n Reg 8

MEMORANDUM

REGARDING THE PROPOSED

NATIONAL SECURITIES EXCHANGE ACT OF 1934

Submitted on behalf of

The Investment Bankers Association of America

by

Robert E. Christie, Jr., President

March 8, 1934.

MEMORANDUM REGARDING THE PROPOSED NATIONAL SECURITIES EXCHANGE ACT OF 1934.

The Investment Bankers Association of America on whose behalf this memorandum is filed is composed of investment bankers who handle in origination and distribution the great majority of all securities offered in the United States. Under the Investment Bankers Code as filed under the National Industrial Recovery Act transactions on stock exchanges are excluded. The investment banking business even exclusive of stock exchange transactions, represents a highly important segment of the securities business of this country.

For the country's economic welfare, for the protection of the credit of States and Municipalities and of industry, generally, and in behalf of the rights of the investing public and of financial institutions, the Investment Bankers Association begs to present to the Congress this memorandum in relation to the proposed National Securities Exchange Act of 1934.

While certain parts of the proposed act are admirable in content and purpose certain other provisions are inimical to the public interest. If the act should be adopted in its present form the inevitable result will be a resumption of further drastic deflation and the destruction of sound and established values. Further restric-

tions on credit will retard if not reverse the progress of business recovery.

Three fundamental qualities determine the value of an investment security. They are:

1. Safety of Principal.
2. Dependability and Amount of Income Yield.
3. Marketability.

These three enter into the valuation of a security in varying degrees, but if you destroy or impair any of them in whole or in part to that extent the value of the security is injured. The proposed act would destroy or impair a material part of the marketability, and therefore of the value, of a vast amount of securities, including both public and corporate securities of the highest grade amounting to many billions of dollars. In particular this would be the inevitable effect of Sections 10, 6, 7 and 19 of the act.

Section 10, by its proposed segregation of brokers and dealers, would not only impair the marketability and value of listed securities, but would break down the efficient and economic marketing machinery that has been built up throughout the years as the means by which the States and their taxing subdivisions obtain and maintain economically the credit demanded by public necessities and advancement. There are approximately $19 billion of our state and municipal obligations, which, with many other types of securities such as insurance stocks and equipment trust issues, are not listed on any securities

exchange. They are dealt in on the so-called over-the-counter market which is maintained by dealers and brokers who may or may not be members of any securities exchange. Neither the over-the-counter market nor any organized securities exchange exists as a separate, isolated and independent unit. They are all interrelated, inter-dependent and integral parts of one whole, financial structure.

Section 10 of the act which segregates the functions of broker and dealer is very vital to those engaged in the investment banking business. The result of this segregation would inevitably be a consolidation of the security business into very few hands. Its operation in financial centers other than New York must be considered if its true significance is to be appreciated. There is not a City in the United States of any substantial importance that does not contain conscientious and honest investment bankers who try to the very limit of their ability to advise customers accurately in connection with the purchase of securities. If the duty of the investment banker is considered to be solely that of selling securities, and if he considers the transaction permanently terminated when he has received payment from his customer, then his situation would be very simple. Such, however, is not the case. The conscientious investment banker recognizes the duty of continuously observing the market and advising the person to whom he has made sale of securities. It is impossible to conduct this type of business in most of the smaller cities upon the income derived either from the brokerage business or the dealer

business. In order to operate, the investment banker in the smaller centers must combine the two functions. The customer is, of course entitled to know exactly the basis upon which he is conducting his transaction. No investment banker who mistreats the confidence of his customer can build a substantial and profitable business.

The investment bankers under the Fair Practice Provisions of their Code in Article VI have spelled out clearly the methods in which the information shall be given to the customer and the limitations to be observed by the investment banker in connection with all retail sales and purchases. It will be of great value to the security business that there will be a set of uniform rules to the end that the customer may know exactly how and where he will receive the information as to whether he is purchasing a security from a dealer or availing himself of the services of a broker.

It would be an unnecessary hardship to a very large number of men, who have given a lifetime to the creation of good will in the security business, to force a segregation of these functions. Such a segregation would produce a result diametrically opposed to what is needed and desired at this time for the re-establishment of an active market in securities to the end that American business men may again secure capital funds at a reasonable price.

The direct effect of segregation on state and municipal bonds and on other securities, which cannot be listed, as a matter of public policy or for other reasons, would be less efficient support in the markets for these securi-

ties, with the consequent loss to investors and ultimately lower prices for public credit and increased burdens on taxpayers. The success of the business recovery program requires that private capital should gradually take over the heavy burden that the Government assumed in its emergency financing of industry. How can this be done by crippling the established credit machinery and by depreciating the value of seasoned securities?

Section 6 of the proposed act would forbid a member of a national securities exchange to accept an unlisted security as collateral for a customer's loan. There are several hundred thousand corporations in the United States. Of these only 788 have securities listed on the New York Stock Exchange. Not only would Section 6 bar the securities of these thousands of corporations, as collateral in brokerage transactions, but it would also forbid any person, "who transacts a business in securities through any such member," to accept such securities as collateral. This has been interpreted that a bank which executes customers' orders by buying or selling securities through a stock exchange would automatically be barred from accepting as collateral any unlisted securities.

The adoption of any such provision would do immeasurable harm. Unlisted securities, barred from use as collateral both in broker and in bank loans would depreciate in value. Both investors and issuers would lose thereby. By what right, rule of reason or economic necessity could such uneconomic and unwise discrimination between listed and unlisted securities be justified?

Under this section a bank might find the purchase of certain municipal and corporate bonds highly desirable or sound investments for its own funds yet be forbidden to make a much-needed and worthy loan to a productive enterprise on the same securities. Loans already in existence and considered worthy and desirable by sound banking standards would have to be liquidated under Section 6 of the proposed act. The resulting restrictions of credit would have a disastrous effect on the credit structure of the entire country.

It is deemed a public duty by the Investment Bankers Association that the attention of the Congress be called to the aforementioned sections of the proposed National Securities Exchange Act and to other provisions therein relating to transactions not on an organized exchange, in order to indicate how vitally the act may affect others than members of securities exchanges. The apparent purposes and applications of the act should be viewed by the Congress in the light of the fact that the investment banking business has already submitted to the National Recovery Administration rules of fair practice designed to accomplish some of the same purposes as the National Securities Exchange Act, and without jeopardizing the processes of business recovery. A copy of the Rules of Fair Practice for the Investment Bankers Code is attached hereto. Of approximately 1,250 investment bankers who assented to the code and were, therefore, eligible to vote on the fair practice rules, 888 out of 1,005 who voted approved the rules, while only 117 disapproved. The majority of those disapproving did so

because of certain specific sections, but indicated their approval of the provisions in general. The rules are the product of four months' of incessant work by a great many investment bankers, and they embody a renewed hope and confidence that the Investment Bankers Code will be the means of abolishing abuses and restoring their business to a greater usefulness and esteem than ever before. The rules of fair practice are also significant of a conviction among investment bankers that in the Investment Bankers Code and its proposed rules the National Recovery Administration has provided the means for the sound economic and equitable development of investment banking. We therefore submit that the provisions of the proposed National Securities Exchange Act should apply only to the regulation of transactions on organized security exchanges.

Section 7 of the act covers the restrictions of "members" borrowing. It would seem important that the language in the first paragraph of this section which reads "person who transacts a business in securities through the medium of such 'member' " be clarified. It is submitted that the limitations of this section should not in fairness be applied to persons or firms, the major part of whose business is other than through members of stock exchanges, and certainly should not be applied to that part of the business of such persons which has no connection with the stock exchange.

Subsection 5 of Section 8 is drawn in language that is almost impossible to determine the extent of its application in individual cases. What matters are "suffi-

ciently important to influence the judgment of an average investor'' are, to put it mildly, difficult to ascertain. In trying to understand this language in order that one may be guided by it in the transaction of his business, it must not be assumed that one's difficulty will arise from a desire to misstate any fact. The difficulty is in knowing what is ''misleading in the light of the circumstances under which it was made.'' The unintentional but actual results of provisions of this type is to deprive investors of the advice of dependable brokers and dealers. The provisions are so vague and the penalties so severe that responsible dealers will not risk incurring ''strike'' suits.

Paragraph (i) of Subsection 9 of Section 8 would seem to prevent exchange trading in warrants in securities with warrants, and in convertible securities. It is important to the investment banker in the distribution of new securities not to have any possible doubt thrown upon the right to issue convertible securities where it seems necessary or wise to do so.

It is submitted that the implications of this legislation are so vitally important to the dealer in securities as well as to the owner of securities and to the public at large that the act should be so drawn that it will not hinder and embarrass transactions not contemplated to be within its scope. It is in no sense the purpose of this memorandum to be narrowly critical, but to place this criticism on a basis of public interest and mutual helpfulness. The high objective which the investment bankers have striven to attain in the fair practice provisions

of their code is that of greater usefulness in advancing the productive enterprises of industry and government. In no other way can the investment banking business advance its own interests except it first advance the Nation's interests.