

The provision to which we refer is, in substance, that it shall be unlawful for any member of a stock exchange (except "odd-lot dealers" and "specialist dealers") to effect any transaction whatever for his own account while on the trading premises of the Exchange (Sub-section (c))

The exclusion of the floor trader from the privilege of trading on the premises would seem to indicate either that the language employed does not express the intention of the Committee or that the functions of the floor trader are imperfectly understood.

The floor trader is a member of the Exchange who acts exclusively as principal and, as a rule, only with his own capital He has no customers and accepts no commission orders He buys and sells securities for his own account, assuming the entire risk of profit or loss He is not restricted to a fixed post nor to a limited number of securities In the course of the day's trading the floor trader is to be found at various parts of the floor in competition with specialists and other traders, contributing in this manner to the maintenance of a fair market in all stocks If he has, on the one hand, as compared with the investor off the floor of the Exchange, the advantage of instant information concerning the technical position of

the market, he is subject, on the other hand, to the disadvantage (in view of the exclusion of news tickers from the trading premises) of not being immediately apprised of developments in the outside world of industry, finance and politics

The floor trader performs indispensable services in the public interest by his contribution to the maintenance of a continuous and liquid market in which securities may be bought and sold at equitable prices

It is obviously in the interest of the investor that the securities which he holds, and which he may desire to use as collateral for the financing of productive enterprises, shall have a continuous fair market value On an Exchange which was limited to the execution of commission house orders, there would inevitably be many occasions on which the divergence between the price bid and the price asked would be so extreme as to result in wide fluctuations In the filling of the gap between bids and offers and the prevention of sudden and unreasonable fluctuations the interposition of the floor trader plays an outstanding part Without the constant personal presence of the floor trader, ready to buy or sell instantly for his own account and on his own responsibility for small profits, the market would be characterized by excessively sharp rises and declines

The initiative of the floor trader and his competition with specialists and other traders are at all times factors of the highest importance in the maintenance of fair market prices

His services in this respect are particularly conspicuous on occasions of stress, when there is a great preponderance of either buying or selling orders from all parts of this country or from abroad On such occasions the floor trader is pre-eminent in taking the initiative in buying or selling as the situation may require So highly are his services in this respect valued on the Exchange that floor traders are frequently informed of an abnormal market situation by a governor of the Exchange, acting in the public interest, with a view to assuring the execution of buying or selling orders at a fair price

In view of the indispensable services performed by the floor trader, as above indicated, we earnestly trust that it is not the intention of the Committee to eliminate the floor trader as such We respectfully submit that the floor trader should be allowed to continue his operations substantially in accordance with the present practice In this connection we wish to signify our hearty endorsement of the suggestion made to the Committee on Interstate and Foreign Commerce of the House of Representatives by Mr Richard Whitney, President of the New York Stock Exchange, with reference to the revision of Section 10 of the Bill

Respectfully,

HERBERT L CARLEBACH,
35 East 76th St, New York City
ARTHUR K HARRIS,
1125 Park Avenue, New York City
ROBERT CRAIG MONTGOMERY,
Bronxville, New York

DRAFT BILL FOR REGULATION OF NATIONAL STOCK EXCHANGE

This bill has been submitted to representatives of the following exchanges for criticisms and suggestion:

Boston Stock Exchange
Chicago Stock Exchange
Los Angeles Stock Exchange
Los Angeles Curb Exchange.
New York Stock Exchange.
New York Curb Exchange
Philadelphia Stock Exchange.
San Francisco Stock Exchange.
San Francisco Curb Exchange.
Associated Stock Exchanges representing:
Baltimore Stock Exchange.
Buffalo Stock Exchange.
Cincinnati Stock Exchange.
Cleveland Stock Exchange.
Columbus Stock Exchange.

Detroit Stock Exchange
Hartford Stock Exchange
Minneapolis-St Paul Stock Exchange
New Orleans Stock Exchange.
Pittsburgh Stock Exchange.
St Louis Stock Exchange
Salt Lake Stock Exchange
Washington Stock Exchange.

and also, for the purpose of consideration of this bill, the following non-member exchanges

Louisville Stock Exchange
Richmond Stock Exchange.
Seattle Stock Exchange

73RD CONGRESS
2ND SESSION

H R —

IN THE HOUSE OF REPRESENTATIVES

A BILL

To provide for the regulation of National Stock Exchanges operating in interstate and foreign commerce or through the mails and to prevent unfair practices in security transactions and for the protection of investors, and other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1 This Act may be cited as the "National Stock Exchange Act of 1934"

DEFINITIONS

SEC 2 When used in this Act, unless the context otherwise requires—

(1) The term "exchange" means any board, market place, exchange, chamber of commerce or association, whether organized or unorganized, however managed or conducted, and whether incorporated or unincorporated, where contracts or offers for the purchase or sale of securities or other transactions in securities are customarily made

(2) The term "national stock exchange" means any exchange which has been duly licensed pursuant to the provisions of Sec 6 of this Act

(3) The phrase "facility of an exchange" includes its premises and tangible property whether on the premises or not, any right to the use of such premises or property or any service thereof, including any system for the distribution of quotations of transactions made on the exchange

(4) The term "person" means an individual, corporation, partnership, association, unincorporated association or exchange

(5) The term "member" means any person who is permitted to effect transactions on a national stock exchange without the services of another person acting as broker or to use the facilities of an exchange for transaction thereon without payment of a commission or fee or with the payment of a commission or fee which is less than that charged the general public, or any firm of which a member is a partner, or any partner of such firm

(6) The term "bank" means (a) a banking institution organized under the laws of the United States, (b) a person engaged in the business of banking pursuant to the laws of any State, who is subject to examination or regulation by Federal or State banking authorities, (c) a banking institution organized under the laws of a foreign country or any agency or branch thereof authorized to engage in business in a State and which is subject to the supervision of State banking authorities, or (d) a receiver, conservator or other liquidating agent of any institution included in clause (a), (b) or (c) of this paragraph.

(7) The term "broker" means any person engaged in the business of effecting transactions in securities for the account of others and receiving commissions therefor

(8) The term "dealer" means any person engaged in the business of making purchases and sales of securities, or of distributing securities, for his own account through a broker or otherwise

(9) The term "broker" or "dealer" shall not include a bank and the term "member" shall include a bank which is a member of a national stock exchange only to the extent that it shall act as broker or dealer

(10) The terms "buy" and "purchase" shall include any contract to buy, purchase or otherwise acquire

(11) The terms "sale" and "sell" shall include any contract to sell or otherwise dispose of

(12) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, voting-trust certificate, certificate of interest in property tangible or intangible, or, in general, any instrument commonly known as a security, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase any of the foregoing.

(13) The term "State" means any State of the United States, the District of Columbia, Alaska, Hawaii, Puero Rico, the Philippine Islands, Canal Zone, the Virgin Islands, or any other possession of the United States

(14) The term "Commission" means the Federal Stock Exchange Commission as constituted pursuant to the provisions of Sec 5 of this Act

MANIPULATIVE PRACTICES PROHIBITED

SEC 3 (a) It shall be unlawful for any person, directly or indirectly, by the use of the mails or any means or instrumentality of interstate commerce or any facility of a national stock exchange—

(1) To effect any fictitious transaction in any security or any transaction which purports to be a purchase or a sale of a security but involves no change in the beneficial ownership thereof;

(2) To enter orders, by prearrangement with any other person or persons, for the purchase and sale of any security at substantially the same time at substantially the same price, for the purpose of creating a false or misleading appearance of the volume of trading in such security or of establishing price quotations therefor which do not truly reflect the market value of such security,

(3) To effect, either alone or in conjunction with one or more other persons, a series of transactions for the purchase and sale of any security for the purpose of creating a false or misleading appearance of the volume of trading in such security or of establishing price quotations therefor which do not truly reflect the market value of such security;

(4) To circulate or disseminate with intent to deceive any false or misleading information in regard to any security for the purpose of inducing the purchase or sale of any security;

(5) To pay or cause to be paid for the purpose of inducing any purchase or sale at prices which do not fairly reflect the market value of any security in which the person making such payment or causing the same to be made is directly or indirectly interested, any consideration to any person to circulate or disseminate as news or disinterested opinion any information intended to induce the purchase or sale of such security at such prices, or to receive knowingly any consideration for such circulation or dissemination

(b) Any person who wilfully violates any provisions of this section shall be liable to any person who shall suffer any injury by reason of such violation for any loss sustained thereby and may be sued therefor in law or in equity in any court of competent jurisdiction.

(c) No action shall be maintained to enforce any liability created under this section, unless brought within two years after the cause of action accrued and unless brought within six years after the violation upon which it is based.

REGULATION OF MARGIN REQUIREMENTS

SEC. 4 It shall be unlawful for any member of a national stock exchange or 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 or to borrow any money, the repayment of which is secured by the pledge or hypothecation of any security, in contravention of such rules as may be established from time to time by the Federal Reserve Board for the purpose of preventing the excessive use of credit for speculation.

FEDERAL STOCK EXCHANGE COMMISSION

SEC 5 There is hereby established a Federal Stock Exchange Commission to be composed of five members to be appointed by the President, by and with the advice and consent of the Senate Not more than three of such appointed Commissioners shall be members of the same political party. No appointed Commissioner shall actively engage in any other business, vocation or employment than that of serving as Commissioner Each appointed Commissioner shall receive a salary at the rate of $10,000 a year, payable in the same manner as the judges of the courts of the United States, and shall hold office for a term of six years, except that (1) any Commissioner appointed to fill a vacancy occurring prior to the expiration of the term for which his predecessor was appointed shall be appointed for the remainder of such term, and (2) the first Commissioners appointed shall continue in office for terms of two, three, four, five and six years, respectively, from the date of the taking effect of this Act, the term of each to be designated by the President, but their successors shall be appointed for terms of six years The Commission shall choose a Chairman from its own membership Any Commissioner may be removed by the President for inefficiency, neglect of duty or malfeasance in office A vacancy on the Commission shall not impair the right of the remaining Commissioners to exercise all the powers of the Commission

The Commission shall have an official seal which shall be judicially noticed.

The Commission shall appoint a Secretary, who shall receive a salary payable in the same manner as the salaries of the Commissioners, and it shall have authority to employ and fix compensation of such attorneys, special experts, examiners, clerks and other employees as it may from time to time find necessary for the proper performance of its duties and as may from time to time be appropriated for by Congress With the exception of a secretary and a clerk to each Commissioner, the attorneys and such special experts and examiners as the Commission may from time to time find necessary for the conduct of its work, all employees of the Commission shall be part of the classified civil service and shall enter the service under such rules and regulations as may be prescribed by the Commission and by the Civil Service Commission

All of the expenses of the Commission, including all necessary expenses for transportation incurred by the Commissioners or by their employees under their orders, in making any investigation or upon official business in any other place than in the City of Washington shall be allowed and paid on presentation of itemized vouchers therefor approved by the Commission

Until otherwise provided by law, the Commission may rent suitable offices for its use

The general accounting office shall receive and examine all accounts of expenditures of the Commission

The principal office of the Commission shall be in the City of Washington but it may meet and exercise all its powers at any other place, and the Commission may, by one or more of its members, or by such examiners as it may designate prosecute any inquiry necessary to its duties in any part of the United States

LICENSING OF NATIONAL STOCK EXCHANGES

SEC 6 (a) Any exchange may be licensed as a national stock exchange by filing with the Commission an application in such form as the Commission may prescribe containing all relevant information in regard to the history, organization, membership, and the rules and regulations of such exchange and a list of the securities in which dealings are permitted on such exchange.

(b) Unless such application shall be withdrawn by such exchange, the Commission shall, within thirty days after the filing thereof or within such further period as may be agreed upon, grant a license to such exchange as a national stock exchange if it shall determine that the rules and regulations of such exchange are adequate to prevent unfair practices in security transactions and to protect investors; otherwise it shall enter an order, after appropriate notice

and opportunity for hearing, denying such application and stating the reasons therefor

(c) Any national stock exchange may upon reasonable notice to the Commission surrender its license under this Act.

(d) Nothing in this Act shall be construed to prevent any national stock exchange from exercising any power vested in it by its constitution or its rules or regulations or from adopting and enforcing any rule or regulation not inconsistent with this Act or any effective order entered by the Commission thereunder.

TRANSACTIONS ON UNLICENSED EXCHANGES PROHIBITED

SEC 7 Unless an exchange is licensed as a national stock exchange under this Act, it shall be unlawful for any person, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of such exchange to effect any transaction in a security on such exchange or to report any such transaction.

REQUIREMENTS FOR LISTING OF SECURITIES ON NATIONAL STOCK EXCHANGES

SEC 8 The Commission shall have power by order to direct any national stock exchange to adopt such requirements for the listing of securities or the admission of securities to trading thereon as the Commission may deem necessary to secure adequate information for the protection of investors.

UNFAIR PRACTICES UNLAWFUL, POWERS OF COMMISSION

SEC 9. Unfair practices in security transactions upon national stock exchanges and by members thereof or persons acting through such members are hereby declared unlawful For the purpose of preventing such unfair practices the Commission shall have power by order to require national stock exchanges to adopt such rules as the Commission may deem necessary for the protection of investors.

RIGHT OF COMMISSION TO INVESTIGATE

SEC 10 Whenever the Commission shall have reason to believe that any person has violated or is violating any provision of this Act or has been or is employing any unfair practice in security transactions upon any national stock exchange or that such an exchange has failed to adopt or to enforce any rule or regulation which it shall have been required to adopt pursuant to this Act, the Commission either directly or through its duly authorized representatives, may make such investigation as it deems necessary and proper For the purpose of any such investigation, the Commission may administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence and require the production of any books, papers or other records which the Commission deems relevant or material to the investigation If any person subpoenaed to attend any inquiry fails to comply with such subpoena without reasonable cause or shall, without reasonable cause, refuse to be sworn or to be examined or to answer a question or to produce any book, paper or other record when ordered so to do, he shall be guilty of a misdemeanor and punishable accordingly.

ORDERS OF COMMISSION

SEC 11 Whenever the Commission shall determine, as a result of investigation or otherwise, that it is necessary that any national stock exchange should adopt any rule or regulation to prevent unfair practices in security transactions or for the protection of investors, the Commission may enter an order requiring any national stock exchange to adopt such rule or regulation Any such order shall be effective on the tenth day after notice of the entry thereof shall have been mailed by registered mail to the national stock exchange affected thereby, provided, however, that if the Commission shall determine that an emergency exists requiring that such rule or regulation be adopted immediately, then such order shall become effective upon the entry thereof, provided telegraphic notice of the entry of such order shall be given to any national stock exchange affected thereby.

ENFORCEMENT OF ORDERS OF COMMISSION

SEC 12 Whenever the Commission shall determine that any national stock exchange has violated or is violating any order or rule or regulation of the Commission, or has failed to exercise due diligence in enforcing compliance therewith by its members, the Commission may, in its discretion:

(1) After appropriate notice and opportunity for hearing, enter an order suspending for a period not exceeding twelve months or revoking altogether the license of any such national stock exchange; or

(2) After appropriate notice and opportunity for hearing, enter an order requiring any or all members of such national stock exchange to secure a license, on such terms and conditions as the Commission may reasonably deem necessary for the prevention of unfair practices in security transactions or for the protection of investors, as a condition of continuing to conduct business as a member of such national stock exchange.

APPLICATION FOR REVISION OF ORDERS OF COMMISSION

SEC 13 Any person aggrieved by any order entered by the Commission may, at any time within thirty days after the effective date of such order, apply to the Commission for a revision of such order The Commission shall fix a time for hearing on such application and shall afford such person a reasonable opportunity to show cause why such order should be modified or rescinded. The evidence in such proceeding shall be reduced to writing and the Commission, after due consideration, shall either affirm, modify or rescind such order

Any application for revision of an order entered by the Commission, other than an order made effective immediately because of an existing emergency, made by a national stock exchange before such order shall become effective, shall operate as a stay of such order No member of a national stock exchange shall be entitled to apply for the revision of an order of the Commission directing such national stock exchange to adopt any rule or regulation

COURT REVIEW OF ORDERS

SEC. 14 (a) Any person aggrieved by an order of the Commission who shall have applied for a revision thereof, as provided in Sec 13 of this Act, may, after such order shall have been affirmed or modified, or in the event that the Commission shall have made no determination on such application for revision within sixty days after such application, obtain a review of such order in the Circuit Court of Appeals of the United States, within any circuit wherein such person resides or has his principal place of business, or in the Court of Appeals of the District of Columbia, by filing in such court, within sixty days after such determination by the Commission or the expiration of such sixty-day period in which the Commission shall have made no determination on such application for revision, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall be forthwith served upon the Commission, and thereupon the Commission shall certify and file with the court a transcript of the record upon which the order complained of was entered and upon which such application for revision was determined No objection to an order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission. The finding of the Commission as to the facts, if supported by the evidence, shall be conclusive If either party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the hearing before the Commission, the court may order such additional evidence to be taken before the Commission or in such other manner as the court may direct and to be presented to the court, upon such terms and conditions as the court may deem proper The Commission may modify its findings as to the facts, by reason of the additional evidence so taken, and it shall file such modified or new findings, which if supported by the evidence shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The jurisdiction of the court shall be exclusive and its judgment and decree, affirming, modifying, or setting aside, in whole or in part, any order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided

in Sections 239 and 240 of the Judicial Code, as amended (U S C, title 28, secs. 346 and 347).

(b) The commencement of proceedings under subsection (a) shall not, unless specifically ordered by the court, operate as a stay of the Commission's order.

JURISDICTION OF OFFENSES AND SUITS

SEC 15. (a) The district courts of the United States, the United States court of any Territory, and the Supreme Court of the District of Columbia shall have jurisdiction of offenses and violations under this Act and of all suits in equity and actions at law brought to enforce any liability or duty created by this Act Any such criminal proceeding may be brought in the district wherein any act or transaction constituting the offense or violation occurred. Any such civil suit or action may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cause may be served in any other district in which the defendant is an inhabitant or wherein the defendant may be found Judgments and decrees so rendered shall be subject to review as provided in Sections 128 and 240 of the Judicial Code, as amended (U S C, title 28, secs. 225 and 347) No costs shall be assessed for or against the Commission in any proceeding brought under this Act

(b) In case of contumacy or refusal to obey a subpœna issued to any person, any of the United States courts, within the jurisdiction of which said person guilty of contumacy or refusal to obey is found or resides, upon application by the Commission may issue to such person an order requiring such person to appear before the Commission, or one of its examiners designated by it, there to produce documentary evidence if so ordered, or there to give evidence touching the matter in question; and any failure to obey such order of such court may be punished by said court as a contempt thereof.

(c) No person, who shall have been subpœnaed by the Commission, shall be excused from attending and testifying or from producing any book, paper, contract, agreement, and other record before the Commission, or any member thereof or any officer designated by it, or in any cause or proceeding instituted by the Commission, on the ground that the testimony or evidence, documentary or otherwise, required of him, may tend to incriminate him or subject him to a penalty or forfeiture; but no individual shall be prosecuted or subjected to any penalty or forfeiture for or on account of any transaction, matter, or thing concerning which he is compelled, after having claimed his privilege against self-incrimination, to testify or produce evidence, documentary or otherwise, except that such individual so testifying shall not be exempt from prosecution and punishment for perjury committed in so testifying

PENALTIES

SEC 16 (a) Any person who wilfully violates any provision of section 3 or of section 7 of this Act, or who wilfully extends credit or borrows money in violation of section 4 of this Act, or who wilfully violates any order of the Commission entered pursuant to section 12 of this Act shall, upon conviction, be fined not more than $5,000 or imprisoned for not more than two years, or both;

(b) Any person who wilfully maintains credit for any person in violation of section 4 of this Act shall be liable to a penalty of not more than $1,000 for each such violation and in addition not more than $100 for each and every day of the continuance of such violation which shall accrue to the United States and may be recovered in a civil action brought by the United States.

SEPARABILITY OF PROVISIONS

SEC 17 If any provision of this Act or part thereof, shall be held invalid, the remainder of this Act shall not be affected thereby.

EFFECTIVE DATE

SEC 18 This Act shall become effective on October 1, 1934, except that applications for licenses by exchanges under this Act may be made to the Commission in accordance with its rules and regulations at any time on and after July 1, 1934: Provided that sections 3, 4 and 5 shall become effective immediately upon the enactment of this Act.

NEW YORK STOCK EXCHANGE

ELEVEN WALL STREET

RICHARD WHITNEY,
President

THE WILLARD HOTEL,
Washington, D C , April 10, 1934.

Hon PHILLIPS LEE GOLDSBOROUGH,
Senate Office Buildings, Washington, D.C.

DEAR SENATOR GOLDSBOROUGH: In reading the testimony of Mr Samuel Untermyer on April 5, 1934, before the Committee on Banking and Currency I noticed on page 9 et seq of the stenographic transcript certain inaccuracies with respect to the disposition of the proceeds of a membership in the Exchange upon the insolvency of a member

Upon admission to membership, a member agrees that the proceeds from the sale of his seat, whether the sale results from his insolvency or otherwise, shall be available to satisfy the claims of members of the Exchange arising out of Exchange or Members' Contracts, as defined in Article XV of the Constitution of the Exchange and as allowed by the Committee on Admissions Mr. Untermyer stated that this agreement embodied in the Constitution of the Exchange "runs up against the law of the land". I am advised by counsel that such an agreement has been upheld by the Supreme Court of the United States as a valid equitable pledge.

In answer ot your question Mr Untermyer also stated that the proceeds from the sale of an insolvent's membership go to the members of the Exchange. Members have a preferred claim, as I have stated, only an Exchange and Members' Contracts allowed by the Committee on Admissions. Between July 1929 and the present date a total of seventeen Stock Exchange memberships were sold because their holders became insolvent The total proceeds of all memberships amounted to $2,980,181 76 The sum of $866,271 78 or 29 1 per cent of the total was paid to members of the Exchange upon claims allowed by the Committee on Admissions and $2,113,909 98 or 70 9 per cent was paid to trustees or receivers of the insolvents The Committee on Admissions disallowed members' claims totaling $1,394,494 49 Although a breakdown of these figures is not immediately available, I am quite confident that a substantial part of the 29 1 per cent paid to members of the Exchange went to the customers of members for whose accounts the claims were presented to the Committee on Admissions I am having prepared and shall forward to you when completed a breakdown of the figures with respect to two of the largest insolvencies, showing the proportion of allowed members' claims which were for the account of customers

Members in accepting contracts for the purchase or sale of securities upon the floor of the Exchange, although in most cases acting as agents for customers, under the rules of the Exchange assume the liability of principals. Furthermore, it is an unwritten law of the Exchange that members must accept the best bid or offer regardless of the financial standing of the member making such bid or offer. These so-called compulsory contracts between members of the Exchange are essential in order that their customers may receive the best available prices in the open market It, therefore, seems only fair that if members are forced to assume the liability of principals and are also forced to accept the financial responsibility of all other members of the Exchange, the business contracts entered into between members should be secured by the proceeds from the sale of the memberships The pledge of particular assets to secure the performance of particular contracts follows a universal business practice Upon this security rests the willingness of members to accept large commitments in security transactions for the accounts of their customers Without this security members would be unwilling to execute orders for the purchase and sale of securities at great financial risk to themselves The result would be to deprive investors of the free and open market which has preserved the liquidity of listed securities throughout the depression.

Faithfully yours,

RICHARD WHITNEY, *President.*

P S —I am enclosing copy of the Constitution of the Exchange, with particular reference to Article XV above referred to.

R. W.