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Foreign trading in American securities.

The following is a very brief discussion of a few points of interest to the Securities and Exchange Commission, which arise in connection with either the trading in American securities for foreign account in our domestic market. We have refrained from going into the tax angle of these problems except for a bare enumeration.

I. Trading in American securities on foreign markets.

1; The fact that a part of the total turnover in American securities takes place on organized exchanges or over the counter in places outside the U. S. makes the American market for securities so traded less representative than it would be if no foreign market existed and all trading were done here. So far as the trading is of the in-and-out or of the purely speculative variety, we probably should not mind this very much. However, undoubtedly a part of the pure investment transactions now takes place in foreign markets and is, therefore, reflected in the American market only indirectly, viz., through arbitrage operations.

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 permits manipulations of prices on foreign markets which may 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 fact that certain American securities can be bought on foreign markets permits some individual traders to evade our margin regulations by buying the securities abroad and having their purchase 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 U. S. where the stock could always be sold, if necessary.

4. 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.

5. American brokerage houses lose the income they would derive if the present trading in American stocks in foreign markets took place here. However, a certain amount of trading in American stocks has always been done abroad and it is only the commissions on that part of trading which has recently shifted from the domestic market to the foreign market and which is not reflected in an increase in business handled by American brokers for account of foreign brokers and dealers which may be claimed as lost.

6. No taxes can be levied on transactions occurring abroad. This is not of very great importance under the present regulations where the loss is more or less restricted to transfer taxes and the like, but would become very serious if an attempt were made to tax the capital gains made by foreigners from trading in American securities. Under the present regulations, moreover, the Treasury is going to lose the 10% flat tax on most of the American securities where the certificates are now held abroad; this loss, however, could be avoided by adequate change of procedure (deduction at source).

II. Foreign transactions in American securities on domestic markets.

1. Insofar as foreign transactions result in a purchase balance and that balance is paid in cash there results an increase in the gold basis of the currency. We are not inclined to regard this as a very serious problem because the inflowing gold could easily be sterilized if the Stabilization Fund borrowed a like amount in the market. Assuming a gold inflow of even $1,000,000,000 a year, the Treasury could borrow the necessary funds on the basis of 1 to 5 year notes at a cost of not over $10,000,000 a year. Moreover, the total net cost to the Treasury would be smaller inasmuch as the difference between the purchase and sales price of the gold would offset a part of the interest paid. If this policy were followed there would be no problem either if considerable amounts of the money coming over now would be withdrawn later. As a matter of fact, the policy suggested here is that adopted by the Bank of England in isolating the in-and-out flow of gold from the internal credit structure.

2. Foreign buying, of course, under the present situation of the market, where the total supply of stocks does not increase, is a powerful force making for rising stock prices. This rise may become a point of serious concern to the Securities and Exchange Commission if exceeding certain limits. Moreover, most likely foreign buying is concentrated in a small number of large issues and thus probably tends to accentuate the disparity existing in the price earnings ratios of blue chips and of smaller issues. Whether such is the case could be tested by

requiring a breakdown of the reports on foreign transactions in American stocks for a short period of time, preferably through the Treasury.

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.

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 against 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 them, 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, which, of course, is chiefly a point of concern for Central banks abroad. Attention should be given to the possibility of determining the actual origin of orders coming into this market from abroad by a sort of census extending over a short trial period during which foreign brokers and dealers would have to give the name of their client for whose account the transaction is made. It is obvious that the difficulties of such a procedure are very great and the possibilities of evasion large.

4. An important problem is presented by the danger of sudden sales of American securities now held abroad. 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. However, such sudden withdrawals are 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. Now, the great majority of American marketable securities held in Europe is owned in Great Britain, Netherlands, Switzerland and France; the holdings of marketable American securities under the control of the governments of Germany and Italy are most likely too small to constitute a serious factor in the market. Moreover, the only purpose to which the proceeds of American securities thus confiscated by European governments could or would be put is the purchase in the U.S. of industrial raw materials or of manufactured armaments. Thus, the only problem would be to provide for an orderly exchange of the American securities to be repatriated against direct or indirect war material produced here. If war breaks out and certain European nations need to buy supplies here, it is certainly preferable that they pay with good American securities than with gold or I.O.U.'s. We should already now think of the creation of an agency in some ways similar to the RFC which would, if

needs be, purchase or loan upon certain American securities now held abroad in order to prevent a decline in prices and a breakdown of the mechanism of the market.

5. Foreign buyers do not pay the full income tax on the interest or dividends derived from the securities bought here, but only a flat tax of 10% which probably is evaded to a considerable extent. They do not pay any tax on capital gains made in the American market. It is obvious that a relatively simple and equitable way to reduce foreign trading in American securities would be to levy the same taxes on current income and profits on transactions in American securities from foreigners than are levied by residents. The trouble with this program is almost entirely the difficulty of its enforcement.

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