December 9, 1936.

Chairman Landis

Paul P. Gourrich, Director, Research Division

Memorandum on Foreign Funds in U.S.A. Market.

I am attaching a draft of a memorandum with "Suggestions for Possible Treatment of Foreign Funds in the United States" which has been prepared under my direction by Mr. Goldschmidt. The memorandum is the outgrowth of a meeting on Monday, November 30, with representatives of the Treasury and the Federal Reserve Board. This meeting was called by Dr. Haas of the Treasury, in accordance with the agreement arrived at the conference held about three weeks ago at Secretary Morgenthau's office in which you participated.

The discussions at the meeting were on a purely personal basis, it being understood that none of those present spoke for the agencies represented, but just expressed personal views on the matter. It was finally decided at the meeting that the representatives of the Treasury, the Federal Reserve Board and the Securities and Exchange Commission prepare a memorandum on the subject again setting forth their personal views only and not committing in any way the respective agencies.

The memorandum attached hereto, therefore, represents chiefly my personal views on the subject, but I am sending a copy up to you because you may want to look it over and possibly to make some changes. Since it was agreed that all memoranda should be submitted to the Treasury, which will act as a clearing center, if possible by Thursday and certainly not later than Friday, I will send the memorandum to the Treasury on Friday morning unless I hear from you to the contrary.

Attach.

Gourrich/Goldschmidt/MKC

SUGGESTIONS FOR POSSIBLE TREATMENT OF FOREIGN FUNDS IN THE UNITED STATES

In every discussion of the recent influx of capital from abroad into this country, and, in particular, into our stock market, a smart distinction should be made between investment made ostensibly by foreigners which in reality emanate from America….

I.

Trading in our markets for American ______ through foreign intermediaries must be opposed from every point of view. We are, however, handicapped in our attack on the problem by lack of knowledge of even the approximate extent _______________. We may be sure on the one hand that it is only the minority of the net purchases from abroad totaling more than $1,000,000,000 since the beginning of 1935 which represents American purchases routed through foreign intermediaries. We have reason to assume, on the other hand, that this type of transaction movement has not been of altogether negligible size. Beyond that our present data do not permit us to go. The only way to shed additional light on this question appears to be a Treasury order, imposing on every person the duty to report every direct or indirect transaction in American securities executed abroad or handled through a foreign intermediary. Transactions by foreign corporations controlled by Americans should be included in the reports. If the penalties are stiff enough, it should be possible to obtain in this way a considerable amount of information and, in addition, to prevent incidentally a certain amount of tax evasion.

Trading for American account in American securities either abroad or on domestic markets through a foreign intermediary is undesirable for the following reasons:

(1) It impairs the representative character of our security markets, which no longer constitute the meeting place for all bids and offers.

(2) The existence of a considerable foreign market for certain American securities abroad which is not subject to our regulations and which is not under the surveillance of the Securities and Exchange Commission may permit the manipulation of prices on foreign markets which will be reflected through arbitrage in the price movements on the home market. In this way a manipulator may achieve his ends indirectly and may carry through operations which are unlawful under the Securities Exchange Act. He may use the foreign market to run prices up and may then unload here. (However, such a procedure is only possible for the small number of securities which are actively traded abroad. These are usually securities with a very large capitalization in which manipulation is extremely difficult and requires a large amount of capital. With few exceptions, manipulation occurs in issues which are not very large and which are relatively inactive except for the period of manipulation; such issues rarely have a market abroad.)

(3) The availability of a foreign market for American securities may further create outlets for new issues of American securities and for secondary distributions. In this way it might be possible to evade the restrictions imposed by the Securities Act of 1933 upon the issue and distribution of new securities by selling exclusively in foreign markets. The fact that such transactions could, if necessary, be financed at relatively favorable terms abroad during the time of distribution should be an additional incentive. Although a development as visualized here is a distinct possibility, the situation does not yet seem to be such to make its realization likely in the near future.

(4) Some individual traders are enabled to evade our margin regulations by buying the securities abroad and having their purchases financed abroad where more liberal margins may be obtained. This evasion is not restricted to the issues actively traded abroad because foreign banks and brokers will lend on almost every issue with an active listed market in the United States where the stock could always be sold, if necessary. It is known that some large traders have taken advantage of this situation. Others may follow if no counter measures are

adopted once the technical difficulties are smoothed out and the methods of circumventions become widely known.

(5) If the foreign market in certain securities develops to a sufficient degree, it may become attractive even to people who do not intend to evade the margin regulations and who are not interested in manipulation. Large traders, particularly in weighing the advantages of one market as against another, take into account not only the pure expenses such as stamp taxes, brokerage commissions and cables, but also the possibility of buying and selling close to the existing market price, the spread between the bid and the ask price, the facilities for financing a transaction and the tax situation. The London market is said to possess already now for certain American stocks sufficient advantages with respect to thickness and closeness of bid-ask spread in addition to more liberal margin practices and lower commission rates to make it a better market than New York.

(6) In addition to the weakening of the representative character of our markets and to the impairment of effective control, both of which are chiefly of concern to the Securities and Exchange Commission, there is, of course, the loss of revenue (chiefly transfer taxes and the like) to be considered, apart even from the straight tax evasion which is much more likely to occur when the transaction is executed abroad far from the scrutiny of the Treasury's agents.

II.

Genuine foreign investments in the United States, and particularly foreign purchases of American stocks, present a much more difficult problem. It must be recognized that foreign funds have flown here for a multitude of reasons, among which the desire to safeguard funds from the anticipated impending disaster in Europe, the desire to participate in the expected rise of American security prices and, although in only a fraction of cases, the higher yield of American securities predominate. A certain idea of the relative importance of these factors is given by the fact that from January 1, 1935 to September 30, 1936 short term banking funds held by foreigners have increased by about $1,350,000 while net foreign investments in American securities have aggregated only somewhat over $600,000,000 (The latter figure has by now probably increased to around $800,000,000). There are reasons to assume that this movement is not yet at its end. For instance, we have been informed from a reliable source that British investment trusts are contemplating large-scale purchases of American equities, possibly to a total of about one billion dollars.

(1) From the point of view of the Securities and Exchange Commission the most serious aspect of this inflow of foreign funds into our securities markets is that it constitutes a force which under our present legislation is almost entirely free from the controls we possess with regard to domestic transactions. Since the net supply of new corporate securities has not been increasing since 1929, every foreign purchase balance necessary means an American sale reducing the total supply of stocks available in the United States. Since American purchasers have obviously in general been reluctant to sell, partly for tax reasons and chiefly because they expect a further rise in prices, foreign buying undoubtedly has considerably intensified the rise in prices over the last year. The continuation of this movement may become a point of serious concern to the Securities and Exchange Commission if exceeding certain limits.

(2) Moreover, foreign buying most likely is concentrated in a small number of issues and thus probably tends to accentuate the disparities existing in the price-earnings ratios of various types of securities in the market. We have no knowledge of what types of securities have actually been purchased and sold by foreigners. It is, therefore, suggested that the firms reporting to the Treasury should be required to give details of purchases and sales for foreign account for a short test period to provide us with a sample of this basic information.

(3) Insofar as foreign buying is done on credit, it adds to the demands on the domestic credit system. It would appear that the amount of debit balances for foreign account of brokers is still very small and so is most likely the amount of loans on securities granted by banks to foreigners. Moreover, total loans on securities at the present time are so small that any increase which may take place for foreign account is not of importance. However, the existence of a large block of American securities in the hands of foreigners represents a continuous potential call of foreigners on our credit resources because a large part of the American securities now

owned abroad is of such character as to constitute collateral on which our banks and brokers could not well refuse to lend on the customary terms. This potential call on our credit resources might easily become actual if monetary authorities abroad began to frown upon their own banks extending credit on American securities or if foreign banks decided to reduce their collateral loans on American securities, possibly under the influence of increasing domestic demand for credit.

(4) There is, however, another point here. Under Regulation U of the Federal Reserve Board loans to foreign banking institutions on securities are exempt, i.e., foreign banks can borrow on American securities from American financial institutions whatever the American banker cares to lend. Loans on securities to foreign brokers and dealers may be made up to 60% of the value of the collateral which compared with the usual domestic margin of 45%. Both foreign banks and foreign brokers and dealers could thus extend credit on American securities to their customers abroad far beyond the ratio possible under our margin regulations without even using their own funds. It goes without saying that they could extend such credits to American buyers of securities which thus would be enabled to circumvent the margin regulations. This preference given to foreign banks and brokers does not appear to be justified. A stepping up of the margin requirements applying to foreign banks and brokers, possibly even beyond the 55% required generally from domestic purchasers, might be an easy way of stopping this form of circumvention of the margin rules. This form, however, is probably far less important than that presented by the outright financing of purchases of American securities by foreign banks for account of American and foreign customers.

(5) The foregoing considerations apply chiefly to the influence of a constant net inflow of foreign funds on the market as a whole. It should not be forgotten, however, that foreigners apparently do a very considerable amount of short term trading. During the period from January 1, 1935 to September 30, 1936, total foreign purchases of securities in American markets exceeded $4,350,000,000, while total sales amounted to almost $3,450,000,000, an aggregate of $7,800,000,000. Thus the building up of a net foreign purchase balance of

$900,000,000 required a total turnover of almost nine times that amount. It may be estimated that trading for foreign account has represented on the average approximately 20% of all stock trading exclusive of member trading and has occasionally risen to 25% and 30%. It is obvious, therefore, that foreign in-and-out trading has been powerful influences in the short term fluctuations in our markets. There are indications, however, that foreign and domestic trading have generally moved in the same direction so that foreign trading has served to intensify domestic movements rather than to counteract them or to initiate movements of its own.

In addition to its influence on the market in general foreign trading, of course, may have been the deciding factor in the price movements of individual stocks. This danger of manipulations originating abroad is ever present, although we have not yet detected an actual example.

(6) The most important problem presented by the recent inflow of foreign funds in the stock market probably lies in the danger of a sudden wave of selling. Concerted foreign sales undoubtedly would present a serious problem to the market in its present condition and would most likely result in a sharp break of prices, possibly even in the necessity of closing the market temporarily. Any sudden liquidation of foreign funds now invested in our stock market is, of course, likely only in the event of the outbreak of a general European war and then only if American securities are confiscated by various European governments and sold by them in this country. Considerable liquidation might likewise follow a very large rise in prices, which usually coincides with the nearness of a recession in business and may lead to a widespread attempt to cash in on the paper profits. Present holdings of American stocks by foreigners probably have a value of approximately $3,000,000,000, which is equivalent to about 4% of the market value of all shares listed on our exchanges. In view of the relatively small floating supply, such a proportion is undoubtedly sufficient to create a very important problem if concerted sales took place. Of course, it is unlikely that the entirety or even the great majority of foreign holdings of American shares would be suddenly offered for sale, particularly because a considerable proportion is owned outside of those European countries most likely to be involved

immediately in the commotion and because, according to all information, a considerable part of the foreign money, which has come over here, has come with the intent – not always unsuccessful, it may be assumed – of hiding from the domestic authorities.

III.

In the present situation, both domestic and international, any further inflow of foreign funds into our markets, particularly into the stock market, is undoubtedly very undesirable and any repatriation of the funds already invested should be welcome. The problem, however, is how to bring about a stoppage or even a reversal of a movement which has very strong forces behind it, most of which cannot be regarded as ephemeral or, for that matter, as unjustified from the point of view of the individual foreign investor.

1. Purchases for American account routed through foreign intermediaries, present a problem only of administration and enforcement. These purchases do not influence the international balance of payments nor do they constitute additional purchasing power in our security markets with the exception of margin trading financed abroad. They can probably be outlawed by the Treasury under its present powers and without any untoward effects. Such a step should be seriously considered.

It will be essential in this connection to insure that evasion through the use of dummy foreign corporations is avoided. The least that should be done in this direction is to require the disclosure of all security transactions made indirectly through foreign corporations in which the American trader has any interest, together with his reports on direct transactions in American securities on foreign markets. In addition, it may well be necessary to demand the submission of balance sheets and income accounts of such foreign corporations as the American trader uses in his operations and a provision which would permit the Treasury to assess the American trader on his share in the unreasonably accumulated profits of such foreign corporations in the same way as is now done for domestic corporation.

2. With regard to foreign purchases of American securities, particularly stocks, various methods suggest themselves, each of which presents serious problems of enforcement and considerable possibilities for evasion.

The mildest and easiest method to deter an inflow of foreign funds, undoubtedly, is an increase in the flat rate of the tax on dividends, interest and other current income from American sources paid to non-resident aliens. This rate was fixed by the Revenue Act of 1936 at 10% for non-resident alien individuals and at 15% for foreign corporations, dividend income of such corporations, however, being subject only to a tax of 10%. If this withholding rate were increased considerably and if the rates were differentiated for various forms of foreign investments, considerable effective obstacles would be put in the way of additional foreign investments in American stocks. Possibly, too, a part of foreign investors would be induced to liquidate their holdings of American securities. A rate of 25% - 30% on dividends and a rate of 10% - 15% on interest (possibly defined to include dividends as non-convertible preferred stocks) and other current income paid to foreigners should suffice for this purpose. Such a differentiation could well be justified by the assumption that foreigners make considerable capital gains on their investments in stocks which cannot be taxed directly and which are covered by this extra 10% of 15% levied on the income from investments in stocks. In order to make a high withholding rate effective, it would be necessary to deduct the tax at source. This means that the paying corporation would have to deduct the tax from all dividend payments on shares standing in the name of persons residing abroad and that banks and brokers would have to deduct the tax on all dividends and all interest payments which they collect for account of foreigners and remit abroad or credit to the foreigners account. That would leave only private nominees who might be used to evade the tax. However, if the penalties be made sufficiently stiff, evasions could probably be held within reasonable limits, the device of private nominees anyhow being a risky one for the foreign principal and feasible only in the case of large investors.

If more radical measures are regarded as justified, there are three ways, (a) compulsion to use a nominee for all transactions, (b) requiring a deposit to guarantee payment of tax liability,

(c) a high transfer tax on all transfers to foreign names and (d) a capital levy on foreign investments. While all of these measures will undoubtedly deter further foreign investments in the United States and will most likely result in a repatriation of a part of the American securities now owned by foreigners, all of them will tend to concentrate the trading in American securities which are owned by foreigners in foreign markets to the more or less complete exclusion of transactions on our securities exchanges.

a. It should be possible to force non-resident aliens to transact all of their security business (possibly even all their transactions in capital assets) in the United States through one nominee only, who, of course, could use agents for the actual execution of the foreign orders. This nominee would have to keep a record of all transactions of the non-resident alien and would be responsible to the U.S. Treasury for making a tax return for the foreign client and for the payment of all taxes due on the foreigner's regular income as well as on any capital gains. The nominee would further be required to retain custody of all securities of the foreigner so long as they remain within the United States. The nominee, in other words, will act in every respect as the alter ego of the foreign investor.

It could be left to the nominee to make arrangements with the foreigner which would make it sure that he is put in funds to pay the foreigner's tax liability to the U. S. Treasury. In order to avoid evasion through irresponsible nominees, a list of approved nominees should be prepared by the U. S. Treasury which might include all banks, registered brokers and dealers in securities, lawyers admitted to practice, tax consultants and investment counsel organization.

The most serious difficulty with this plan is that provision would have to be made to avoid evasion of tax through shipment of securities purchased here to the foreigner and their sale abroad. Since it is probably not feasible to tax the unrealized gain existing at the time of the shipment of the security out of the United Station, it is doubtful whether an effective measure can be devised short of the stamping of all certificates sent abroad and a regulation (of doubtful constitutionality) stipulating that in case of their reimportation into the United States, they be valued for tax purposes at the price at which they were originally purchased in the United States, such price to be certified at the time the certificate leaves the United States.

We would, therefore, probably be driven to couple this with an embargo on the shipment abroad of American securities owned by foreigners and held in the United States. This embargo would have to be made effective immediately after the introduction of the nominee regime is announced, even if it is to go into effect only at a later date. Otherwise, a large-scale exodus of the stock and bond certificates held by foreigners would follow and make it impossible to ascertain on reimportation at which price they had been bought in the United States. Even so, some arrangement will have to be made for the valuation of the certificates which were held abroad at the date of the announcement of the nominee regime and which will necessarily have to be shipped from abroad to the United States when sold. It is doubtful whether in such a case an affidavit as to the price at which the securities were originally bought will suffice. More likely, we will have to resort to a flat tax of five or ten per cent in lieu of the not ascertainable exact capital gains tax due.

b. Not much different is the plan to require from every foreigner purchasing securities (and possibly even any other type of capital assets) in the United States a deposit with the U. S. Treasury, such deposit to be used to pay any tax which will become due on occasion of the sale of the security. The difficulty here, too, arises when securities are shipped out. If the deposit is refunded at that time provided the original purchaser still owns the securities, the deterrent effect of the regulation is lost and the extension of the market for American securities abroad favored. If, on the other hand, the tax deposit is made non-refundable, unless the security be resold in the United States and if the tax in the case of such resale is figured on the difference between the purchase and sales price without regard to any changes of ownership in the intervening period through purchases and sales occurring abroad, the method really amounts to a conditional capital levy on foreign purchases made after a certain date. Should it be made to apply to sales of securities purchased before that date in the form of a regulation that no security can be sold for account of a foreigner, unless the required deposit is made the measure comes still nearer to a straight capital levy.

If adopted in the less comprehensive form, a deposit rate of possibly 10% or 15% for stocks and about 5% for bonds and debentures should provide a very potent deterrent to further foreign purchases of American securities in the United States. It is open, furthermore, to the serious objection that it makes the gain on every individual transaction taxable (since the depositiis refundable only insofar as it exceeds the capital gains tax payable on the sale of a specific block of securities), thus denying to the foreigner the benefit accorded to the resident taxpayer of offsetting profits with losses suffered during the same fiscal year.

(c) A high transfer tax on all transfers of American securities into foreign names would probably have a considerable deterrent effect on additional foreign investments in the United States. However, it would require rather elaborate precautions against evasion through the use of dummies. Most likely it would necessitate the introduction of an affidavit on the occasion of every transfer to a domestic name that the transferee is not directly or indirectly holding the securities for foreign account and the abolution of the present practice of having certificates endorsed in blank or carried in street names. Such a tax obviously would not effect the present foreign holdings of American securities. Should a transfer from one foreign name to another foreign name be subject to the tax, there would certainly develop a market in foreign financial centers for certificates already now standing in foreign names. Arrangements would undoubtedly be worked out under which the present foreign owner could sell his securities without the necessity of having the certificates transferred to the name of his foreign buyer. Such arrangement might for instance take the form of the issue abroad of British, or Dutch or French shares of American securities (the counter part of the “American shares” of certain foreign corporations now traded in this country).

(d) The most radical measure, of course, is a straight capital levy on all foreign investments in the United States after a certain date. After that date only securities stamped on the payment of the levy could be acquired or sold by foreigners or shipped out of or into the

United States. Even if such a levy were only at the rate of possibly 10% of the market value for stocks and 5% or less for bonds and liquid funds, it most likely would result in a large scale repatriation of foreign investments. However, it is very doubtful whether such a measure would stand the test of constitutionality. It is, moreover, very difficult to enforce for such foreign holdings where certificates of ownership are already held abroad or may be transferred abroad before the dead line. The difficulties will be particularly great in the case of bearer securities or of certificates of endorsement in blank. In such cases, all that could be done would be practically to stop dividends and interest payments, a measure which in the course of time, of course, would lead either to the payment of the levy or to the sale of the securities in the United States (if a sale of unstamped securities from abroad be permitted at all). If quicker results are desired, the practice of endorsing certificates in blank or of carrying them in street name would have to be abolished. The technical and legal difficulties of such a procedure are obviously very large. The announcement of such a capital levy be accompanied by an immediate embargo on shipment of stock or bond certificates abroad in order to prevent evasion.