

CONFIDENTIAL

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REPORT

ON

**THE TRADING IN AMERICAN
SECURITIES ON THE
BRITISH MARKET**

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CONTENTS

	<i>Page</i>
PREFACE.....	IV
PART I. THE BRITISH MARKET	
CHAPTER I.	
Certain Characteristics of the British Capital Market.....	1
A. Law	1
B. The “City” of London	4
C. The Factors in the English Market.....	5
CHAPTER II.	
Trading on the London Stock Exchange.....	13
A. Introduction.....	13
B. Assembly of Orders – Brokers.....	17
C. Execution of Orders – Jobbers.....	22
D. Conclusion as to Persons With Whom Orders are Executed.....	27
E. Trading Procedure.....	28
1. Fortnightly Settlement	29
2. Contangoing or Carrying Over	30
3. Floor Procedure.....	31
4. Method of Negotiation.....	34
5. Deliveries	41
CHAPTER III.	
Speculation on the London Stock Exchange	45
A. Credit for Speculative Trading.....	45
1. Fortnightly Settlement	47
2. Contangoing.....	49
3. Loan Contract.....	50
4. Direct Bank Loans	51
B. Flow of Trading is Less Than in America	52
1. General.....	52
2. Relative Costs as Between London and New York.....	57
a. The Jobber’s Turn	57
b. Commissions and Taxes	59
(1) Purchase for Investment	60
(2) Speculative Purchases	61
3. Facilities for Quick-Turn Trading are Less	63
4. Conclusion	67

	<i>Page</i>
CHAPTER IV	
General Comparison Between Trading on the London Stock Exchange and the New York Stock Exchange	69
A. Introduction.....	69
B. Factors Other Than Trading Procedure Which Make for Stability in Prices	76
C. Trading Procedure as a Stabilizing Factor	78
1. General.....	78
2. The Jobber System as a Stabilizing Factor	81
a. The Jobber as a Buffer	83
b. The Two-Way Price.....	84
c. In Times of Crisis the Jobber System Tends to Prevent Panicky Selling.....	85
 PART II. THE TRADING IN AMERICAN SECURITIES ON OR EMANATING FROM THE ENGLISH CAPITAL MARKET	
CHAPTER I.	
General Foreign Stake in American Securities	87
 CHAPTER II.	
Direct Trading Emanating from London Executed on American Exchanges	97
A. Means Through Which Business Arrives to the New York Market.....	97
B. Sources of Business	101
C. Nature of Direct Business	103
 CHAPTER III.	
General Features of Trading in American Securities on English Markets	107
A. Introduction.....	107
B. Relationship Between New York and London Markets Close	109
C. “American Market” Marked off and Distinct from Rest of London Exchange	112
 CHAPTER IV.	
Factors in the “American Market”	117
A. Assembly of Orders	117
B. The Persons With Whom Orders are Executed	123

	<i>Page</i>
C. Execution with Arbitrageurs, and Arbitrage	124
	<i>Page</i>
1. General	124
2. Arbitrageurs	129
a. Non-Member Arbitrageurs	131
3. Arbitrage is Largely Speculation	133
 CHAPTER V.	
Method of Doing Business.....	139
A. General	139
B. Opening Price.....	141
C. Course of Prices and Trading.....	142
D. Cheaper for Jobber to “Undo” with Arbitrageur Rather than Directly in New York	149
E. London Overflows in the Day to New York.....	153
 CHAPTER VI.	
Nature and Volume of Trading	155
A. Trading is Speculative and Concentrated in a Few Market Leaders	155
B. Volume.....	162
1. General.....	162
2. Indication of the Extent of London Markets in Particular Market Leaders	165
a. Special Case of U. S. Steel Common	168
3. Total Volume in Americans.....	171
a. General	171
b. Rough Estimates	173
c. Influence Greater than Total Volume Indicates: Foreign Trading in Steel Common	175
 CHAPTER VII.	
Nature of Relation Between New York and London Markets.....	179
A. London Market in American Securities is Parasitical to New York.....	179
1. General.....	179
2. Without Ability to “Undo” in New York, London American Market Would Shrink Up.....	184
B. Use of the London Market to Escape American Law.....	188
1. London Market Offers Efficient Means to Escape American Law.....	188
2. Sales by “Insiders”	189
3. Escape from Securities Act of 1933.....	190

	<i>Page</i>
4. Large Amount of Unregulated Short Selling in Americans on London Market	191
5. Manipulation in Americans on the London Market.....	195
a. Manipulation in General Has Been Prevalent on London Market	195
b. London offers Facile Means to Manipulate in Americans	200
CHAPTER VIII.	
The Professionals on the Two Markets.....	205
A. The Jobber Has Distinct Advantage Over the Specialist	205
B. The New York Joint Arbitrageur Enjoys Exemptions.....	207
C. The London Joint Arbitrageur Has Additional Privileges, Which Carry Over to his New York Correspondent.....	209
D. The New York Stock Exchange for a Considerable Time Prohibited Joint Account Arbitrage	210
CONCLUSIONS.....	213

PREFACE

The charge has been frequently made that recent legislative enactments have caused trading in American securities to flee from this country, with a resulting escape from the law properly controlling and an undue loss to the American business community. This report is concerned primarily with the consideration of the quantity and kind of that trading in England. To obtain the proper framework, some general indications of certain relative features of the English capital markets will be given. Although this may serve, incidentally, to throw light upon procedures of our own markets, the immediate purpose has been to furnish the background necessary to a proper understanding of the English trading in American securities.

Since the investigation leading to the report, the outbreak of the war has seriously changed the kind and method of trading, so that some of the matter may have pertinence only upon the cessation of hostilities and the resumption of normal financial markets.

There is a dearth of statistical information in England as contrasted with America, particularly as to the stock Exchanges; for example, the volume of trading is not reported, either in total or by individual issues. Also, governmental statistics are not published concerning the movements of capital and payments commensurate to those issued in this country. In consequence, for the greater part, an attempt is made merely to condense impressions gained from interviews with a number of competent observers of the English market. No claim is made to the exactitude which results from precise statistical studies.

Appreciation is expressed for the intelligent cooperation and help given in making the report by Messrs. Charles R. McCutcheon and Paul N. Culp.

THE TRADING IN AMERICAN SECURITIES

ON THE ENGLISH MARKET

PART I. THE BRITISH MARKET

CHAPTER I

CERTAIN CHARACTERISTICS OF THE BRITISH CAPITAL MARKET

After a cursory examination of the English law affecting the securities markets, we shall take a bird's-eye view of the "City" of London, followed by a brief indication of the various factors in the securities markets and a fuller discussion of the London Stock Exchange. Special attention will be paid to the division between broker and jobber and their respective functions.

A. *LAW.*

The first major difference between the English capital markets and our own is the singleness of applicable law: the presence of only one corporate law prevents the abuse in the choice of law which exists in America.

The basic English law affecting securities is the Companies Act, 1929. Although more stringent than the majority of the laws of the several states in America, this law is recognized by authorities as failing to perform its function of social control; for example the means of evasion of disclosure requirements in prospectuses are self-evident. It is further said that the administrative implementation is not effective; as an instance,

provision is made, under certain circumstances, for investigations of corporate management, but these investigations are said to be slow and ineffective.

The Act fails particularly in not making adequate provisions concerning subsidiaries, and, in consequence, the subsidiary is more and more used as an effective means of evasion. This is especially true as to accounting matters. The non-requirement to disclose the operating results of subsidiaries allows the large companies to make their earnings what they see fit; all the more so since there is no legal requirement to take depreciation. Thus the large companies can make their earnings appear more stable than they are in fact.

There are numerous other laws affecting the securities markets which cannot be examined within the compass of this report. To get a complete understanding of the English system, however, it would be necessary to consider these other laws, which probably have a greater incidence than is true of our own general legislation. The common law also, it is believed, has been applied more vigorously than in America to the securities business in general. At times, however, the courts have permitted subterfuge through the creation of family and subsidiary corporations, to escape tax laws and legislative prohibitions.

No act is directed to the stock exchanges as such. There has recently been enacted, however, the so-called Share-Pushing Bill,¹ to regulate the business of the "outside dealers," that is, those persons in the securities business who are not members of an exchange. From the compass of this statute, however, are excepted the members of recognized organized exchanges. Indeed, under the English system, the London Stock Exchange is supposed to be, itself, an instrumentality of control, and the intimate relationship existing between business and government make this more than a mere

¹ Prevention of Fraud (Investments) Act, 1939.

matter of form. Opinion in England exists, however, that the self-control has not been sufficiently effective.

Although there is no legislation directed primarily at manipulation, there are several cases holding it to be unlawful.² The real difference between the London and New York markets in this regard, insofar as legal prohibitions are concerned, would seem to lie in the absence there of sufficient means of enforcement.

The comparison, however, of English and American law would be devoid of meaning without consideration of the large means of control exercised in England by the government without direct legal authority. Through these these indirect controls, the securities markets may be made to respond to the national needs. They are the more effective the less the number of people involved.

As an instance of such influence may be given the action of the Chancellor of the Exchequer in the early spring of 1939 concerning the purchase of foreign securities. He expressed the wish, in view of the foreign exchange situation, that the purchase of foreign securities cease. This effectively stopped the private placings of foreign securities, curtailed trading on the London Stock Exchange in American securities, and affected gravely the business of American brokerage branch offices in London.

Although the Bank of England is a private institution, it operates as a link between the government and finance in general. It is not at the present time directly engaged in the securities business, except for its open-market operations and its acting as the bank of issue for certain gilt-edge securities, but it does assume leadership in regard to new issues made by public bodies such as municipal corporations and cities. This control is effective, although not sanctioned by law. Thereby the order of arrival of such securities on the market is regulated, the primary consideration being the absorptive power of the money market. The Bank at times makes unofficial embargoes on the

² See for example, *Rex v. De Berenger* (1814), 3 M. & S. 67, and *Scott v. Brown, Deering, McNab & Co.* (1892), 2 Q.B. 724, C.A.

flotation of new capital issues, and it is said that “important foreign issues * * * are seldom underwritten in London unless the Governor of the Bank of England has been first consulted and that any opinion he may offer will carry great weight.”³

As a further instance of government control other than through direct legislation may be mentioned that of the Foreign Transactions Advisory Committee. Although set up without real authority of law, this body has exercised an effective control. Designed to serve as a check on new issues involving foreign exchange transfers, the powers of the Committee have been extended in practice, so that at times its action has prevented access to the market of securities which it deemed undesirable. The powers of this body must be considered in connection with that of the Bank of England, mentioned above, to regulate the advent of gilt-edge securities to the market.

B. *THE “CITY” OF LONDON.*

The “City” of London corresponds to what is commonly called Wall Street, the area in Manhattan south of Chambers Street. It is the inheritor of the old Roman City, and its limits are roughly the same. Even to this day it has preserved for itself, as a community of merchants, privileges distinct from the general community. When the King proceeds to the Guild Hall, which lies within the “City” precincts, he is met at the confines and introduced, this formality being symbolic of the “City’s” special position. The “City’s” governing body is not elected by the general population, but by the old guilds, now constituted of the leading business men and financiers.

The Bank of England on Threadneedle Street occupies the point of vantage. Within a stone’s throw is the Stock Exchange Building of Throgmorton Street, and around it, on all the surrounding streets and alleys, are the offices of stock brokers and jobbers. A little removed is Lombard Street, on which are found the offices of foreign

³ *Report of the Committee on Finance and Industry*, Great Britain (“McMillan Report”). London, 1931, p. 155.

banks. Lloyds, as the center of maritime insurance, is likewise not far away. Scattered about are the investment bankers, the so-called "finance" companies, the banks of deposit, the "outside dealers," the investment trusts, which latter often occupy quarters with their sponsors, and some of the insurance companies.

Within the "City" are found representatives of the major English financial interests. These various agents are well-known to one another through social ties and inter-locking interests. The area is small and the acquaintanceship is extended.

The "City" is a cosmopolitan center, both in its history and in its present position, more so than New York. Its history is replete with importation from the Continent: Lombard Street is named after the early Lombard bankers who first made London a money center. At the present time the principal banks of all the nations of the world have offices or representation there, and many English firms are not English from the standpoint of the original nationality of the proprietors or their forebears, as can easily be seen from any calendar of names of prominent "City" people.

C. *THE FACTORS IN THE ENGLISH MARKET.*

Before coming to the stock exchanges, a few words may be devoted to the several factors in the English capital market.

In the first place, the general public has less interest in the securities markets in England than in America, particularly insofar as equity securities are concerned. People of smaller means are more inclined to make "thrift" investments. The local following of the markets is therefore undoubtedly more informed, and, taken as a whole, possesses greater individual means than is true in America. To state it otherwise, the English public interest in stock exchange securities does not go as far down the cone as in America. And the English public is said to be more inclined to gamble on the races than to speculate on the exchange. On the other hand, the English market necessarily serves as the great monetary and securities clearing-house for the Empire, and indeed, in part for

the world, so that there is a large world interest in the transactions on the London Exchange.

Deposit banking as contrasted with America shows a vital difference, due to its concentration in the "Big Five," with branches in all corners of the country. In this great extension of branch banking, England resembles the Continent. The "Big Five," however – in this regard in striking contrast to the Continent -- in principle do not engage in underwriting. But they do perform an important role in the day-to-day trading in securities, since they and their branches receive orders for dealing in securities to be executed through the exchanges. For such business the banks receive one-half of the brokerage. Insofar as the distribution of securities is concerned, the banks of deposit limit their activities in principle to what in England is called "banking," which means merely the physical work of receiving applications and issuing allotments. These operations they perform as agent for the account of the principals sponsoring the issue. The link between the banks of deposit and the Bank of England as the central monetary authority is made by the discount houses and discount brokers, who constitute one of the peculiarities of the English markets. Since their function, however, concerns the flow of short-term funds and the contraction and extension of banking credit, they are not of interest here except to mention that to some degree they have supplanted the stock exchange as the market in government securities.

"Investment bankers" are in England called "merchant banks." Their name indicates their origin; originally merchants, they passed over into the acceptance business -- and from there into the sponsoring of foreign issues and, more lately, domestic issues. Although the major ones have their roots far in the past, there are other houses tending to partake of their characteristics, but not having the same prestige and perhaps not always the same standards.

A peculiarity of the English market are the so-called "finance houses." Their prime function is the "nursing" of new companies, accompanied generally by effective

control, even though there may not be control by share ownership. The major “finance companies” limit their operations principally to mining and other raw material enterprises, particularly gold mining. They bring the enterprise to such point that share capital can be issued to the public, and then sponsor and direct the financing, continuing thereafter to furnish management to the new company. They also trade in the sponsored securities, with the primary purpose, it is said, of evening out valleys in price movements. Naturally, these companies are of varied quality and degree. The shares of some of them and their subsidiaries constitute leading speculative counters both on the London market and the markets of Johannesburg and Paris, in which, in normal times, there is a large and active international arbitrage. There are other “finance companies” which do not enjoy too great a reputation and, in boom times these have a mushroom growth.

As contrasted with America, there are several great differences in the role played by the large insurance companies in the securities markets. In the first place, they have a direct part in original distribution to the public, in that they constitute one of the chief sources of “underwriting” capital: they are “underwriters” in the sense of agreeing to take what the public does not subscribe. This is done not only for fixed income securities, but also for equities. In the second place, a very substantial part of life funds are invested in equity securities, there being no limitation by law in England upon the investment of life funds. Due to the fact that the English life insurance companies do a world-wide business and have existed for so long, they dispose of enormous funds for investment, and in normal times the annual increment resulting from the excess of premiums received over disbursements attains a very large figure. In view of these large funds, their mode of operation in the securities market constitutes an essential difference from our own markets. These companies also play an important direct role in American securities, since in their portfolio they carry a large amount of American securities as pure investments, and also as required reserves for their American business.

The investment trusts, both fixed and management, likewise are important factors in the English markets and in American securities. Many of them are subject to a common control and represent, in the aggregate, very large financial interests. The management trusts essentially differ from the equivalent institutions in America in that they also directly “underwrite” new issues; further, their portfolios are not so frequently shifted.

In addition to the 5,000-odd members of the recognized stock exchanges, and the banks and other agencies which act as “feeders” to the exchanges, there exist between 600 and 800 “outside dealers.” This group has been marked by its independence from regulation and its widespread use of advertising and circularization in obtaining new clients, practices which are deemed, on the English market, to be the badge of improper conduct. This class of persons is very small indeed -- practically insignificant, in contrast with the over-the-counter dealers in this country. The class is not important, since the primary market for bonds is on the Exchange and there is no over-the-counter market of consequence. Although some of its members do a legitimate business, the standing of the class is not high. The lower elements have been composed of fraudulent “share-pushers,” “hawkers” and “touts,”

“whose methods are endless variations on two main themes -- the exchange of worthless shares for the victim’s cash or sound securities, and the eventual confiscation of ‘margins’ in a non-existent gamble for the rise.”⁴

Business of this kind has increased greatly in boom times, and has been conducted by means of misrepresentation and high-pressure sales efforts by telephone, correspondence and personal call. Attempts have been made to stop it at its fountain-head, by limiting solicitation, both in the Companies Act, 1929, and in the recent Share-Pushing Bill.⁵

⁴ See “Fraudulent Share-Pushing,” in the *Economist*, August 14, 1937, V. 128, p. 347.

⁵ Prevention of Fraud (Investments) Act, 1939.

The Companies Act, 1929, imposing minimum requirements for prospectus material used in any offering of securities, goes on to provide in Section 356:

“It shall not be lawful for any person to go from house to house offering shares for subscription or purchase to the public or any member of the public.”

“House” is defined to include a business office. This section also provides that any written offer of securities should contain information similar to that required for prospectuses. These regulations proved to be ineffective, however, due in part to the evasion of the ban on “house-to-house” solicitation through the use of the telephone and the mails. In consequence, the Share-Pushing Bill was passed, and has since been implemented by rules and regulations issued by the Board of Trade.

The Share-Pushing Bill has little impact upon the organized securities business. Members of the recognized stock exchanges are exempted from its provisions, and independent dealers may form associations under the statute, to police themselves. However, their rules are subject to control by the Board of Trade. Dealers who are not members of an association must procure individual licenses, and the Board of Trade has issued rules of conduct for this group.

Both the statute and the rules of the Board of Trade have curtailed severely the practice of “touting” shares by solicitation and circularization. The statute outlaws the distribution or possession of circular material by unauthorized persons. The Rules of the Board of Trade, in turn, contain strict limitations upon the matters to be included in any written offer to deal in securities, and provide that:

“3. -- (i) A licensed dealer shall not, during or as a consequence of a call upon any person, deal in securities unless --

(a) he calls upon such person at his request; and

(b) before any contract is entered into he furnishes to such person a written statement containing the particulars required by Rule 2 to accompany an offer in writing.

(ii) The expression ‘call’ includes a communication by telephone.” The rules, however, make exceptions for regular clients.

As an example of rules adopted by associations formed pursuant to the Share-Pushing Bill, there may be given the following extract from those adopted by the association formed for the twenty-odd members of New York Stock Exchange operating in Great Britain, who, from the English standpoint, are “outside dealers”:

“1. No Member shall at any time issue or permit to be issued any circulars or business communications in the nature of circulars to any persons in the United Kingdom other than the Member’s own principals or clients and no Member shall advertise or permit the appearance in any European publication of any advertisement for business purposes referring to its office or representation in the United Kingdom.”

This rule should be considered in conjunction with the analogous rules of the stock exchanges as to their own members, later to be described.

To conclude, the basic principle under the English system is that savings should seek the investment opportunity rather than that the investment should seek the savings. As a consequence, there is probably less diversion of bank credit into capital investment. Definite restrictions cut the mail campaign and personal solicitation at its source. In this regard, the English treatment is more drastic than the Securities Act or the Blue-Sky legislation in America. Indeed, in a critical review made by the *Economist*, of the Securities Act and the Securities Exchange Act, the author states:⁶

“There are other surprising omissions. The whole system of touting securities throughout the length and breadth of the land, largely prohibited in Great Britain, is apparently to be left untouched.”

⁶ See “Stock Exchange Control,” *Economist*, February 7, 1934, V. 118, p. 336.