Confidential

MEMORANDUM

DATE October 15, 1938

TO: Chairman Douglas

FROM: Paul P. Gourrich

SUBJECT: Comments on Part Two of the W Report

Summary

Although I could not help including some general comments in the body of the remarks on specific points and pages, which follow this summary, I want at this point to generalize on the subject matter of this report. I must confess that this report gave me a lot of trouble. It is a very complicated and delicate matter, and I assume that many of the things that were incorporated in this report have been discussed with the interested parties.

For nearly a year I have done nothing on the subject, and I am somewhat rusty on it. I have had no occasion to speak to anybody in our organization on the subject, not knowing who worked on it, and hence can rely exclusively on my own thinking on the subject, which is not always a safe way, as you know. Two heads are better than one, particularly heads that are fresh from the work on the subject. It is too delicate a subject for me even to talk about with my friends in the Street and to try out their reactions, which possibly they may give me personally in a more frank and unofficial manner than to some others. I will do it, however, if you think I should. Hence, at best I can give you just preliminary thoughts, pending my mulling it over further in my head.

You will recall that we were supposed to study some important phases of the problem; that I prepared at one time elaborate questionnaires which might have given us more light. I am not particularly sorry that these questionnaires were not used, because the Street has been complaining of being over-questionnaired. Yet, a program of that kind needs very careful consideration from every angle and the thinking out of all its possible implications. It certainly can benefit from a cooling period; but all this you know yourself, and I am suggesting it merely as a possible apology for my tentative ideas.

It seems to me that the smaller broker-dealer, and particularly what is called in Wall Street the "out-of-towner", may find his business pretty much jeopardized. Conditions are totally different in the small places, and you have made such big efforts to help in building up the regional capital markets, the nucleus of which is always the local exchange and local over-the-counter market, that you ought to consider this angle as well. It is for this reason that I have been so greatly impressed with the self-regulation formula. Under it, each exchange can pass its own rules, and this goes particularly for the New York Stock Exchange which is a totally different institution from, e.g., say, the Washington Exchange. It is a national institution with very obvious national implications to it. The New York Stock Exchange can make rules for its own members, and those rules need not affect the smaller exchanges in outlying districts or the dealer-brokers in New York who are not members of the New York Stock Exchange. Moreover, if the New York Stock Exchange discovers that rules which it had made need correction, those corrections can be made almost overnight, whereas for us, once a rule has been promulgated, it may not be easy to retrace our steps. Occasional changes of our own rules, or retracings, may be all right, but obviously too many of them may hurt our prestige.

I realize that the Whitney experience has been a shocking one. Within one month after my joining the SEC, I suggested that every broker should submit an intelligible balance sheet to us with the possibility even of making it available for public inspection. If such a balance sheet were audited, it is possible that the Whitney affair would not have gone that far, although, of course, when it comes to crookedness there isn't such a thing as complete protection. Crooks will forge signatures, steal, and do whatnot; and, finally, as the case of Interstate Hosiery has shown, even the senior supervisory, independent accountant (not the firm of auditors who, I understand, were innocent) may himself prove to be a crook. While there is no 100% insulation against crooks, of course, under your program the yearly reports made by independent auditors, if the scope of such report is adequate, and further audit and surprise checks by the stock exchange, should go a long way to reduce the looseness on which crookedness tends to flourish.

There are many laudable things in this report, and probably every one of the suggestions is sound on its own merits. But whether, in a network of Maginot lines, all of them are necessary, and whether the impact of some such fortified lines may not cramp financial business, particularly the capital market and the development of regional financial centers, that is to say, whether the "game is worth" every one of the candles, I am not so sure. It is for this reason that I would, at least in the first step of the program, stick to only such rules and changes as are adopted by the New York Stock Exchange itself. In light of the leadership supplied by the New York Stock Exchange, other centers will then very likely draw up their own programs of regulation, under our inspiration but in every case as a matter of self-regulation, so that we will remain merely an inspiring and supervisory body, seeing that their own rules, passed with our approval, are lived up to. The exception may be, of course, such rules which the exchanges may ask us to promulgate, in order that their own rules, regulations, inspection, and enforcement are made effective. If we accept this general formula for regulation of exchanges and over-the-counter markets (the philosophy of self-regulation under your leadership has been widely proclaimed in business circles as a constructive method), it will then be possible in each case to take into consideration the concrete circumstances of the case, see to it that regulations fit their environment, that, for example, the capital at the disposal of the brokerage and dealer community does not shrink, which may be the case if rules are over-restrictive, and in a general way that the true basis of organic and natural development is afforded in each case, which may not happen if we set national patterns. It is all right to have a simple philosophy about that thing, but a living statute and its constructive administration necessarily imply careful application of the underlying philosophy to all the circumstances of the case.

The underwriting capital is now very small. It is particularly small out-of-town. The dealer out-of-town can scarcely do anything but conduct a small department store, or rather a general country store which sells groceries, shoes, haberdashery, clothing, etc; otherwise he can't exist. Like the general store in a village, so the small dealer-broker is a definite part of the American milieu. Both have grown up in a natural way. Sure enough, it may not be the most desirable way, and it may be worthwhile paying the price for improving that milieu, but we may not know what will be the price of radical changes.

Some of the ideas suggested in this report raise a number of questions bearing upon the constitution of the New York Stock Exchange and legal matters which, with my present facilities, I am not capable of answering, and hence I am forced to deal with generalities. For example, it is my impression that at present a broker can figure as part of his capital the loan value, i.e., about 60% of the listed securities which he may have in his possession. Under your program such securities will have to be taken out of his capital account. It will probably create no hardship on the big brokerage house, but even the middle-sized broker in New York will have quite a problem. The answer to that may be “let them get additional capital.” But in the last six years I have seen all kinds of capital withdrawn or disappearing from Wall Street (through death of partners, liquidation, losses, etc.) and very little, if any, going into it, and the question is “how will they get it?” To the extent that brokers are participants in the underwriting and distributing machinery for new securities and they may need their capital to conduct their brokerage business, they will have little, if any, capital to put at the disposal of the dealer affiliate. To that extent the underwriting machinery will be further crippled. After all, the new issue market is the most important thing from an economic point of view. We must never dismiss it in weighing evidence for decisions taken in connection with financial matters.

I do not know whether these general observations in the nature of a summarization of my ideas can boast of any particular wisdom. I am torn between two different forces: one which, for want of a better wording, I may call the morality and the decency of the thing, and the other is economic exigencies. Both are important. There must be somewhere a between point where each is given proper consideration, not to the exclusion of the other. Frankly, I do not know where and what that middle point is, except that I have faith that the formula of self-regulation, which, because you hammered it down over and over again, is sinking deep into the heart of American business, is away from the turbulent and unchartered seas and nearer to shore. It is in this light that I ask you to read my page-by-page observations on the report, as follows: