88th Congress, 1st Session - - - - House Document No. 95, Pt. 4

REPORT OF
SPECIAL STUDY OF SECURITIES MARKETS
OF THE
SECURITIES AND EXCHANGE COMMISSION
PART 4

CONSISTING OF

LETTER OF TRANSMITTAL OF AUGUST 8, 1963, FROM THE CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, LETTER OF TRANSMITTAL OF AUGUST 6, 1963, FROM THE SPECIAL STUDY OF SECURITIES MARKETS, AND THE FOLLOWING CHAPTERS:

CHAPTER X.—SECURITY CREDIT

CHAPTER XI.—OPEN-END INVESTMENT COMPANIES (MUTUAL FUNDS)

CHAPTER XII.—THE REGULATORY PATTERN

CHAPTER XIII.—THE MARKET BREAK OF MAY 1962

OF THE REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS, RELATING TO THE ADEQUACY OF INVESTOR PROTECTION IN THE SECURITIES MARKETS, PURSUANT TO SECTION 19(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (PUBLIC LAW 87-196)

AUGUST 8, 1963.—Referred to the Committee on Interstate and Foreign Commerce and ordered to be printed with illustrations

88th Congress, 1st Session - - - - House Document No. 95, Pt. 4

REPORT OF
SPECIAL STUDY OF SECURITIES MARKETS
OF THE
SECURITIES AND EXCHANGE COMMISSION
PART 4

CONSISTING OF

LETTER OF TRANSMITTAL OF AUGUST 8, 1963, FROM THE CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, LETTER OF TRANSMITTAL OF AUGUST 6, 1963, FROM THE SPECIAL STUDY OF SECURITIES MARKETS, AND THE FOLLOWING CHAPTERS:

CHAPTER X.—SECURITY CREDIT

CHAPTER XI.—OPEN-END INVESTMENT COMPANIES (MUTUAL FUNDS)

CHAPTER XII.—THE REGULATORY PATTERN

CHAPTER XIII.—THE MARKET BREAK OF MAY 1962

OF THE REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS, RELATING TO THE ADEQUACY OF INVESTOR PROTECTION IN THE SECURITIES MARKETS, PURSUANT TO SECTION 19(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (PUBLIC LAW 87-196)

AUGUST 8, 1963.—Referred to the Committee on Interstate and Foreign Commerce and ordered to be printed with illustrations

U.S. GOVERNMENT PRINTING OFFICE

96-746 WASHINGTON : 1963

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C., 20402 - Price $3.75

REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS—PART 4

SUMMARY TABLE OF CONTENTS OF PART 4

(*Detailed tables of contents appear at the beginning of each chapter*)

LETTER OF TRANSMITTAL

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., August 8, 1963.

The PRESIDENT OF THE SENATE.
The SPEAKER OF THE HOUSE OF REPRESENTATIVES.

SIR: I have the honor to transmit the final installment of the Report of the Special Study of Securities Markets containing chapters X through XIII. This report is transmitted pursuant to section 19(d) of the Securities Exchange Act of 1934, Public Law 87–196.

I

As directed by the Congress, the whole report is a broad study of the securities markets and a commentary on the adequacy of investor protection in those markets. As we indicated in our first letter of transmittal, the report demonstrates that, although serious problems do exist and additional controls and improvements are much needed, the regulatory pattern of the securities acts does not require dramatic reconstruction. In important respects this pattern has been effective, efficient, and adaptable; it has advanced and guarded investor participation in our economic growth. The functions of this report and of any changes proposed are to strengthen the mechanisms facilitating the free flow of capital into the markets and to raise the standards of investor protection, thus preserving and enhancing the level of investor confidence.

II

The chapters here submitted deal with diverse subjects, including the adequacy of the structures and practices of the self-regulatory agencies, security credit regulation, mutual fund selling practices, and events surrounding the market break of May 1962. As in the case of prior sections of the report, the Special Study was given freedom to analyze and point out problems as they appeared to it; in this respect the judgments, analyses and recommendations in the report are those of the Special Study and not the Commission. We strongly endorse the general soundness of these chapters as a basis for discussion with the industry, for rulemaking, and for legislative proposals. Without public notice and comment, we may not speak definitely on those questions involving substantive changes in our rules or the rules of the self-regulatory agencies. In any case, we believe the responsible course of action calls for discussions with the securities industry before final decisions are made.

Rather than taking up the chapters in order, we shall first focus on chapter XII—which analyzes the role of the self-regulatory institutions and their relation to the Commission.

A

In section 19(d) of the Securities Exchange Act, the authorizing resolution for the Special Study, the Congress emphasized an examination of the adequacy of the rules of the self-regulatory agencies. The whole report is a comment on this theme. Chapter II evaluates the rules of the NASD and of the principal exchanges relating to qualifications and chapter III those governing selling practices and investment advice. Chapters VI and VII examine the rules and procedures of the self-regulatory agencies with respect to trading practices in the exchanges and over-the-counter market. Chapter XII, transmitted today, analyzes the organization and self-regulatory operation of those agencies, with primary emphasis on the New York Stock Exchange and the National Association of Securities Dealers, Inc., and their relationship to the Commission and each other.

We agree with the report that "the basic statutory design of substantial reliance on industry self-regulation appears to have stood the test of time and to have worked effectively in most areas." This conclusion obviously does not minimize in any way the need promptly to remedy the disclosed inadequacies, a need more critical as increased reliance is placed on the self-regulatory agencies—which this report and the Commission contemplate.

(1)

The New York Stock Exchange occupies an unrivaled position as a self-regulatory institution because of its importance as a market and because of the dominant position of its membership in the securities business. We believe it important to point out, first, that the study quite properly devoted particular attention to problem areas and, secondly, that, although there are defects in the functioning of the Exchange market which should be corrected, the Exchange has worked diligently, and on the whole successfully, to maintain a fair and honest market. The report points out the strong performance of the Exchange in many areas, including qualifications and net capital. Its disclosure and related requirements, some antedating the enactment of the Federal securities laws, represent a major contribution to investor protection and, in some respects, have gone beyond anything the Commission could do. In certain areas, judged by the Exchange's own standards of accomplishment, performance has been less satisfactory. For example, controls over branch office operations and investment advisory and selling practices require strengthening; the Exchange itself has recognized this in its initiation of new programs. The report discloses a failure of regulation over odd-lot dealers and raises serious questions about floor trading. The Special Study's examination of the Exchange's specialist system reveals no widespread abuses or patterns of illegality. On the other hand, there are subtle and complex problems discussed in the report which call for examination and review by the Exchange and the Commission with a view to strengthening the system and raising the quality of operation of some segments to that of the most effective and most efficient.

Moreover, disciplinary action does not appear to have been as forceful as circumstances have warranted. With regard to the organization of the Exchange, the report points to a need for a reallocation of voting power among members and allied members in order to give firms dealing with the public more responsibility in the government of the Exchange.

The importance of the New York Stock Exchange as a self-regulatory institution and as a market makes it imperative that it bring its entire level of performance up to its demonstrated capabilities. The recommendations in chapter XII-B of the report and elsewhere are designed, as the report states, "to point toward an even stronger future role" for the Exchange. With limited reservations in two instances which are footnoted below, we agree with these recommendations.[1]

(2)

Early in 1962 the Division of Trading and Exchanges of the Commission, in conjunction with the Special Study of Securities Markets, issued a report concerning the American Stock Exchange. This report pointed out serious problems in regard to the operations of that Exchange and practices occurring on its floor. The American Stock Exchange, together with selected representatives from the securities industry, and in consultation with the Commission, has since engaged in a substantial reorganization of its management, constitution, and operations. As the report concluded in subchapter XII-C: "In contrast to the prior breakdown of self-regulation described in the staff report, the accomplishment of this reform appears to be an excellent demonstration of the effectiveness of self-regulation under responsible Exchange leadership and active Commission oversight." It is apparent that the American Stock Exchange has now instituted a responsible regulatory system as a basis for meeting its obligations under the Exchange Act, including problems it shares with the NYSE.

The Special Study made a more limited examination of the regional exchanges, with primary emphasis on the Midwest and Pacific Coast Stock Exchanges—the major regional exchanges. We agree with the recommendations with respect to these exchanges in subchapters XII-D, XII-E, and XII-F of the report.

(3)

The primary responsibility of the National Association of Securities Dealers, Inc., is to regulate the conduct of its members in the over-the-counter market. Because the over-the-counter market is scattered throughout the country, includes all varieties of securities, and is open to all persons, the NASD's job is a difficult one. Its role will become more important, since many recommendations in the report call for increased activity on the part of the NASD in both policymaking and enforcement.

The work of the NASD is in large measure performed by its members who volunteer their time and effort to the job of self-regulation.

[1] As to the recommendations in item 2, we favor steps looking toward a more representative distribution of voting power among regular and allied members. We will explore further the need for altering the composition of the governing bodies of the Exchange. With respect to item 7, the obligation of the Exchange, of which it is not unmindful, to avoid exaggerations and misunderstandings in its advertisements is clear. Whether any further restrictions should be placed on the Exchange's public relations activities is not so clear. The Commission has encouraged the Exchange to undertake the supervision of the advertising of its member firms, including advertising of an institutional character, some of which is the work product of the Exchange's own staff. The Commission is not now prepared to dispense with the advantages of the present system without further examination of the problem.

The NASD has established important standards of business conduct, including restrictions against unconscionable underwriting compensation and rules dealing with "free-riding." It has assisted in the general enforcement efforts against overreaching and abuses in the over-the-counter market. However, there are many key areas in need of improvement in the over-the-counter market, in terms of new standards, as well as strengthened enforcement programs. In this context, certain organizational characteristics, including the emphasis on member participation and the heavy demands on the Board of Governors, necessitate significant rethinking and redirection. More effective regulation requires a larger staff—a direction in which the NASD has been moving during the last few years—with increased responsibility and a reallocation of work among member participants in the government of the NASD. The participants would then have more opportunity to consider general policy and the NASD could better carry its formidable workload.

We agree with all of the recommendations of the report in subchapter XII–G which are designed to strengthen the organization of the NASD and make its operations more effective.

(4)

The fundamental issue of the relationship between the Commission and the self-regulatory agencies requires special comment. The report states in chapter XII–I that "regulation in the area of securities should, in short, be a cooperative effort, with the Government fostering maximum self-regulatory responsibility, overseeing its exercise, and standing ready to regulate directly where and as circumstances may require." We subscribe to this statement of policy and generally agree with the specific recommendations in chapter XII–I. The obligations of the self-regulatory agencies should be increased, through both their adoption of rules in many areas and their assumption of new enforcement duties—including certain duties now borne by the Commission.

The failure of the self-regulatory agencies to operate at maximum capacity and with full regard for the public interest in certain areas is in part attributable to the Commission's own failure to provide the necessary continuing guidance and oversight. We are certain that the present statutory pattern permits more effective and more pervasive self-regulation than has yet been achieved. Undoubtedly this will require a reorientation of our present procedures in the directions suggested by the report's recommendations. For example, under section 19(b) of the Exchange Act, we have a duty to review exchange rules to determine whether they are consistent with the protection of investors. We should place more emphasis on newly adopted rules than is now the case. Thus, our present arrangements with regard to the exchanges' notification to us of rule changes prior to their adoption might be revamped along the lines of the procedures worked out with the New York Stock Exchange respecting changes in the minimum commission rate schedule. With respect to the NASD, our authority to alter or amend their rules is more limited than in the case of the exchanges. We have, however, direct powers over practices in the over-the-counter market, in many respects unexercised, which can be utilized. Until these have been fully exercised and found wanting, we shall not ask Congress for legislation. In any event, up to this time needed improvements have been secured after conferences and discussions with the NASD.

We shall examine with the exchanges the need for further procedural safeguards for those affected by exchange actions—a problem that has taken on new significance because of the recent Supreme Court case of *Silver* v. *New York Stock Exchange.* In addition, as suggested by both subchapters XII–I and XII–J, we will confer with the self-regulatory agencies to determine methods by which enforcement and inspection responsibilities can be better allocated between the Commission and the self-regulatory agencies and among those agencies themselves.

One sector of the self-regulatory scheme will require joint analysis with the exchanges of the need for legislation. In the *Silver* case the Supreme Court held that the termination, at the order of the New York Stock Exchange, of wire service from its members to a nonmember, without any hearing afforded the nonmember, involved a violation of the antitrust laws.

We believe it essential that the *Silver* decision should in no way be construed to inhibit vigorous performance by the exchanges of their self-regulatory responsibilities. We are confident that the Supreme Court intended no such result: indeed the Court emphasized "the federally mandated duty of self-policing by exchanges." Steps can and must be taken to avoid any possible problems. These could include appropriate procedural changes by the exchanges and careful analysis of the need for some form of review of exchange actions by the Commission. If review procedures are thought necessary, legislation may be required.

Our firm conviction is that self-regulation, an essential ingredient in investor protection, must continue in a strong, forward movement. Accordingly, we have written to the New York Stock Exchange advising of our concern and shall undertake to resolve with it any problems presented by the *Silver* case.

B

In chapter X, the report has examined security credit regulation as a factor in the securities markets. This regulation, of course, has broader aims: it is an instrument for credit control in the economy. As such, it is the primary concern of the Board of Governors of the Federal Reserve System. Accordingly, as the Special Study has pointed out, recommendations in this area including legislative proposals relate essentially to matters within the jurisdiction of the Board of Governors. The Commission believes that all the recommendations of the study have merit, but, recognizing the paramount authority of the Board, will not initiate any action. We shall work closely with the Board toward the resolution of the problems raised.

The staff of the Special Study received generous assistance and cooperation from the staff of the Board of Governors who reviewed chapter X from a technical point of view and who also prepared all of the appendixes. Of course, none of the Reserve personnel, nor the Board, is in any way responsible for the final views expressed in the chapter.

C

Chapter XI of the study deals with selected aspects of open-end investment companies, so-called "mutual funds," including selling practices, contractual plans, insider trading in portfolio securities and portfolio-brokerage reciprocal business patterns. It must be emphasized that this chapter should in no way be construed as a reflection upon the investment merits of mutual fund shares, upon the investment company as an important vehicle for investment, or upon any particular company. Furthermore, it should also be emphasized that the questions raised with respect to contractual plans do not, and should not, affect present holders of these plans. As the study has stated, its analysis should not be taken by any planholder as a reason for redeeming any plan certificates. Early redemption of a plan almost invariably results in loss to the planholder. The problems analyzed by the report are in no way related to the merits of the underlying investments or to shares bought outright. The recommendations are focused solely on *future* contractual plans as distinguished from plans already entered into.

Contractual plans involve the purchase of mutual funds on an installment basis, with a substantial portion of the initial payments—up to 50 percent—taken out for sales load in the first year. Their sponsors justify this deduction on the ground that it provides a necessary stimulant to saving. The report has raised serious questions about contractual plans, basically revolving around the first year sales load deduction. As chapter XI–B recommends, steps should be taken to deal with the problems disclosed. Discussions will commence with the industry immediately; but definitive action, whether legislation or otherwise, will await the completion of our general structural study of mutual funds.

In chapter XI the report also analyzes mutual fund selling practices, reciprocal business activities, and potential conflicts of interest related to insider trading in fund portfolio securities. With the limitations footnoted below, we agree with the accompanying recommendations.[2]

As the Congress is aware, on August 27, 1962, the Commission transmitted to the Congress "A Study of Mutual Funds," representing a factfinding survey of certain aspects and practices of open-end investment companies. This study was prepared by the Wharton School of Finance and Commerce of the University of Pennsylvania. At the same time, the Commission requested its Division of Corporate Regulation to undertake a detailed analysis of the Wharton School Study and conduct its own examination into structural problems of mutual funds. That examination should be submitted to the Commission some time late this year or early in 1964. Meanwhile, chapter XI of the report represents an important contribution to the overall picture.

D

Chapter XIII of the report deals with the events surrounding the severe market break of May 1962. This chapter was specifically prom-

[2] With respect to item 2, subch. XI–B we shall examine various ways by which our prospectus requirements for mutual funds can be further refined. Finally, with respect to the recommendation of subch. XI–D, we believe that each registered investment company should adopt, and take appropriate steps to enforce, a written policy concerning insider trading along the lines suggested in this recommendation.

ised at a congressional hearing. The report draws upon data collected by the New York Stock Exchange and also its study of May 28, 29, and 31. The report presents additional data with respect to transactions by institutions, foreign investors, and members and also an analysis of transactions in selected stocks.

As pointed out in subchapter XIII–E, neither the report of the study nor that of the New York Stock Exchange was able to isolate and identify the causes of the market events of May 28, 29, and 31. Moreover, contrary to some speculation at the time that the events might be the result of some conspiracy, neither of these reports presents any evidence that the break was deliberately precipitated by any group or resulted from manipulation or illegal conduct in the functioning of the market.

The study—after noting the extreme nature of any action by the Commission suspending trading under section 19(a)(4)—recommends that the Commission and the industry should make a joint study of possible measures which might be taken by the Exchange "to assure minimum disruption of the fair and orderly functioning of the securities markets * * *." We interpret this to mean measures to improve the efficiency and effectiveness of the operations of market mechanisms during periods of severe market stress.

The Exchange, of course, has at its disposal a number of measures to deal with unusual conditions in the marketplace and invokes these from time to time on a security-by-security basis as, for example, the controls exercised over "openings" and the temporary suspension of trading in particular securities.

The Special Study was not able to address itself to the manner in which these measures were or might have been employed with particular reference to the events of May 28–31. The material published by the Stock Exchange likewise does not deal with this specific question.

The various recommendations made elsewhere in the report, in part upon the basis of data relating to the market break, with respect to such matters as short selling, the capital position of specialists, floor trading and odd-lot transactions, should improve the ability of the mechanism to function more effectively in normal periods as well as in times of stress. It seems clear that, in the course of our consideration of these matters with the Exchange, events leading up to and during the market break must inevitably join the considerable array of complex and, to some degree, technical factors which must be weighed in reaching decisions. We agree that it would be desirable for the Exchange to review the data accumulated in the course of the two studies, with particular reference to whether the procedures available to it were employed always as fully or as effectively as they might or should have been and whether sound policy would suggest some changes, and whether it is feasible or necessary to obtain additional trading information. The results of this review could thus be available to assist both the Exchange and the Commission in seeking solutions to some of the problems described in the report. Certainly, it would seem that the performance of some specialists during the market break was not considered satisfactory by the Exchange itself; moreover, it is not clear why the machinery for handling some odd-lot orders should have failed as it apparently did. These and similar matters deserve the particular attention of the Exchange and of the Commission in the exercise of its oversight. It should be kept in mind that the role of the Commission, and that of the Exchange, does not extend to "managing" price movements or purposefully affecting prices.

III

This transmittal completes the Report of the Special Study of Securities Markets. The report is clearly the most thorough examination of the securities markets since the early 1930's. Size alone is but a poor measure of its importance and achievement. The report would have high usefulness if only for its orderly presentation of basic facts about the markets. More importantly it offers a foundation for regulatory and industry actions for a long period to come.

Implementation of the report can be prompt in many cases. Fundamental recommendations of the Special Study have already been incorporated in the Commission's legislative proposals, embodied in S. 1642, as amended, H.R. 6789 and H.R. 6793. S. 1642, as amended, has passed the Senate and, together with H.R. 6789 and H.R. 6793, is now pending before the House of Representatives. It is our judgment that these bills represent essential amendments to the securities laws. By providing for more reliable and extensive disclosure as to companies traded in the over-the-counter market and by raising qualification standards for those dealing in over-the-counter securities, enactment of the bills will have a pervasive impact on the raising of standards in the securities markets and will serve as a base to achieve many of the improvements suggested by the study. At the same time, as we noted in connection with the transmission of chapters V through VIII, the legislative program stands by itself; thus consideration of the bills can appropriately proceed independently of the discussion and resolution of the questions raised in the chapters here transmitted.

We do not plan to submit any further legislative proposals to the Congress this session. We may at a later session recommend legislation relating to quotations bureaus and to review of exchange actions—the latter only if it is found necessary after further analysis of the *Silver* case. Furthermore, we shall work with the Federal Reserve Board in any program respecting security credit regulation which they believe should be submitted to Congress.

In addition to our legislative proposals, substantial benefits have resulted since the institution of the study. Some of these are summarized in subchapters XII–B and XII–G. Many more will result as the report is carefully and selectively implemented. We will work expeditiously and in conjunction with the securities industry on the numerous recommendations requiring rulemaking on our part and on the part of the industry agencies. Certain areas, such as the impact of automation on the securities industry, are clearly long-range in nature and require continuing and elaborate analysis before decisions can be reached.

IV

In measuring others, we must measure ourselves. As we said in our first letter of transmittal, while the report focuses upon the shortcomings in the industry and in the self-regulatory agencies, in certain respects it is an express or implied criticism of the Commission as an institution. For example, on the exchange side, the failure to regulate odd-lot activities and, on the over-the-counter side, the lack of more specific standards and of more effective enforcement procedures in certain sectors represent problems unsatisfactorily resolved by the Commission. We have at times been hampered by a lack of personnel or concentrated on particular areas. Further, we, like the self-regulators, have been preoccupied with day-to-day problems and have not been able fully to preceive new trends and weaknesses which arose with the expansion of the securities markets—an occurrence in itself intensifying the routine administrative tasks as well as creating new problem areas. However, institutions—Government, quasi-public, or private—all benefit from reexamination. It has required a Special Study, detached from involvement with routine, but necessary, tasks, to produce a comprehensive, overall view of securities regulation. But what we have done is not so important as what we must do—and that must be the case with the self-regulatory agencies and the financial community as well.

* * *

In concluding, the Commission would again like to acknowledge the cooperation offered throughout the conduct of the study by members of the securities industry, by the self-regulatory agencies and by others in Government. We once more express our appreciation for the extraordinary work of the staff of the Special Study of Securities Markets under the leadership of Milton H. Cohen as Director, Ralph S. Saul as Associate Director, Richard H. Paul as Chief Counsel, Sidney M. Robbins as Chief Economist, and Herbert G. Schick as Assistant Director. The staff of the study has proceeded always in a responsible, thorough, and craftsmanlike manner. We have indeed been fortunate to have retained the services of so many dedicated individuals from private law practice and industry, from the universities, from Government and from our regular staff. We are also grateful to the many in our operating divisions and offices who contributed much to the study in ideas, experience and information.

We believe that the study has fully justified the confidence entrusted in the Commission by the Congress in authorizing an examination of the securities markets.

By direction of the Commission:

William L. Cary, *Chairman.*

LETTER OF TRANSMITTAL

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., August 6, 1963.

To the Chairman and Members of the Securities and Exchange Commission:

We have the honor to transmit herewith the final four chapters—X, XI, XII, and XIII—of the Report of the Special Study of Securities Markets. (In our transmittal letter of April 3, 1963, we referred to a possible chapter XIV to cover topics that might not fit within the scope of any of the other chapters or within the limits of later transmittal letters. It has not been found necessary to have a separate chapter XIV.)

In our two previous transmittal letters, we have made some general comments about the nature of the study and of our findings. These were intended to apply to the entire report and we find no reason to modify them at this time. The following paragraphs from our letter of April 3 should have reemphasis as we complete the report:

> The enormous growth of the securities markets experienced since the original enactment of the Federal securities laws, reflecting both the vigor of the industry's own activities and the general expansion of the country's economy and population in the intervening years, has been accompanied by many qualitative changes in methods, practices, controls, and standards. A basic objective of the Special Study was an evaluation, in the light of both quantitative and qualitative changes, of the theories and mechanics of direct governmental regulation and industry self-regulation originally envisaged by those laws. The study and report indicate that under the stresses of its expanded role the framework of regulation needs considerable adjusting and strengthening, but its basic design appears to have stood the test of time and to have worked effectively in most areas.
>
> Since the Federal securities laws have been in force for a full generation, it is hardly surprising that the Special Study has not disclosed the prevalence of gross abuses such as were characteristic of the era which preceded their enactment. Nevertheless, as will be evident from the entire report, many serious problems do exist and important improvements are needed. It is inevitable that in reflecting the results of any investigation, a final report will give greatest attention to the problems uncovered and the areas in which the need for improvement is most pressing. Nevertheless, the emphasis in this report on present shortcomings should neither obscure nor detract from the many aspects of the securities business and its regulation and self-regulation which afford reason for pride and satisfaction. The strength of the American economy and its free-enterprise system both reflect and are dependent upon an investment banking system and market institutions that are basically strong and sound, but this makes it all the more, rather than less, necessary to expose and correct the weaknesses and abuses that still exist. Many of the substantive recommendations in the report can, indeed, be regarded as attempts to raise the entire securities industry to the best standards which the industry itself proclaims and to the highest levels of attainment which some of its participants have in some sectors achieved.

The chapters first transmitted (I to IV and IX) called for certain legislative solutions and these have been substantially embodied in S. 1642, recently passed by the Senate, and in the pending bills H.R.

6789 and H.R. 6793. The second group of chapters (V to VIII) essentially called for only one item of legislation—authority to regulate over-the-counter quotations systems. As to the present group of chapters: Chapter X, dealing with security credit, would require statutory changes if the Federal Reserve Board and the Commission subscribe to certain of our substantive recommendations. Chapter XI, relating to mutual funds, would call for a legislative solution in respect of so-called contractual plans, but in this instance we have assumed that the formulation of a legislative program will await completion of the Commission's other pending studies regarding structural aspects of mutual funds. With regard to chapter XII, dealing with the self-regulatory and regulatory pattern, various statutory changes would unquestionably contribute to a more complete and logical pattern of relationships between the Commission and the various self-regulatory agencies and at the same time might be the most direct means of resolving issues presented by the case of *Silver* v. *New York Stock Exchange*. On the other hand, we are not prepared to say, in the absence of a more detailed legal analysis than we have been able to make, that the Commission's present broad statutory powers would not be adequate for all purposes indicated in the chapter, and accordingly we make no specific legislative recommendation in this area. Chapter XIII, relating to the 1962 market break, likewise does not contain any recommendation for legislation.

It should be emphasized, in any event, that any questions of legislation arising out of the present group of chapters are quite separate from the matters covered in our prior legislative recommendations as embodied in the bills now pending, i.e., qualifications for entry into the securities business and disclosures for over-the-counter securities. Nothing in our later studies or analyses has in the slightest degree shaken our conviction that the latter subjects of legislation are basic and urgent, both in their own right and as foundations for other improvements in rules and practices in the securities markets.

The legislative recommendations of the total report are relatively few, not because there is little to be done, but because most of what we recommend can in all likelihood be accomplished under existing powers of the Commission and the self-regulatory agencies. The total report constitutes not only a comprehensive factual presentation but also a major agenda for action by the Commission and the industry groups to correct the shortcomings in the market and regulatory mechanisms that have been disclosed.

* * *

In our prior transmittal letters we expressed appreciation for the contributions of the groups and individuals, within and outside the Special Study staff, who have importantly contributed to the work of the Special Study. Without repeating their names, we again express appreciation for the loyal and devoted efforts of the very competent group who served directly on the study staff and for the indispensable assistance and cooperation received from others, including the members of the Commission, members of the staff of other divisions, other governmental and private agencies, and, by no means least, individuals and firms in the securities business and their self-regulatory institutions. Our previous letter neglected to mention the valuable assistance received from Joseph A. Keenan, Jr., of the Division of Trading and Exchanges.

Our previous letter incorrectly listed Bernard H. Garil as a member of the clerical staff rather than a financial analyst, and omitted mention of Gerald L. Feigen, who served on the study's staff as a financial analyst.

Having been stationed at the Commission's office facilities at its headquarters in Washington, we can not refrain from commenting on these facilities. The Commission is a permanent, important agency of the U.S. Government, in existence since 1934, yet it still has its headquarters in a "temporary" building and annexes whose many inadequacies, inconveniences, and discomforts cannot but impair the efficiency of its operation and even hamper its efforts to recruit and retain needed personnel. In the name of good government, the Commission urgently needs a more business-like office where its personnel may do their work efficiently, comfortably, and pridefully.

* * *

As the Special Study leaves the scene, others must assume the large responsibility of converting recommendations into programs of action. In the long run we are confident that the information, analyses, and recommendations that have been produced by the Special Study will improve the operation of the securities markets, produce a healthier securities business, and provide stronger safeguards for the investors of the Nation.

Respectfully submitted.

MILTON H. COHEN,
Director,
RALPH S. SAUL,
Associate Director,
RICHARD H. PAUL,
Chief Counsel,
SIDNEY M. ROBBINS,
Chief Economist,
HEBERT G. SCHICK,
Assistant Director,
Special Study of Securities Markets.

96-746—63—pt. 4——2

CHAPTER X

SECURITY CREDIT

SUMMARY TABLE OF CONTENTS

DETAILED TABLE OF CONTENTS

A. INTRODUCTION

B. THE FUNCTIONS AND NEED OF INITIAL MARGIN REQUIREMENTS

C. DISPARITIES AND GAPS IN MARGIN CONTROLS

D. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

TABLES

APPENDIX TABLES

APPENDIX B

APPENDIX C

APPENDIX E

APPENDIXES

CHAPTER X

SECURITY CREDIT

A. Introduction

1. TYPES AND VOLUME OF SECURITY CREDIT

Security credit, as the term is used in this chapter, is created either when loans are obtained for the purpose of purchasing or carrying securities or when loans for other purposes are collateralized by securities. As background to a discussion of security credit, some idea of the types of credit extended and its volume may be helpful.

Not all security credit is regularly reported and it is therefore impossible to measure its total amount. There are, however, some accepted indicators of volume. New York Stock Exchange (NYSE or Exchange) member firms regularly report to the Exchange as customers' net debit balances the volume of such credit they extend. Bank loans to broker-dealers and "loans to others" for the purpose of purchasing or carrying securities are reported by banks to the appropriate banking authorities and NYSE member firms report their borrowings regularly to the Exchange.

Security credit, like all other forms of credit, is constantly fluctuating in amount. Thus, in the period immediately preceding, and during the early part of, World War II, when the volume of transactions was low and prices were depressed, the volume of credit represented by the sum of NYSE member firms' net debit balances and bank loans (by weekly reporting member banks of the Federal Reserve System) to "others" for the purpose of purchasing or carrying securities (excluding loans secured by U.S. Government obligations) was low; [1] in December 1941, it amounted to only $1,022 million.[2] In December 1945 the two categories above accounted for $1,374 million. Since that date, there has been a general rising tendency with periods of contraction during security price declines. In December 1962 the net debit balances of customers of NYSE member firms was $4,125 million while bank loans to other than broker-dealers for security purchases were $1,369 million.

Among registered broker-dealers extending security credit, NYSE member firms are clearly dominant. The study obtained from questionnaire OTC-3 [3] information as to net debit balances of all registered broker-dealers on or about January 31, 1962. NYSE member firms accounted for over $3.8 billion in customers' net debit balances, over 98 percent of such balances on that date.[4]

---

[1] Loans to broker-dealers are omitted since these are, in large part, the source of broker-dealers' loans to customers. Thus, the figures tend to overlap.

[2] All figures in this paragraph were supplied by the staff of the Board of Governors of the Federal Reserve System. Member banks in the weekly reporting series account for about 85 percent of all bank loans to others than broker-dealers for purchasing or carrying securities.

[3] Questionnaire OTC-3 was sent to all broker-dealers registered with the Commission. See ch. VII for a further explanation.

[4] See table X-1.

Loans collateralized by securities also may be granted, principally by commercial banks, to borrowers for business or personal financing purposes. Although the credit obtained in this manner does not enter directly into the securities stream, it has important market implications because, as prices recede, securities serving as collateral may be vulnerable to forced sales resulting from margin calls. Detailed statistics concerning the estimated amounts and characteristics of such loans, available for the first time from a sample survey of member banks conducted by the Federal Reserve System for the Special Study, are presented later in this chapter.

2. PURPOSES OF CREDIT CONTROLS—ROLES OF FRB AND SEC

"The Great Crash of 1929" produced the essential features of present security credit controls. Before the reform legislation prompted by that catastrophe, the authorities attempted to curb the excessive use of credit by "moral suasion" (1919 and 1929), by publication of statistical data (commencing in 1926) and by controls over lending to brokers by banks (1913 and 1933). None of the attempts was signally successful, however, and Congress therefore resorted to the Exchange Act measures described in section 3 below.

In the extensive discussions that preceded enactment of the Exchange Act, proponents of margin controls advanced three aims that they hoped to achieve by the measures they advocated to prevent "the excessive use of credit." Thomas G. Corcoran, one of the drafters of the Exchange Act, stated two of them to the Senate Committee on Banking and Currency:

> One is to protect the lamb; another, and probably the more important of the two, although it does not appeal to one's human instincts as completely, is the protection of the national business system from the fluctuations that are induced by fluctuations in the market, which in turn stem back to this very exquisite liquidity you get when you have a lot of borrowed money in the market.[5]

The House Committee on Interstate and Foreign Commerce stated the third in a report submitted with the proposed Exchange Act:

> The main purpose is to give a Government credit agency an effective method of reducing the aggregate amount of the Nation's credit resources which can be directed by speculation into the stock market and out of other more desirable uses of commerce and industry—to prevent a recurrence of the pre-crash situation where funds which would otherwise have been available at normal interest rates for uses of local commerce, industry, and agriculture, were drained by far higher rates into security loans and the New York call market.[6]

Apart from the first of the aims stated, protecting "the lamb," the thin-margin purchaser, whose slim equity puts him at risk of total loss in the event of a price decline, it is doubtful whether margin controls alone would accomplish what was hoped in 1934. The Board of Governors of the Federal Reserve System (FRB) in fact has not viewed regulation of security credit as an independent or isolated undertaking, but rather, in Chairman Martin's words, as—

> * * * a supplementary instrument of credit policy—one of the means of making a broad credit and monetary policy effective * * * [E]ach instru-

[5] Hearings before Senate Committee on Banking and Currency, pt. 15, 73d Cong., 1st sess., p. 6494 (1934).
[6] H. Rept. 1383, 73d Cong., 2d sess., p. 8 (1934).

ment of credit policy has its own characteristics and each should be used in such manner as to blend all the instruments into a harmonious whole for the maximum contribution to stable economic progress for the whole economy.[7]

In any event, the broader aims of credit controls have appeared to be beyond the immediate concerns of the Commission. Congress originally assigned primary administrative responsibility to the FRB as the most experienced and best equipped credit agency of the Government and assigned to the Commission only the responsibility of enforcing the FRB's regulations.[8] The Special Study's inquiry and recommendations, in recognition of the Commission's more limited responsibilities, have been limited to the question of security credit as a factor in the securities markets themselves.

3. EXISTING SECURITY CREDIT CONTROLS

The Exchange Act contains provisions empowering the Board of Governors of the Federal Reserve System to control the use of credit for the purchase or carrying of securities and, in conjunction with the requirements of the Banking Act of 1933,[9] to regulate its general availability for those purposes. The margin requirements, which establish the percentage of the market price which may be lent on these securities, are basic.[10] Section 7(a) of the Exchange Act gives broad authority to the FRB to prescribe both the amount of credit that may be initially extended and the amount which subsequently may be maintained on any security registered (listed) on a national securities exchange. The statute prescribes the original standard [11] which was to be the basis of FRB rules and regulations. With respect to all or specified securities or transactions, or classes of securities or transactions, however, the Exchange Act gives the FRB power to—

> (1) Prescribe such lower margin requirements for the initial extension or maintenance of credit as it deems necessary or appropriate for the accommodation of commerce and industry, having due regard to the general credit situation of the country; and
>
> (2) Prescribe such higher margin requirements for the initial extension or maintenance of credit as it may deem necessary or appropriate to prevent the excessive use of credit to finance transactions in securities.[12]

The statute provides that the FRB's rules may make appropriate provision for special circumstances or contingencies.[13]

---

[7] Joint Committee on the Economic Report, "Monetary Policy and the Management of the Public Debt," S. Doc. 123, 82d Cong., 2d sess., pp. 409–410 (1952).

[8] See Exchange Act, secs. 7 and 21.

[9] Banking Act of 1933, 48 Stat. 167. To prevent the undue use of credit for the speculative carrying of securities, sec. 7 empowers the Federal Reserve Board to establish from time to time percentages of bank capital and surplus that may be represented by loans secured by stocks and bonds.

[10] The partly paid for securities, together with all other assets in the customer's account, stand as collateral for his indebtedness.

[11] The standard on which rules and regulations governing the extension of credit were to be based is as follows: "An amount not greater than whichever is the higher of—(1) 55 per centum of the current market price of the security, or (2) 100 per centum of the lowest market price of the security during the preceding 36 calendar months, but not more than 75 per centum of the current market price." This is now only of historical significance for reasons indicated below.

[12] Exchange Act, sec. 7(b).

[13] The statute provides, among other things, that the FRB may make appropriate rules and regulations with respect to carrying undermargined accounts for limited periods and under specified conditions, withdrawal of funds or securities from margin accounts or substitution of additional purchases of securities in these accounts, transfer of accounts from one lender to another, special or different margin requirements for delayed deliveries, short sales and arbitrage transactions, methods for calculating loans, and margins and market prices, and other, similar administrative matters.

The statute includes further specific provisions governing broker-dealers who are members of, or deal through members of, national securities exchanges,[14] and all other persons including domestic banks.[15] Broker-dealers may not extend credit on listed securities except in accordance with the regulations of the FRB. They are prohibited entirely from making loans without collateral or on any collateral other than listed or exempted securities[16] except, to the extent permitted by FRB regulations, where the extension or maintenance of credit is not for the purpose of purchasing or carrying securities,[17] and for certain other limited purposes.

Under section 7(d) persons other than broker-dealers, including domestic banks, may not extend or maintain credit for the purpose of purchasing or carrying listed securities in contravention of the rules and regulations of the FRB. This subsection is limited, however, in a number of respects and expressly excludes from the Board's regulatory authority: (1) loans made by a person not in the ordinary course of his business; (2) loans on exempted securities; (3) loans made by banks on nonequity securities;[18] and (4) loans to dealers to aid in the financing of distributions to customers otherwise than through the medium of a national securities exchange. Furthermore, since section 7(d) governs only the extension of credit for purchasing or carrying listed securities, banks are free to make loans to their customers, on any collateral or no collateral at all, for any other purpose and on whatever terms are consistent with prudent banking standards, the policing of such standards being one of the purposes of bank regulation.

Thus there are certain differences in the statutory credit regulation pattern between broker-dealers, on the one hand, and banks and other lenders on the other. With respect to broker-dealers, the FRB appears to have the power to regulate or entirely forbid nonpurpose loans. With respect to banks and other lenders, it has no such powers. Where purpose loans are involved, the provisions relating to broker-dealers prevent them (with certain limited exceptions) from extending credit on any securities other than those which are listed or exempted; generally, they may not extend credit on unlisted securities for the purpose of purchasing or carrying securities. The provisions relating to other types of lenders, however, permit the extension of credit on unlisted

---

[14] Exchange Act, sec. 7(c).

[15] Exchange Act, sec. 7(d).

[16] "The term 'exempted security' or 'exempted securities' shall include securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States; such securities issued or guaranteed by corporations in which the United States has a direct or indirect interest as shall be designated for exemption by the Secretary of the Treasury as necessary or appropriate in the public interest or for the protection of investors; securities which are direct obligations of or obligations guaranteed as to principal or interest by a State or any political subdivision thereof or any agency or instrumentality of a State or any political subdivision thereof or any municipal corporate instrumentality of one or more States; and such other securities (which may include, among others, unregistered securities, the market in which is predominantly intrastate) as the Commission may, by such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors, either unconditionally or upon specified terms and conditions or for stated periods, exempt from the operation of any one or more provisions of this title which by their terms do not apply to an 'exempted security' or to 'exempted securities.'" (Exchange Act, sec. 3(a)(12).)

[17] Throughout this chapter, the term "nonpurpose loan" will be used to indicate that a loan is for a purpose *other than* purchasing or carrying securities. The term "purpose loan" will be used to indicate that the loan is used to purchase or carry securities.

[18] "The term 'equity security' means any stock or similar security; or any security convertible, with or without consideration, into such a security; or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security." (Exchange Act, sec. 3(a)(11).)

securities, except to the extent that this may be forbidden by the FRB if the purpose is to purchase or carry listed securities.

The Board has exercised only a part of the powers granted to it under the Exchange Act. While the act gives the Board authority to regulate the extension of credit by brokers and all persons other than brokers, the Board has promulgated only Regulation T [19] (relating to brokers) and Regulation U [20] (relating to domestic banks). There are persons engaged in the business of lending for the purpose of purchasing or carrying securities, notably so-called factors and foreign banks, which are not subject to either regulation; these will be referred to in this report as "unregulated lenders." [21]

The FRB has exercised only part of its powers in a second respect: the Exchange Act enables it to prescribe "margin requirements for the initial extension or maintenance of credit," [22] but it has done only the former. The stock exchanges, however, prescribe requirements of the latter kind that their members must observe and many brokers and banks voluntarily observe even more stringent standards. These initial margin and maintenance requirements interact and a brief elaboration is called for.

The FRB establishes initial margin requirements under Regulations T and U. These requirements, in effect, establish the amount of the downpayment which a credit purchaser of securities must pay. If he buys securities that cost $10,000 and the initial margin requirement in effect at the time is, say, 60 percent, he may borrow up to $4,000 but must himself pay the remaining $6,000. The securities purchased will stand in the account as collateral for the loan. If, prior to the transaction, there are securities with a "loan value" of at least $6,000 in the account,[23] the purchaser can borrow the entire $10,000 required to make the purchase and will not be required to "put up" any cash at all. Both the securities purchased and the securities already in the account will then stand as collateral for the loan. Once the transaction is completed, the regulations do not require that additional collateral be supplied in the event of a decline in the market value of the collateral pledged.

The function of preserving sufficient equity for the lender's protection in a margin account in the face of fluctuating prices is performed by the "maintenance" requirements of the exchanges or those imposed in the course of business by banks and brokers individually. However they may be expressed, their effect is to prescribe a maximum indebtedness-to-current-value-of-collateral ratio that, if exceeded, must be reduced by the deposit of additional "margin" (i.e., equity). The NYSE, for example, generally requires that the margin in a customer's account be at least 25 percent of the value of securities long in that account. If, in the example described above in which a purchaser effected a loan of $4,000 to make a $10,000 securities purchase, the value of the securities collateral in the account had fallen below

---

[19] 12 CFR, pt. 220.
[20] 12 CFR, pt. 221.
[21] Sec. 221.3(q) of Regulation U, adopted in 1959, establishes certain special requirements for banks lending to persons whose principal activity, or one of whose "important" activities, is making loans for the purpose of purchasing or carrying listed securities. These persons, referred to, here as "q lenders," are discussed in sec. C.4.d(2), below.
[22] See p. 3, above.
[23] "Loan value" is the amount which can lawfully be lent on the securities under the credit regulations. In this example, it is assumed that there are no debit or credit balances in the account other than those described.

about $5,350, he would be required by the NYSE rule to supply additional margin.[24] If he failed to do so, the broker would be required to sell sufficient securities to bring about compliance. The effect of these requirements is that the value of cash and securities in a margin account must always be greater by one-third than the amount owed by the customer to the lender. It should be pointed out that, while certain classes of securities may have no loan value under the credit regulations for purposes of satisfying the initial margin requirements, they may be given their fair market value under the rules of the exchanges for purposes of determining whether or not the exchanges' maintenance requirements are satisfied.

The authority granted in the Exchange Act to the FRB to control security credit is shown in table X–a, below. The extent to which this authority has been exercised is shown in table X–b, below.

TABLE X–a.—*Authority of the Board of Governors to regulate transactions under section 7 of the Exchange Act*

Collateral offered	Source of credit [1]	Credit for purchase of— Listed stocks	Listed bonds	Unlisted stocks and bonds	Other purposes
Listed stocks	Broker	Yes	Yes	Yes	Yes.
	Bank	Yes	Yes	No	No.
	Other	Yes	Yes	No	No.
Listed bonds: Convertible	Broker	Yes	Yes	Yes	Yes.
	Bank	Yes	Yes	No	No.
	Other	Yes	Yes	No	No.
Other	Broker	Yes	Yes	Yes	Yes.
	Bank	No	No	No	No.
	Other	Yes	Yes	No	No.
Unlisted stocks	Broker	(2)	(2)	(2)	Yes.
	Bank	Yes	Yes	No	No.
	Other	Yes	Yes	No	No.
Unlisted bonds: Convertible	Broker	(2)	(2)	(2)	Yes.
	Bank	Yes	Yes	No	No.
	Other	Yes	Yes	No	No.
Other	Broker	(2)	(2)	(2)	Yes.
	Bank	No	No	No	No.
	Other	Yes	Yes	No	No.
Other than securities	Broker	(2)	(2)	(2)	Yes.
	Bank	Yes	Yes	No	No.
	Other	Yes	Yes	No	No.
None	Broker	(2)	(2)	(2)	Yes.
	Bank	Yes	Yes	No	No.
	Other	Yes	Yes	No	No.

[1] As used here, the term "broker" includes "dealer."
[2] Transaction prohibited by Exchange Act.

[24] In this example, the customer's equity is $1,350 since the value of securities long is $5,350 and his debit balance is $4,000. His equity thus is only slightly greater than 25 percent of the market value of securities long in the account. Expressed another way, the customer's indebtedness-to-market-value-of-collateral ratio cannot exceed 3 : 4.

TABLE X–b.—*Limitations on credit under Regulations T and U of the Board of Governors of the Federal Reserve System (July 1, 1963)* [1]

Collateral offered	Source of credit [1]	Credit for purchase of— Registered stocks	Registered bonds	Unregistered securities	Other purposes
Listed stocks	Broker	50%	50%	50%	(T)
	Bank	50%	No (U)	No (§7)	No (§7)
	Other	No (U)	No (U)	No (§7)	No (§7)
Listed bonds:					
Convertible	Broker	50%	50%	50%	(T)
	Bank	Good faith test	No (U)	No (§7)	No (§7)
	Other	No (U)	No (U)	No (§7)	No (§7)
Other	Broker	50%	50%	50%	(T)
	Bank	No (§7)	No (§7)	No (§7)	No (§7)
	Other	No (U)	No (U)	No (§7)	No (§7)
Unlisted stocks	Broker	(*)	(*)	(*)	(T)
	Bank	50%	No (U)	No (§7)	No (§7)
	Other	No (U)	No (U)	No (§7)	No (§7)
Unlisted bonds:					
Convertible	Broker	(*)	(*)	(*)	(T)
	Bank	Good faith test	No (U)	No (§7)	No (§7)
	Other	No (U)	No (U)	No (§7)	No (§7)
Other	Broker	(*)	(*)	(*)	(T)
	Bank	No (§7)	No (§7)	No (§7)	No (§7)
	Other	No (U)	No (U)	No (§7)	No (§7)
Other than securities	Broker	(*)	(*)	(*)	(T)
	Bank	Good faith test	No (U)	No (§7)	No (§7)
	Other	No (U)	No (U)	No (§7)	No (§7)
None	Broker	(*)	(*)	(*)	(T)
	Bank	No (U)	No (U)	No (§7)	No (§7)
	Other	No (U)	No (U)	No (§7)	No (§7)

[1] As used here, the term "broker" includes "dealer." It should be noted that banks are limited by Regulation U, sec. 221.3(q) in the amount which they may lend to certain persons engaged in the business of making loans to purchase listed stocks.

NOTE.—(T) indicates exemption from restriction under Regulation T.
No (§7) indicates no restrictive authority granted by sec. 7.
No (U) indicates authority under sec. 7 but no restrictions imposed under Regulation U.
(*) Indicates transaction prohibited by sec. 7.
50% indicates maximum loan value under Regulation T or Regulation U.
Good faith test: §1(a) of Regulation U requires a "good faith" determination of maximum loan value of collateral other than stock when loan is for the purpose of purchasing or carrying listed stock.

4. SCOPE AND METHODS OF STUDY

Despite the historic limitations on the scope of the Commission's concern with security credit controls, the legislative history of section 19(d) of the Exchange Act, added in 1961 to authorize the Special Study, leaves no doubt that Congress intended margin controls to be a subject of review.[25] The rules of exchanges and securities associations, which were to be studied, either already included or might include margin maintenance requirements and such requirements interact significantly with FRB-imposed initial requirements. The Chairman of the Commission, moreover, called to the attention of Congress [26] the disparities and gaps that existed in the regulatory pattern and undertook to study them.

The study as undertaken, which has been conducted with mindfulness of the Commission's limited concern and FRB's broader responsibilities, has taken various forms. Existing statutory, regulatory, and self-regulatory controls have been reviewed and analyzed. Informa-

[25] See ch. I.A.1.
[26] "Hearings Before Subcommittee of House Committee on Interstate and Foreign Commerce" on H.J. Res. 438, 87th Cong., 1st sess., pp. 6–7 (1961).

tion relating to margin calls by brokers and banks during the market break in the spring of 1962 has been assembled and analyzed. As many of the persons and firms active as unregulated lenders as could be identified and feasibly interrogated were questioned about the nature, scope and methods of their operations and a number were again questioned after the break. Finally, the FRB staff, at the request of the Special Study, conducted a survey of bank loans secured by listed and unlisted securities and supplemented it by a series of interviews of selected banks made by Federal Reserve Bank personnel to determine their methods and practices in relation to loans collateralized by securities.

The FRB Bank Loan Survey, the results of which are discussed at relevant places below, might appropriately be described briefly here. Its purpose was to estimate the total volume on the date chosen, September 26, 1962, of all securities-collateralized loans outstanding from member banks of the Federal Reserve System as well as the composition of the collateral held. By statistical procedures designed to permit system aggregates to be projected, a sample of banks of varied sizes and locations was drawn and asked to complete a questionnaire.[27] The questionnaire requested data about selected loans in the recipient banks' loan files, including dollar amount, purpose, age, maturity, nature of collateral and, in the case of loans secured by unlisted stocks, the identity of the one or two most important stocks. The results were tabulated to show various distributions of aggregate amounts and numbers of loans by purposes and types of collateral, together with certain geographic and bank-type characteristics.[28] Additionally, corporations whose securities were identified among the collateral used to support the loans were classified, from information available to the Special Study, by size of assets and number of shareholders; an attempt was then made to correlate these classifications with dollar amounts and number of loans.[29] The survey made available for the first time since World War II reliable estimates about the volume of securities-collateralized loans of member banks of the Federal Reserve System as well as purpose and collateral classifications.

The results of the various studies are presented below as follows:

Part B generally discusses the function of and need for an initial margin in respect of loans collateralized by securities by reason of the potential market impact of inadequately margined loans. Included are data relating to margin calls by brokers, banks, and unregulated lenders during the 1962 market break.

Part C analyzes disparities and gaps in the present regulatory scheme with particular reference to the purpose-nonpurpose distinction; the listed-unlisted distinction; the seemingly inconsistent treatment of unlisted securities as collateral for bank loans, on the one hand, and broker loans on the other; the freedom of banks from margin controls on loans on convertible bonds; the special treatment of subscription accounts; and unregulated lenders.

Part D contains the summary, conclusions, and recommendations.

Enforcement of Regulation T is discussed in chapter XII. No independent investigation has been made of the enforcement of Reg-

---

[27] See app. X–A for the form of questionnaire used.
[28] See app. X–B.
[29] See app. X–C.

ulation U, which is undertaken primarily by banking regulatory authorities.

B. The Functions and Need of Initial Margin Requirements

The broad economic aspects of security credit mentioned in the legislative hearings and reflected in the language of section 7 of the Exchange Act—determining the amount of credit required for the accommodation of commerce and industry and limiting the amount used for securities transactions to the extent deemed appropriate in the light of the general economic and credit situation of the country—transcend the immediate concerns of the Commission and are properly the province of the FRB. To the extent that the problem can be segregated from the economic web of which it is a strand, and dealt with independently, the Commission's primary concern is the efficacy of security credit controls in preventing speculative excesses that produce dangerously large and rapid securities price rises and accelerated declines in the prices of given securities issues and in the general price level of securities. Losses to a given investor resulting from price declines in thinly margined securities are not of serious significance from a regulatory point of view. When forced sales occur and put pressures on securities prices, however, they may cause other forced sales and the resultant snowballing effect may in turn have a general adverse effect upon the entire market.

The problem arises from the unique nature of securities as economic assets. A major reason for the wide acceptance of securities as collateral is their ready marketability, a characteristic made possible by their easy transferability and the highly efficient marketing methods of the exchanges and the more diffuse over-the-counter markets. Not all individual issues exhibit this characteristic to the same degree, but for a large segment of securities actively traded by the general public the result is an almost "instant" liquidity at a price which tends to equate supply and demand at the moment of sale. Likewise, although there are important differences by type of securities and among securities within any type, volatility resulting from liquidity is more characteristic of securities than of most other kinds of financial assets.

Instant liquidity and price volatility have significance to both borrowers and lenders and, in turn, to the regulatory authorities. It is the assurance of ready realization provided by liquidity that enables the borrower to persuade the lender to assign a high collateral value to his asset—that enables him to obtain funds that might not otherwise be forthcoming or obtain them on easier terms because of decreased risk. At the same time it is price volatility that causes the lender to require the indebtedness-to-collateral ratio to be maintained at a minimum level however prices might fluctuate (margin maintenance). It is, similarly, liquidity that enables, and price volatility that causes, the lender to demand the right to "sell out" the collateral if the maintenance limit is passed when prices decline. Thus, wholly apart from public or self-regulatory controls, the unique nature of securities as economic assets and the private economic interests of borrower and lender cause both an initial margin and margin maintenance requirement at some level to be a characteristic feature of most security credit transactions.

Public concern is with the wholesale effect of the private arrangements just described. Thus the stock exchanges in their capacity as regulators of their members impose minimum maintenance requirements because the ultimate consequence of inadequate security in a member firm's customers' accounts might be member insolvency and it is one of the responsibilities of an exchange to foster member firm stability. Similarly, lending banks, showing the same kind of concern for their own solvency, have self-imposed policies for margin maintenance by borrowers. In a larger arena, the FRB imposes initial requirements—and changes them from time to time—as part of its effort to regulate the total volume of credit in the economy at large and in the securities segment over against other segments. Both exchange maintenance standards (but not bank maintenance requirements as such) and FRB initial requirements involve the Commission. The Commission is a supervisor of the exchanges and self-regulatory agencies and also bears primary responsibility for the enforcement of FRB credit regulations under the Exchange Act. Together with the stock exchanges, the FRB and the public at large, it has a vital concern for orderliness and normal stability of the market, with the interrelation of the two types of margin provisions and with the disruptive impact that might be the result of an inadequate initial requirement. In periods of rising prices, an inadequate initial margin requirement might result in speculative excesses and untenable price levels. When prices decline, forced securities sales might turn an orderly market retreat into a rout.

The interaction of initial margin and margin maintenance requirements—and the efficacy of the former to prevent forced liquidations—may be illustrated by an example:

The rules of the New York Stock Exchange generally require that a customer's margin be at least 25 percent of the value of securities long in the account.[30] Assume that, in December 1961, Mr. Smith purchased through his broker, an NYSE member, listed stocks with a value of $10,000. The initial margin then required was 70 percent and Mr. Smith had to deposit at least $7,000 margin. If he paid $7,000 cash and used the securities purchased as collateral, his debt balance (loan) became $3,000, and his margin (equity) $7,000. The market value of the securities would have had to decline to under $4,000 (a 60-percent decline) before the credit status of his account would violate the New York Stock Exchange maintenance requirements.[31] If the initial margin requirement had been only 40 percent, a 20-percent drop in market value would have threatened liquidation.[32] If only a 25-percent initial margin had been required, the broker would have had to send a margin call and a liquidation might have ensued on the slightest decrease in value of the collateral.

No comprehensive information is available as to the margin which broker-dealers generally require their customers to maintain in margin accounts. The responses to the Special Study's questionnaire FR–1,[33] however, indicate that at least some broker-dealers require a

[30] NYSE rule 431. The rules of other exchanges are generally similar.

[31] If the securities in the example above declined to a value of $4,000, the customer's equity would be $1,000 (the value of securities in the account minus the customer's debit balance)—exactly 25 percent of the market value of the securities in the account.

[32] In this situation, a $2,000 decline would result in the customer having an equity of $2,000 (the value of securities in the account minus the customer's debit balance) or 25 percent of the market value of the securities ($10,000 minus $2,000).

[33] Described in ch. III.D.

maintenance level above 25 percent of the market value of securities long: Of 48 NYSE member firms in the sample which described their practices, 17 stated that they require margin to be maintained at a level of 25 percent, 20 at 30 percent and 11 at 33⅓ percent or more.

It is evident that the higher the initial requirement in relation to the maintenance standard the greater protection against a forced liquidation that a margin purchaser enjoys. A substantial initial margin requirement does more, however, than protect an occasional Mr. Smith; the very forced sale that the absence of the requirement would tend to make more likely could itself contribute downward pressure on the market price of the security or securities involved, and any decline in price would, if many or all accounts were thinly margined, in turn tend to produce further margin calls. A kind of chain reaction may then ensue in which series of margin calls and waves of selling, each caused by the other, will follow with increasing rapidity and effect. Investor "psychology" being what it is, the increasing decline in one or several issues can easily spread to others. Once the process becomes generally operative, the stage is set for a serious market break.

This phenomenon is known to have been a significant feature of the great crash of 1929. There is reason to believe that the legislative response in the form of section 7 of the Exchange Act and the implementation provided by the FRB had a significantly moderating effect on the number of margin calls that went out during the market break of May 1962, and may have been responsible for its not having been worse, either in depth or duration, than it was. It cannot be said with certainty where one cause might have given way to another or what might have happened if the initial margin requirement had been at some other level before the break occurred. Those loans that were regulated had been subject to a 70-percent initial requirement for almost 4 years immediately before the break, however, and available evidence indicates both that credit subject to initial margin requirements may have played a minor role and that credit not subject to those requirements may have played a more significant one during that event.

During the 1962 market break, margin calls by brokers [34] increased substantially, but were still few in number and resulted in only a relatively minor volume of forced liquidations. Data for a continuing sample of margin customers of NYSE member firms collected by the Exchange for the FRB indicate that, at the end of December 1961, only 14 percent of the adjusted debit balances in the 1,639 customers' accounts [35] in the sample at that time were margined under 50 percent and 9 percent were margined under 40 percent.[36] At the end of May 1962, 41 percent of the adjusted debit balances in the accounts of the 1,664 customers included in the sample at that time were margined at less than 50 percent but only 22 percent of the adjusted debit

---

[34] Brokers may lend for the purpose of purchasing or carrying securities only on listed securities and only subject to the FRB initial margin requirements. See pt. A.3, above.

[35] NYSE member firms accounted for more than 98 percent of customers' net debit balances with broker-dealers on or about Jan. 31, 1962. See pt. A.1.

[36] Margin Panel Survey of New York Stock Exchange. Even though a 70-percent initial margin requirement had been in effect for almost 4 years, accounts at this time could have been less than 70 percent margined for at least two reasons. First, a reduced margin could occur, even if there were no activity in an account, owing to a decline in the market value of securities in the account. Second, Regulation T permits certain withdrawals of cash and securities and substitution of securities in margin accounts under circumstances which will result in a reduced margin.

96-746—63—pt. 4——3

balances were margined at under 40 percent.[37] It is therefore not startling, even in view of the severity of the break, that only one in nine of all NYSE member-firm margin accounts received written calls during May 25–31.[38] The average daily number of calls for margin maintenance purposes ("maintenance calls") during this period rose to 19,000 from the average daily number of 5,300 during the preceding 3-week period, or somewhat more than three times.[39] Written calls resulted in liquidations in 28 percent of the cases (24-percent voluntary and 4-percent involuntary,) [40] or only 3 percent of all margin accounts. The NYSE estimates that the share volume involved was 1 million shares, or 2.5 percent of total sales during that period.[41] Nonwritten "calls" or mere consultation between broker and customer may have resulted in additional liquidations, but the extent of such liquidations is not known. No one can say what the effect would have been if less stringent requirements had prevailed before the break or if the market had continued down instead of turning on May 29, but it would appear safe to say that during the break as it in fact happened, while liquidations in margin accounts may have had some effect on the severity of the break, brokers' margin calls did not themselves produce a runaway chain reaction.

In the case of banks, margin calls may have been of greater moment. The importance of securities-collateralized bank loans was shown by the FRB Bank Loan Survey, from which it is estimated that on September 26, 1962, member banks had almost $11 billion of such loans outstanding. Loans collateralized principally by stocks totaled $9.6 billion of which $8.6 billion had been granted free of initial margin controls.[42] Thus, unless a redical increase took place between May 28, 1962, and the following September (a change, moreover, which is unlikely), a very substantial amount of stock-secured bank credit was outstanding at the time of the 1962 market break and a large part of it was not subject to Regulation U.

Information obtained for the Special Study indicates that a substantial portion of unregulated, stock-secured bank loans was subject to lower initial margins than the FRB-imposed requirement under Regulations T and U. The FRB obtained information about bank margin practices for the Special Study in a series of interviews by which they supplemented their Bank Loan Survey. A group of 31 member banks located in various parts of the United States, including 7 with total deposits of over $500 million, 12 with total deposits in $100 to $250 million range and 12 in $15 to $30 million range, answered a set of identical questions relating to their stock-secured lending standards and procedures.

The responding banks were willing to make loans on listed stocks for unregulated purposes in initial amounts ranging up to 80 percent of

---

[37] Ibid.

[38] NYSE, "The Stock Market Under Stress," p. 41 (1963).

[39] Unpublished data collected by New York Stock Exchange. Data are projected from reports of 25 member firms accounting for approximately 36 percent of all member firm margin accounts. In addition to "maintenance" calls, routine calls under Regulation T, many of which were issued to customers making new commitments, rose to an average of 3,900 per day during the period May 25–31 from 1,900 during the preceding 3-week period.

[40] NYSE, "The Stock Market Under Stress," p. 58 (1963). The percentage of liquidations in maintenance calls alone may have been higher. The NYSE was not able to indicate the number of liquidations arising from maintenance calls alone.

[41] Id. at p. 41.

[42] See app. X–B.

their market value, i.e., on a 20-percent margin; 17 of the 31, or over half, lent from 70 to 80 percent, i.e., on a 30- to 20-percent margin; 12, or almost two-fifths lent from 60 to 66⅔ percent, i.e., on a 40- to 33⅓-percent margin; and only 1 had a margin requirement as high as 50 percent. One bank reported that it had no fixed percentage, but judged each case on its merits.

The range for unregulated loans on unlisted stocks was the same; between 50 and 80 percent was lent on these securities but the general tendency was to be more stringent. Seven banks, or about a quarter, lent 70 to 80 percent; 6 lent 60 to 66⅔ percent; and 15, or almost half, were unwilling to lend over 50 percent. Three banks had no fixed rule of thumb.

Margin maintenance requirements of the 31 banks surveyed covered a considerably broader spectrum than those of the NYSE member firms in the FR–1 sample.[43] With respect to listed stocks, 8 banks specified that they had no fixed requirements or that requirements varied according to the customer and/or the collateral, 3 had a requirement of less than 25 percent, 7 had the same standard as the NYSE, 10 required margin to be maintained at between 30 and 33⅓ percent and 3 required a 40-percent margin. With respect to unlisted stocks, there was some tendency toward a higher maintenance requirement: 11 banks in the sample required margin on unlisted stocks to be maintained at 40 percent or more.

The FRB also assembled, in July 1962, limited data on the number of margin calls by banks during the 1962 market break. Eighty-one member banks, at least five in each Federal Reserve District, were asked to try to supply estimates of the number and dollar amount of loans called during the period from May 21 to June 1, 1962, including the extent of collateral liquidation that resulted, and to specify the regulatory status of the loans involved.

Seventy-eight of the banks polled were able to respond; they accounted (at the end of 1961) for one-third of all loans (both secured and unsecured) outstanding at member banks and nearly one-half of the "purpose" loans. The responses showed that during the 2 weeks surveyed the responding banks issued margin calls on 15,124 loans to borrowers who were indebted in the aggregate amount of $383 million.[44] Only 94 of the loans called were regulated; of those 41 were to permit exercise of AT&T subscription rights and thus were allowed an initial margin as low as 25 percent. Approximately one-eighth of all calls resulted in sales of collateral (about $35 million).

By comparison, in an average 2-week period in February and March 1962, the responding banks issued approximately 400 margin calls. Several possible reasons exist for the increase reported in margin calls between this period and the May 1962 market break. Banks generally do not value collateral as regularly or as often as broker-dealers; they tend to rely to a greater extent on the general creditworthiness of the borrower and may not have acted until the severity of the break became apparent. Furthermore, the FRB did not

[43] See p. 10, above.

[44] It should be noted that unlike the data given at p. 12, above, with respect to margin calls by all NYSE member firms which are projected from a sample to provide an estimate of the number of calls for all firms, these figures include only those given by banks in the sample. These are primarily larger banks; those which accounted for the bulk of calls and loans are located in major financial centers. Undoubtedly other member banks of the Federal Reserve System also made margin calls; their number, however, is unknown.

define the term "call" to mean a formal written demand for additional collateral as did the NYSE; the more than 15,000 calls reported might, therefore, have included mere informal discussions with borrowers or possibly even internal consideration by bank lending officers. The fact remains that an exceedingly large increase occurred in the number of margin calls by banks during the period of the May 1962 market break, virtually all of which was concentrated among loans not subject to initial margin requirements under Regulation U.

The activities during the market break of a number of "unregulated lenders," persons other than brokers or domestic banks engaged in the business of lending on securities but not subject to FRB controls, appear to reflect the effect of limited initial margins.[45] As a part of a broader study, 14 such lenders, who had been interviewed in March 1962, and each of whom had reported at least $500,000 in security loans outstanding at some time during 1961, were reinterviewed in June 1962. Each was asked to state his total securities loans outstanding on May 1, 1962, his total outstanding at the time of the survey (in almost all cases the first week of July 1962 was used by the lenders), the number of his customers on May 1, 1962, and the number of margin calls he issued during March, April, and May, with a detailed breakdown for May. Certain details of sales resulting from margin calls during May were also obtained.

The 14 selected unregulated lenders reported aggregate securities loans outstanding of $18 million between March 1 and 10, 1962, $10.5 million on May 1 and only $3.5 million on July 1.

The loans outstanding on May 1, 1962, were to an aggregate of 500 customers. During the month of May the 14 lenders reported issuing over 300 margin calls, approximately 100 of which were issued during the period May 25–31. Several of the lenders reported, however, that they did not have records adequate to determine when margin calls had been made. One added that its loan agreement included specifications of a "stop" price below which the collateral would be sold. If, for example, the market value of the security at the time of the loan was $60, a stop price of $55 might have been specified. The lender would have lent up to 90 percent of the stop price and the customer would, in effect, have agreed in advance that if the market value of the security should fall to $55, the collateral would be sold without further ado. Still another lender apparently did not bother with margin calls as such at all, since it reported no margin calls, but forced liquidations of all customers on May 28.

The records of many of the unregulated lenders were not sufficiently detailed to show the names of dollar values of securities sold as a result of margin calls. Eight of the lenders interviewed were able to supply some data. They sold shares of approximately 200 issuers during May. All but about 10 were listed on either the New York Stock Exchange or the American Stock Exchange and presumably were on a smaller margin than would have been allowed by an NYSE or Amex member firm. Most of the sales involved blocks valued at between $2,000 and $5,000, but there were a number of blocks worth more than $10,000 and several in the $35,000 to $50,000 range.

In certain cases, these sales represented a high proportion of all sales on the exchange during a given day. On May 10, 1962, for example, unregulated lenders were responsible for sales of 1,500 shares of

---

[45] A comprehensive discussion of unregulated lenders is presented at pt. C.4, below.

Telautograph Corp. out of a total volume of 3,400 and 1,000 shares of Union Asbestos out of a total volume of 1,600. Other examples could be cited. Such concentration, entirely apart from the aggregate size of the blocks involved, may tend to accelerate a decline in the price level of given issues.

The foregoing data with respect to unregulated lenders are fragmentary. Nevertheless, the partial evidence available indicates the effect of inadequate initial margins and suggests that the longstanding prebreak 70 percent level provided considerable protection.

In summary, the evidence available to the Special Study gives strong indications that a substantial initial margin requirement is a strong defense against forced liquidations of securities in a declining market. Where these requirements were applicable, there appears to have been a more limited increase in the number of margin calls than where they were not. Where loans on the smallest margins were made by unregulated lenders, on the other hand, a substantial portion of loans appear to have been called during the period of the 1962 market break.

C. Disparities and Gaps in Margin Controls

In the New York Times for December 12, 1961, the following advertisement appeared:

> LOANS ON
> UNILEVER STOCK
> BROAD & WALL CORP.
> *A public-owned company*
> 101 Park Ave. ORegon 9–9030

December 12, 1961, was the date on which Unilever stock was listed on the NYSE. Before that date, because Unilever was then not listed:

(1) A broker-dealer was forbidden to extend credit to a customer for the purpose of purchasing or carrying any securities (including Unilever stock) if the Unilever stock was to be used as collateral; the Unilever stock was acceptable, however, as collateral for a loan for any other purpose;

(2) The customer could have used the Unilever stock as collateral for a loan from a domestic bank for any purpose including purchasing or carrying the Unilever stock; if the purpose of the loan had been to purchase or carry a listed stock, however, the bank could have lent only up to 30 percent (now 50 percent as a result of a change in margin requirements) of the market value of the Unilever stock;

(3) The customer could have used the Unilever stock as collateral for a loan from a lender other than a broker-dealer or domestic bank for any purpose whatsoever and for any amount the lender would permit; the lender, however, might have been limited by Regulation U in his ability to rehypothecate the stock with a bank;[46] and,

---

[46] If the lender's principal activity, or one of its "important" ones, had been making loans to purchase or carry listed stocks, no more could have been lent by the bank to the lender on the Unilever stock than was permitted under the general provisions of Regulation U *unless* the loan from the bank to the lender had been clearly disassociated from any financing by the bank for the lender to purchase or carry listed stocks. See Regulation U, sec. 221.3(q) and discussion in pt. C.4.d(2).

(4) A broker-dealer could have borrowed from a domestic bank or any other lender on Unilever stock in the same manner as any other customer.

When the Unilever stock was listed, its loan value was affected in several respects. Thereafter:

(1) A broker-dealer could lend up to 30 percent (now 50 percent) on Unilever stock for its purchase or for the purchase of any listed or unlisted security; the Unilever stock continued to be acceptable as collateral for a loan for a purpose other than purchasing or carrying securities and the broker-dealer could lend any amount on it;

(2) A domestic bank could lend only 30 percent (now 50 percent) on Unilever stock where the purpose was to purchase Unilever or other listed stocks; where the purpose of the loan was other than purchasing or carrying listed stocks, however, the bank could lend any amount on Unilever stock.

(3) A lender other than a domestic bank or broker-dealer could still lend any amount on Unilever stock for any purpose whatsoever including purchasing or carrying Unilever or other listed securities;[47] and,

(4) A broker could no longer borrow on Unilever stock from any source other than a member bank of the Federal Reserve System or a bank that had agreed to be bound by the restrictions to which members were subject.

If it had been Unilever bonds that had been listed, a different pattern would have emerged: before listing they would have had the same margin status as unlisted stock. Upon listing the bonds would have become eligible for brokers' loans, subject to margin requirements. Banks, however, would have been permitted to lend any amount on the bonds even after they were listed and even if the purpose of the loans were to purchase or carry the bonds or other listed stocks or bonds.

From the illustration just given it will be seen that, despite the theoretical desirability and demonstrated usefulness of initial margin controls, they apply at present to only some securities transactions and in some instances in seemingly inconsistent ways. Some of the disparities or gaps represent deliberate policy choices; others, the effects of circumstances not fully known or foreseen when the law or regulations were adopted. It is therefore appropriate to survey the existing regulatory pattern to determine its adequacy in the light of experience and of present and possible future circumstances.

1. NONPURPOSE LOANS

"Nonpurpose" loans, i.e., those for a purpose other than purchasing or carrying securities, are not subject to regulation under present security credit controls. There is a fundamental distinction between the treatment accorded nonpurpose loans, on the one hand, and loans to purchase or carry securities ("purpose" loans), on the other hand. While not all types of purpose loans are regulated, they are in large measure subject to credit controls. Whatever the effect of observing the distinction on the broad credit-monetary control effort might be, it is necessary, in view of the significant protection provided by an initial

[47] But see note 46.

margin requirement against the snowballing effect of margin calls,[48] to consider whether the distinction should be retained in its present form, modified, or abolished.

The volume of stock-collateralized, nonpurpose loans is far greater than that of the purpose loans subject to margin requirements. On September 26, 1962, for example, member banks held about $7.8 billion of nonpurpose loans principally collateralized by stocks, compared with only about $850 million in loans principally collateralized by stocks for the purpose of purchasing or carrying securities registered on a national exchange.[49] By comparison, at the end of September 1962, NYSE member firms reported $3.9 billion in customers' net debit balances representing loans to customers for the purpose of purchasing or carrying securities.

When the $8.6 billion of stock-secured unregulated loans were classified, two principal components appeared. Slightly less than 50 percent of the total *dollar amount* was represented by single payment personal loans and 37 percent by business loans; the remaining 14 percent was about equally divided between installment loans to individuals and all other loans. Single-payment loans to individuals constituted an even larger portion—about 70 percent—of the total *number* of stock-secured unregulated loans.

Moreover, for 66 percent of the total amount of stock-collateralized, single-payment bank loans, the principal collateral was listed stocks. Not only were these stock-collateralized, single-payment personal loans the largest single category of unregulated, stock-collateralized loans, but they represented nearly three-fifths of the dollar volume of all single-payment loans (stocks secured or otherwise) reported by all member banks in their regular Condition Report to the FRB on September 28, 1962, 2 days after the survey date. No other category of loans approached this proportion; in the other cases, the percentages varied from less than 1 percent for installment loans to about 8 percent for business loans.

In summary, over 80 percent of the securities-collateralized loans granted by the member banks of the Federal Reserve System on the survey date were in the nonpurpose category and a somewhat higher percentage were not subject to margin controls. The two principal types of stock-collateralized, unregulated loans were single-payment personal loans and business loans. The former represented the major portion of single-payment loans at all member banks and were relatively more numerous but smaller in size; the principal collateral in most instances was listed stock. The latter (stock-collateralized business loans) represented only a small portion of the business loans of all member banks, were fewer in number but larger in size, and the principal collateral was likewise usually listed stock. With respect to purpose loans the principal collateral was more evenly divided between listed and unlisted stocks.[50]

---

[48] See pt. B.

[49] In addition, there was about $750 million in unregulated loans to purchase or carry securities which were principally collateralized by stocks.

[50] No general study of nonpurpose loans by broker-dealers to their customers has been made. The 245 broker-dealers receiving questionnaire FR-1 (see description in ch. III.D), however, were asked to state the amount of their nonpurpose loans outstanding on April 30, 1962; 35 of the 50 NYSE firms in the sample had such loans outstanding in amounts ranging from about $4,000 to about $5 million—2 of 15 Amex and 6 of 44 regional exchange members in the sample had nonpurpose loans ranging in size from $4,000 to more than $530,000. No nonexchange firms in the sample had nonpurpose loans outstanding on that date.

It seems probable that some of the individuals who obtained nonpurpose, single-payment bank loans with stock as collateral bought securities during the period of the loan on a cash basis and that the decision to employ stocks as collateral for the nonpurpose loan rather than for a purpose loan simply reflected the difference between the initial margin requirement of Regulation U and the greater amount which banks would lend on stocks for nonpurpose loans. In terms of potential impact on speculative bull markets or precipitous declines, it may make little practical difference whether the loan proceeds are channeled directly to the purchase of securities and the other funds to a nonpurpose use or vice versa; the margin requirements, however, often apply in one but not the other.

The existence of a large amount of nonpurpose loans principally collateralized by stocks which could be carried at low margin and are readily subject to call during deteriorating markets must be regarded as a potential threat to market stability. As indicated in part B above, the great increase in bank margin calls with respect to unregulated loans contrasted sharply with the virtual immunity of regulated loans at the same banks during the 1962 market break. Undoubtedly, a part of this increase may be ascribed to the fact that nonpurpose and other unregulated loans were made by banks on smaller margins than either banks or broker-dealers are permitted for purpose loans. It would seem that, strictly from the point of view of safeguarding the securities markets against the risk of forced sales of collateral, the need for public control, in the form of an initial margin requirement, is no less in the case of a nonpurpose loan than in the case of a purpose loan.

In relation to the concerns of the FRB, charged as it is with broader economic aspects of security credit control, the purposes for which investors borrow may be of primary significance. The purpose standard is most relevant to those aims of margin controls that transcend protection against an uncontrolled, self-feeding decline; it relates primarily to more general considerations of credit and economic regulation. Requiring an initial margin on all stock-secured loans, however, would not be incompatible with continuance of separate or special controls on credit to purchase or carry securities. In other words, it is entirely possible that the FRB might be satisfied that a particular initial-margin level was adequate to guard against a precipitous, runaway decline, even though below the level established for purpose credit in the exercise of its broader responsibilities. In any event, it appears to the Special Study, in light of the general principles and data discussed in part B and in this section, that the authority of the FRB should be broad enough to encompass nonpurpose loans collateralized by actively traded securities and flexible enough to enable it to adjust initial margins with both the narrow and broader objectives in view as changing economic or market conditions might require.

2. UNLISTED SECURITIES

The second pervasive distinction in existing credit controls is that between the margin status of listed and unlisted securities. Unlike the purpose-nonpurpose division, this distinction results less from the underlying aims of regulation, as originally conceived, than from practical considerations. The decision to prohibit broker-dealers entirely from extending credit on unlisted securities for the purpose of purchasing or carrying securities while permitting greater freedom of action to banks was a deliberate one. It was based primarily on the lack of reliable and current prices and the presumed illiquidity of over-the-counter issues as they related to the different economic functions served by bank and broker credit. It may very well be that on the basis of experience up to 1934, and in view of the market procedures and institutions then prevailing, no other decision would have been wise; however that might be, it is appropriate at least to reconsider the question in the context of the knowledge and circumstances of the present.

Preliminarily, it may be helpful to provide some indication, from the FRB Bank Loan Survey, of the characteristics of bank loans on unlisted securities and the issues employed as principal collateral to obtain them:

Of the total amount of $10,936 million of securities-collateralized bank loans outstanding on September 26, 1962, $3,120 million, or about 28.5 percent, was principally secured by unlisted stock.[51] On the average, the loans on unlisted securities were large, amounting to approximately $19,000, compared with those principally collateralized by listed stock, which averaged about $12,500. Of the $3,120 million in loans principally secured by unlisted stock, the most important collateral for about 60 percent of these loans was in issues that were not "actively traded." Issues were defined as "actively traded" only if market interest was sufficient to warrant their inclusion in any regional or national NASD quotation list.[52]

Business loans constituted the highest amount (36 percent) of loans principally secured by inactive, unlisted stocks. Conversely, single-payment personal loans constituted the highest percentage (38 percent) of loans secured principally by actively traded unlisted stocks. As has already been noted, single-payment personal loans also represented the highest percentage of loans secured by listed stock.

In order for margin controls framed in terms of a percentage of market value to be feasible, it is essential to have accurate and current prices. A lender forbidden to lend more than x percent of the value of collateral offered—and subject to penalty if he exceeds the permissible amount—must be able readily to solve the equation that confronts him and solve it in a way that will satisfy not only himself and his borrower at the time, but also the regulatory authorities at some later time. In the case of listed securities, the centralization of the market and public reporting of transactions on the tape provide a perfectly adequate means of ascertaining market value. No such means was apparent for unlisted securities in 1934 and Congress therefore thought that permitting broker-dealers to extend credit on them would make it possible to dilute margin controls in their application to listed securities (by the assignment of questionable or bad faith values to unlisted issues in a mixed bag of collateral) and would be unworkable in its own right.[53]

The different ways Congress applied its decision to banks and brokers appears to have resulted from differing assessments of the

---

[51] See app. B.
[52] See p. 21, below. It should be noted that this criterior of trading activity differs from that used elsewhere in the report. See chs. VIII and IX.
[53] H. Rept. 1383, 73d Cong., 2d sess., p. 8 (1934).

economic roles of the lending of the two types of entities.[54] One of the principal functions of a bank is to lend money and in exercising that function it tends to develop long-term relationships with its customers. It becomes familiar with their financial circumstances and can accurately gage their creditworthiness. It may or may not demand collateral for its own security. If the market value of the collateral is volatile, like that of readily marketable, publicly traded securities, a price decline will not normally cause a bank immediately to "sell out" a longstanding customer. Since it has included his general creditworthiness in its calculations, it will "go along" with him for a while, give him some time to provide additional security and take drastic action only when that becomes unavoidable. A bank, similarly, will have the time and, in view of its function, the inclination to make the investigation necessary to determine the collateral value of securities that are off the beaten track and to correlate that value with its customer's reliability. The impact of bank lending on the market, therefore, may frequently be relatively remote rather than immediate.

Brokers, however, are sellers and they extend credit in order to facilitate making sales. They may not require a long-established customer relationship nor as thorough awareness as banks of the customer's financial status as a prerequisite to a margin transaction.[55] They are not principally engaged in the business of lending money. To allow brokers to lend on over-the-counter securities that might be extremely difficult to evaluate in the absence of accurate and current prices could be thought of as both endangering broker solvency and introducing into the market a potentially disruptive force that might seriously impair its stability.

To some extent, if it is said that banks place greater emphasis on a customer's general creditworthiness than do broker-dealers, this characteristic of their lending policies applies to listed as well as unlisted securities. The rationale of a distinction in the power of broker-dealers and banks to lend on unlisted stocks thus may largely rest on the availability of reliable price information when reliance is principally on the collateral.

In some measure the failure to evolve regulatory measures for over-the-counter securities equal to those applying to listed securities, especially measures requiring adequate corporate financial reporting, has warranted continuance of the distinction. A stock may be readily and adequately evaluated as collateral, however, even when regular quotations are not available, if financial reports and the corporate information necessary to a proper proxy statement are regularly made public. When regular quotations are available, adequate corporate reporting goes far toward assuring their reliability as a measure of collateral value. Such disclosure in itself fosters investor interest and confidence and, thereby, the liquidity that is one of the desiderata of marginability. Extending the benefits of sections 13, 14, and 16 of the Exchange Act to the over-the-counter markets would not necessarily confer on the securities of every issuer to which they might

---

[54] Testimony of Thomas G. Corcoran, "Hearings Before Senate Committee on Banking and Currency on Stock Exchange Practices," pt. 15, 73d Cong., 1st sess., pp. 6473–6474 (1934).

[55] In this connection, see the discussion of NYSE rule 405(1) (the "know your customer" rule) in ch. III.B.6.b(3)(a) of the report.

apply the attributes that are desirable as a precondition of the availability of credit, but, had these protections been achieved as Congress envisaged in 1934,[56] they would have helped to eliminate a major distinction in underlying circumstances which led to the listed-unlisted disparity in margin provisions.

In any event, the circumstances of today, assuming the protections of sections 13, 14, and 16 are made available to a substantial segment of unlisted securities, as recommended in chapter IX, warrant a reexamination of the sharp disparity now embedded in the Exchange Act in respect of at least some securities in that segment. Elsewhere in this report a comprehensive exposition of present-day over-the-counter communications facilities and trading practices is presented, as well as a detailed description of methods of compiling disseminating over-the-counter quotations.[57] Existing means do not yet approach the exchange tape but, for at least some over-the-counter securities, reasonably reliable and current interdealer quotations and "retail" bid prices are available.

The heterogeneity of the over-the-counter markets and of the issues traded there is also discussed in the report.[58] It is pointed out, in chapter VIII.B, that many over-the-counter issues are as active as, or more active than, many listed issues and display equal or greater trading depth. Indeed, the outward characteristics of a considerable segment of over-the-counter issues are indistinguishable from those of a considerable segment of listed securities.[59] For some over-the-counter issues, therefore, the presumed illiquidity that influenced Congress in 1934 does not now, at least, obtain.

In chapter IX, along with recommendations to improve corporate disclosure, a proposal is made to establish and emphasize a categorization of over-the-counter issues by designating those issues, the issuers of which will comply with the disclosure recommendations, as "OTC-listed." [60] The class of issues thus created, all of them owned by a substantial body of shareholders and many of them actively traded and quoted, would constitute a subgroup of over-the-counter issues surrounded by relevant protections now applicable to listed issues, from which some more selective process might designate a further subgroup to which it would be feasible to apply margin controls. In other words, the OTC-listed concept would be the outside limit, but not necessarily a sufficiently restricted limit, of a category of securities to be considered equivalent to listed securities for margin purposes.

The extent of bank lending on the over-the-counter stocks has been indicated above. The need for margin controls over such loan where feasible has already been stressed and need not be elaborated here; some additional indications of the data at hand should, however, be mentioned. That extending margin controls to bank lending on some categories of unlisted issues would be desirable and is practicable is indicated by the September 1962 Bank Loan Survey and the supple-

[56] See ch. IX.
[57] See ch. VII.
[58] See ch. VII.
[59] For example, consider the Unilever stock, mentioned at p. 1 above, just before and after its listing.
[60] Since ch. IX was published, it has been suggested that the particular designation of "OTC-listed" could be an unfortunate one because of possible confusion with "listed" (on a stock exchange). If this objection is deemed a valid one, an alternative designation could readily be found ("OTC-special," "OTC-disclosure-list," "OTC-registered," or "OTC-public," for example) without impairing the principle that there should be a special designation.

mentary interviews of the FRB. At that time $3,120 million was owed to banks on the security of unlisted stocks and it is now possible to give some indication of the characteristics of the issues involved. It proved possible to classify $1,425 million of this debt, or slightly less than half, according to certain characteristics of the corporation issuing the security serving as the single most important collateral. Of the loans so classifiable, $1,063 million were secured by stocks of corporations with 1,000 or more shareholders; when classified by assets, collateral for $1,172 million of these loans was in the form of stock of issuers with assets of $10 million or more. Stocks in these categories, as shown by numbers of transfers and by indications of broker-dealer interest, generally appear to be active.[61]

The FRB's supplementary interviews show, moreover, that in contrast to the situation in 1934, the banks in the sample were readily able to obtain quotations with respect to many over-the-counter securities and that these securities in fact had a high degree of liquidity. As a result, with respect to these securities, the banks were enabled to forgo primary reliance on the borrower's general creditworthiness and could look instead principally to the collateral.

There is no reason, however, to abandon the existing pattern of controls, actually absence of controls, in relation to closely held, inactive issues on which bankers lend in their "traditional" capacity. Elimination of the collateral value of such issues would be a drastic measure not called for by any data at hand. It would be unwarranted in view of the relative absence of volatility that stems from their inactivity, and the relatively small number of affected persons, and would be unnecessary in view of the indications that reliance on collateral, as distinguished from credit standing of borrowers, is less important for smaller, inactive issues than for actively traded ones.

As a means of distinguishing between the two classes of issues for bankers' margin purposes, the standard for over-the-counter corporate disclosure pursuant to the study's recommendation in chapter IX is suggested.[62] As in all cases of line drawing the division has to be on a rough-and-ready basis that necessarily will fail to take into account some difficult borderline cases. The data presented in chapter IX shows that, at the 300-shareholder level, a substantial majority of issues show marked trading activity and substantial broker interest.[63] The OTC-listed category,[64] therefore, might well serve as a practical classification for bank margin purposes.

By the same token, issues in that category, or at least some of them, should be considered for eligibility for broker credit without, however, necessarily including all issues in that category. It is probably the case that the class of issues to which it would be feasible and advisable to extend bank-margin controls is not necessarily identical with that to which it would be desirable to extend broker-margin privileges. The differences between the credit functions and procedures of banks and of brokers are not entirely eradicated by improved

[61] See ch. IX.B.

[62] In ch. IX.B, it is proposed that the provisions of secs. 13, 14, and 16 of the Exchange Act be eventually extended to all issuers having 300 or more equity security holders of record and/or beneficial holders, subject to certain exemptions and exemptive powers. The Commission's current legislative proposals, embodied in S. 1642, and H.R. 6789 (also H.R. 6793) (88th Cong.), specify a minimum of 500 shareholders and $1 million in assets.

[63] Of course this would be even truer of the narrower category suggested in the Commission's pending legislative proposal. See note 62, above.

[64] Excluding those issues so classified on the basis of mere voluntary compliance.

quotations, increased liquidity, and extensions of corporate disclosure. The involvement of brokers in the trading process and the noninvolvement of banks, as well as the mechanisms of the over-the-counter market themselves—absence of specialists, for example—cannot be overlooked. Many over-the-counter issues, however, even if by no means all of those that will become OTC-listed, exhibit most if not all of the characteristics of listed issues. Several hundred over-the-counter stocks, for example, actually meet substantially the minimum listing requirements of the New York Stock Exchange.[65] It should be possible, therefore, to identify among the OTC-listed class of securities those issues equal to or most nearly approaching listed issues in activity, trading depth, and ready availability of reliable price information and it would appear to be desirable to place such issues on a par with listed issues for margin purposes and to entrust the establishment of standards and procedures for that purpose to the FRB. Alternatively, the category of securities might be broadened but the margin level might be more stringent instead of on a par with that for listed securities.[66]

3. CONVERTIBLE BONDS AND SUBSCRIPTION ACCOUNTS

Two other regulatory disparities should be discussed briefly: the treatment accorded convertible bonds and that accorded subscription accounts. Convertible bonds present a special problem because Regulation U, which unlike Regulation T applies only to loans to purchase "stocks," leaves them free of margin controls; [67] banks may therefore extend credit on the security of either listed or unlisted convertible bonds, and even for the purpose of purchasing or carrying such bonds, on any terms that they wish so long as the "good faith" test of Regulation U is met.[68]

No comprehensive figures are available as to the aggregate amount of convertible bonds outstanding. Standard & Poor's Earnings and Ratings, Bond Guide, for March 1963 includes a broad list of well known and active issues. The aggregate market value of NYSE-listed convertible bonds included in the Bond Guide on that date was about $2,300 million; that for Amex-listed convertible bonds was about $92 million; and that for unlisted issues was about $880 million. These figures may not be large in relation to the aggregate market value of all securities [69] but the September 1962 Bank Loan Survey and its supplementary interviews indicate that a considerable amount of bank lending on convertible bonds exists, a substantial part of such lending is purpose credit and some is on very low margin. The survey itself showed credit outstanding secured by convertible bonds in the aggregate amount of $286 million, 71 percent of which was classified as "purpose" credit. (The percentage might be compared with 13 per-

[65] See ch. VIII.B.
[66] Exchange Act sec. 7(b) gives broad powers to the FRB to classify securities and transactions for purposes of margin requirements.
[67] Sec. 7 of the Exchange Act expressly prohibits restricting bank credit on nonequity securities, but sec. 3(11) defines the term "equity security" to include securities convertible into stock or a similar security. If a loan is made for the purpose of purchasing or carrying a security other than a listed stock, the security is converted into listed stock and the stock is substituted as collateral, the initial margin requirement for the stock must be met in 30 days. Regulation U, sec. 221.3(r).
[68] See table X–b.
[69] At the end of 1962, the market value of NYSE-listed stocks alone was $346 billion and that of NYSE-listed bonds was $111 billion. NYSE Fact Book (1963), p. 14.

cent for listed, and 25 percent for unlisted stocks.) The banks interviewed had varying policies: some would not lend on convertible bonds at all; others, among those that would, had no margin policy; but approximately half had an established policy—and therefore presumably routinely engaged in such transactions—and of those, half (7 banks) required as little as 20 percent margin.

Whatever the quantitative significance of the convertible bond problem might be, its qualitative importance is such that it should not be ignored. It should be noted that not all convertible bonds present the same problem. Where the price of the underlying stock is below the conversion price, it is probable that there is a greater tendency for the bonds to sell as debt securities and not on the basis of their conversion price. With respect to listed issues, however, when the convertible bonds are selling at a price including an increment over par value reflecting the conversion right, the ability to borrow from banks on the bonds provides an obvious avenue of avoidance of restrictions on loans on the underlying stock. The problem, moreover, is compounded by the circumstance that brokers, otherwise prohibited from arranging credit on better terms than they themselves are permitted to grant, enjoy an exemption for arranging loans with banks,[70] an exemption of which several registered brokers have taken full advantage. The NYSE member firm of Garvin, Bantel & Co., for example, when interviewed in 1962, had established relationships with approximately 300 banks that were willing to advance funds on the security of convertible bonds to customers of any broker that might apply through Garvin, Bantel. Most of the details of such transactions were attended to by Garvin, Bantel in circumstances such that the lending banks clearly looked solely to the collateral for its security. The firm professed to be responsible for approximately 25 percent of the bond trading volume on the NYSE; its activities, therefore, necessarily had a substantial impact on that segment of the market and the issues underlying the convertible issues in which it dealt.

Entirely apart from problems of avoidance, however, convertible bonds in their own right are equity securities and may be subject to all of the market-disruptive potential of stocks. Margin controls over convertible bonds, at least those selling at prices reflecting the conversion privilege, should be the same as those now existing for other equity securities. Regulations might be drawn in such a manner that those convertible bonds not selling in clear relation to their conversion price would continue to be treated as nonequity securities.

Subscription accounts present different problems. The low margin level applicable to such accounts—currently 25 percent—has been set in view of the consideration that individual shareholders to whom rights are distributed by their corporations have no control over the time of distribution or, for that matter, over whether there should be such a distribution. Since these shareholders will be participating in the market involuntarily, so to speak, some of the important reasons for margin controls have no application and it is apparently thought that they should not be deprived, or unduly hindered from availing themselves, of their opportunity to maintain their proportionate corporate interest. The relaxation thus seeks to minimize an impediment to a method of corporate financing generally looked upon with favor.

---

[70] Regulation T, sec. 220.7(a).

It would appear that the relaxation may have the effect of permitting a wholesale, low-margin credit decision to be made by the management of the corporation making the distribution, a decision that can have a significant market impact on the issue involved and, if the issue is a market bellwether, on the whole market. Information available with respect to AT & T subscription accounts, for example, indicates that during the period May 25–31, 1962, there were 1,200 margin calls for NYSE member firms, a 500-percent increase over the incidence of such calls during the period from May 7 to May 24. From May 21 to June 1, 41 of the 94 margin calls that were in regulated accounts of a sample of the banks included in the bank margin call survey described above [71] involved AT & T subscriptions.

Notwithstanding, the Special Study recognizes that there are important considerations other than potential market impact involved in the treatment accorded subscription accounts under Regulation T. Since it has been impossible for the study to explore and evaluate the competing considerations, no recommendation respecting subscription accounts is made.

4. UNREGULATED LENDERS

a. Identity and characteristics

The term "unregulated lenders" [72] is broad enough to include any person or firm, other than a domestic bank or a broker, lending money for the purpose of enabling the borrower to purchase or carry securities. A group of persons and firms, other than domestic banks and brokers, exists that either intermittently or regularly transacts a substantial amount of such business.[73] Study of the unregulated lender phenomenon initially involved an effort to identify the principal participants and learn something of their characteristics.

Information about unregulated lenders was derived, in the first instance, from reports required by the FRB to be made by these lenders on form FR 728.[74] These reports have been required since 1960, and must be submitted once by each unregulated lender; no supplemental, current reports are required. The reports include a balance sheet and a statement as to the number and volume of loans they made in the preceding year.

Approximately 200 lenders responded when the requirement was adopted in 1960 and other lenders have since reported. About 135 of those lenders originally reporting were credit unions, most of which had made only an occasional purpose loan on securities. Analysis of the reports showed that many of the remainder were under the same management or control so that only approximately 44 separate enterprises or enterprise groups reported. Fourteen other lenders that had come to the attention of the Commission or the New York Federal Reserve Bank were also identified. Of the 58 domestic lenders or affiliated groups about which some information is available, 36, including most of those in New York City and the 14 that had not reported in 1960, were interviewed by the Special Study.[75]

---

[71] There were more than 15,000 calls together, the great preponderance of which were in unregulated accounts. See pt. B above.
[72] See pt. A.3., above.
[73] Broad & Wall Corp., whose advertisement with respect to Unilever stock appears above, is one example of a firm regularly engaged in lending on securities.
[74] The reports are required under the authority of Regulation U, sec. 221.3(j).
[75] Two lenders refused to answer any questions, and a third, after reporting he was out of business, refused to submit any further information.

The 36 domestic unregulated lenders that were interviewed represent a broad variety of businesses. The business of making loans on securities was the sole or primary business of 10; 6 were engaged primarily in general commercial financing, and 7 financed promisory notes and installment paper. A breakdown of the remainder is as follows: three, primarily fur factors; three, import-export business; three, real estate; two, broker-dealers (mutual fund salesmen); one's principal business was lending money on ship mortgages; and one was a diamond importer. A consequence of the fact that most unregulated lenders have other sources of income is that they can increase their securities loans when demand is high, as it was in 1961, and fall back on their other businesses when demand slackens, as it did during 1962. They can support themselves during bear markets and still be on hand to satisfy the rising demand of a bull market.

The identified unregulated lenders displayed a variety of forms of organization and changed from one to the other frequently. Of those interviewed 25 were corporations, 9 partnerships, and 2 individual proprietorships. In the course of 2 years one individual effected unregulated lending transactions successively through Richgold Trading Corp., Alan Development Corp., Gladstone Securities Corp., Nalco Securities Corp., Rochelle Trading Corp. and Reldan Trading Co., all controlled entities.

Unregulated lenders are widely distributed geographically, but the majority are in New York City. Of the 58 about which some information is available, 47 are located in New York, 6 in Boston, and 1 each in Chicago, Detroit, San Francisco, Philadelphia, and Miami. Unregulated lenders have also been reported in Los Angeles, Atlanta, Hartford, and Texas.

In addition to the domestic lenders interviewed, available evidence shows that there are a substantial number of active foreign lenders. The mechanics of borrowing from the latter will be discussed in the section dealing with the sources of funds of unregulated lenders.

b. Typical transactions

(1) *Terms*

Unregulated lenders make loans of two basic kinds. One is a so-called "straight loan" in which securities that the customer provides serve as collateral. The second is a so-called "clearance transaction." Clearance loans developed as a method by which a borrower could avoid the so-called "free-riding" restrictions in the credit regulations. Those restrictions are designed to prevent a customer from buying securities and selling them within the time permitted for payment provided for margin and cash accounts [76] with only enough funds to pay for any difference in the market value, viz, "free-riding" as to the initial cost of the securities. The regulations, in effect, substantially limit a customer from obtaining the proceeds of the sale until he has tendered the payment due on the purchase.[77] A clearance loan is, in effect, a 1-day loan of funds with which to make the required tender.

---

[76] Regulation T, sec. 220.3(b) (margin accounts) ; sec. 220.4(c) (cash accounts).

[77] If a customer withdraws the proceeds of a sale from a cash account before tendering the purchase price, no further transaction may be made in the account for 90 days unless the purchase price is in the account prior to the purchase; the account, in short, is "restricted." The general rule with respect to margin accounts is that no withdrawal of cash may be made at any time if the "adjusted debit balance" created in the account would exceed the maximum loan value of securities in it. Regulation T, secs. 220.4(c) ; 220.3(b).

Subject to some variations, all unregulated lenders lend money on securities on approximately the same terms. On securities listed on the New York Stock Exchange a customer can obtain from 70 to 90 percent of the current market value. Some firms have a set rate for all New York Stock Exchange securities, although others attempt a qualitative judgment. The amount lent on unlisted securities is generally less, from 50 to 80 percent of current market value. The reasons given for the distinction were (1) that market value was less certain and (2) that most foreign banks will lend only on listed securities.

The typical unregulated lender charges interest at the rate of from 1 to 2 percent per month. Some lenders that were interviewed charged 1¾ to 2 percent per month for the first month and 1½ percent thereafter. Most large lenders charged a uniform rate, but others varied the rate depending upon the customer, the amount of the loan, and the quality of the collateral. There were loans reported with interest as high as 3 percent per month.

All of the loans made by unregulated lenders are "demand" loans. Almost all lenders reported that there was an extremely high turnover of loans. It was uncommon for any loan on a particular security to be outstanding for more than 6 months and the average period was approximately 1 month. Most unregulated lenders treated "clearance," or 1-day, loans as a separate category excluded from the foregoing average. Many charged a minimum of 1 month's interest for all loans, including clearances, but some lenders had separate transaction charges for clearances.

(2) *Mechanics*

In order to avoid the risk of receiving forged or counterfeit certificates as well as the safekeeping responsibility, most unregulated lenders employ banks as integral parts of their operations. When the borrower has completed arrangements for the loan, he will instruct his broker to deliver the securities to a lender-designated bank against payment. The lender meanwhile will instruct its bank to receive the securities from the broker and pay the amount due. Since the lender will be lending less than the purchase price, the customer will have to pay the balance either to his broker or, more usually, directly to the lender. The bank will usually have the certificate registered in its "street" name and keep them in the account of the lender. The bank will charge an "activity fee" ranging from $1.50 to $5 per receipt or delivery. The lender will, of course, incur interest costs if it itself borrows in the transaction.

Almost all the unregulated lenders reported that customers rarely redeem their collateral; usually customers sell the security and pay the loan from the proceeds. When a sale is made, the customer informs the lender, who in turn instructs the bank to deliver the certificates to a broker. The bank receives payment from the broker and credits the account of the lender. The lender then pays the customer any surplus after deducting charges.

Some of the banks which have discontinued lending to unregulated lenders are still performing custodial and clerical services for them. There are no formal restrictions on such services. Many banks are still willing to handle both clearances and "straight" loans of known lenders who are clearly covered by section 221.3(q) of Regulation U.[78]

(3) *Securities involved*

The bulk of borrowing from unregulated lenders is on listed securities which most often excite customer interest. Many unregulated lenders described foreign banks, from which they themselves borrow,[79] as being completely ignorant of the over-the-counter market and generally distrustful of all securities other than those listed on the New York Stock Exchange. Some foreign lenders will not accept American Stock Exchange securities and most treat securities solely listed on regional exchanges like over-the-counter issues.

Securities used as collateral for unregulated loans are overwhelmingly those that would be classified as the most active and/or most volatile of the listed securities. The high rate of interest charged, from 18 to 24 percent per year, makes the borrowing attractive only if a rapid price movement is anticipated. Thus, unregulated loans are made primarily to speculators, "in-and-out" traders. Examples of concentration of lending are given below.

c. Sources of funds

Almost all domestic unregulated lenders have to use borrowed capital. Only those lenders whose loan volume is small operate with their own funds exclusively.

Of the 36 unregulated lenders interviewed, 24 reported that they were still active in March 1962; of these 15 reported that they currently had either secured or unsecured bank loans from U.S. banks while 13 reported that they were currently borrowing money from foreign banks. Of the 14 largest active unregulated lenders, 6 borrowed from both United States and foreign banks, 3 borrowed only from foreign banks and 4 borrowed only from U.S. banks. All but one thus used some credit. Sources are loans from domestic banks secured by customers' securities, loans from domestic banks, either secured by collateral other than securities or unsecured, and loans from foreign banks, both secured by customers' securities and unsecured. Each will be discussed in order.

d. Loans from domestic banks

(1) *Clearance loans*

Before May 1, 1962, unregulated lenders made extensive use of exemptions designed to enable banks and brokers to close transactions among themselves free of margin restrictions, the so-called "clearance" exemptions. They included loans by banks for temporary advances, Regulation U, section 221.2(f); loans against securities in transit, section 221.2(g); and loans to be repaid in 1 calendar day, section 221.2(h). In May 1962 the Federal Reserve Board promulgated amendments intended to prevent unregulated lenders from using the exemptions to obtain bank credit to finance clearances. The effectiveness of the amendments to curtail bank credit for clearances during another bull market would appear to depend on the general effectiveness of section 221.3(q), discussed below. In the main, however, banks report that they no longer lend money to known unregulated lenders

[78] See subsec. d(2), below.
[79] See subsec. e, below.

for clearances, although they are still involved in facilitating clearance transactions in a custodial and clerical capacity.

(2) *Lenders subject to section 221.3(q) of Regulation U.*

In 1959, the FRB amended Regulation U by adding a new section 221.3(q). This section attempts to regulate the extension of credit by banks to unregulated lenders "* * * engaged principally, or as one of the [lender's] important activities, in the business of making loans for the purpose of purchasing or carrying stocks registered on a national securities exchange * * *." Under section 221.3(q), any loan to such a lender—

* * * is a loan for the purpose of purchasing or carrying stocks so registered unless the loan and its purposes are effectively and unmistakably separated and disassociated from any financing or refinancing, for the borrower or others, of any purchasing or carrying of stocks so registered. Any loan to any such borrower, unless the loan is so separated and disassociated or is excepted by § 221.2, is a loan "subject to § 221.1" regardless of whether or not the loan is secured by any stock; and no bank shall make any such loan * * * without collateral or without the loan being secured as would be required by this Part if it were secured by any stock. * * *

The credit restrictions of section 7 of the Exchange Act and Regulations T and U depend generally on the nature of the collateral and the purpose of the loan; section 221.3(q) is the one instance in which the restrictions depend on the nature of the borrower. It requires a bank to determine in relation to each loan it makes whether the borrower is engaged in the business of making loans to purchase or carry listed securities. The determination must be made regardless of the nature of any collateral or the absence of collateral and regardless of the stated purpose of the loan. If the borrower falls within the quoted description (i.e., is a so-called "q lender"), the loan is subject to margin restrictions, whether or not it is secured by stock and whatever its stated purpose might be. The only exception is for a loan that can be "* * * effectively and unmistakably separated and disassociated from any financing or refinancing, for the borrower or others, of any purchasing or carrying of stocks so registered (listed) * * * ."

Section 221.3(q) appears to have had little effect on borrowing by unregulated lenders. None of the unregulated lenders interviewed referred to it as a deterrent to their obtaining loans. Of six banks interviewed five appeared to have little acquaintance with it. The sixth bank had on one occasion designated a lender a "q lender," and had attempted to assure that funds lent had been segregated. The rest thought that the section did not apply to any of their borrowers. They relied on their familiarity with a particular borrower and typically would say that "people of his type are just not 'q' lenders."

The attitude of these banks may be partly explainable by the fact that section 221.3(q) is not clear as to the standard on which a determination that a borrower is "* * * engaged principally, or as one of [his] important activities in the business of making loans * * *" is to be based. Security loans by one unregulated lender interviewed, for example, amounted to only 4 percent of its total loans, yet the absolute amount was $1 million. It was not considered by the bank from which it borrowed to be a "q lender." There have been no published interpretations in this area and it is perhaps not surprising that banks have not acted to any significant extent on their own.

Many bank officers questioned expressed the view that it was very difficult, as a practical matter effectively to separate and disassociate funds as the language of the section requires. In the first instance, however, it is incumbent upon the borrower to effect the allocation required by section 221.3(q) if the bank makes a determination that the borrower is subject to it.

The apparent lack of effectiveness of section 221.3(q) has been mitigated to some extent by "business" considerations. Three of the banks interviewed said that they have refused to make any loans to certain individuals known to be unregulated lenders because they consider unregulated lenders "undesirable." Banks which have adopted that policy have done so primarily because they have considered the borrower a poor risk. Another bank expressed the view that the spirit of Regulation U should be observed and that unregulated lenders should not be aided. In summary, however, section 221.3 (q) itself does not appear to have played an appreciable role in restricting bank loans to unregulated lenders except those that are well known and confine their activities to lending on securities.

e. Foreign loans

Loans from foreign sources are important sources of capital for large, active unregulated lenders. In a few instances unregulated lenders have direct lines of unsecured foreign credit,[80] but usually unregulated lenders rehypothecate their customers' securities with the foreign bank. In practice, the securities that are rehypothecated do not leave this country but are held in custody accounts with U.S. banks acting as agents of foreign banks. U.S. banks have also been active as intermediaries between their domestic customers and foreign lenders. The role of U.S. banks in relation to foreign credit varies from active, knowing participation to mere passive custodial and clerical activity.

A foreign-owned bank, located in New York City, registered under the New York banking laws, is an example of the former. Loans made with its own funds are subject to Regulation U. In addition to its own funds, however, the bank has on deposit in a custody account funds of a bank located in the West Indies. Several of the well-known unregulated lenders have obtained substantial lines of credit (up to $500,000) with the West Indian bank on the security of a "balanced portfolio of New York Stock Exchange securities." The credits were established by letters from the West Indian bank to the unregulated lenders. Copies of the initial letters went to the New York bank and thereafter the day-to-day contacts have been between the unregulated lenders and the bank. It receives securities from brokers on instructions from the unregulated lenders and checks to insure the authenticity of the certificates and to determine that the collateral in each of the accounts represents a balanced portfolio. The New York bank charges the West Indian bank from 1/4 to 1 percent per month of the amount of credits actually drawn (loans outstanding) as an "activity fee" and, in addition, charges the unregulated lenders a minimum fee of $5 for every "in-or-out" transaction (i.e., a receipt from or delivery to a broker). When the New York bank was interviewed it was

[80] One foreign bank coming to the attention of the study, for example, had outstanding about a dozen lines of credit to domestic borrowers for about $500,000 each. Five were for domestic unregulated lenders and the remainder were for individuals.

apparent that a program of checking margins in the loan accounts of the West Indian bank had been under way. The manager said that they checked margins and called unregulated lenders as a service to the West Indian bank, but that he could not accurately determine the amounts due because the unregulated lenders paid interest directly to the West Indian bank.[81]

The manager conceded that if the loans had been made with funds of the New York bank, they would violate Regulation U. Since the funds were those of the West Indian bank, however (the New York bank owned approximately 50 percent of the outstanding shares of the West Indian bank), the loans were not subject to Regulation U.

Minimal involvement is exemplified by a large New York bank. It carries, for instance, a custody account for a Swiss bank which is a source of foreign funds frequently used by unregulated lenders. The New York bank appeared to be unaware of the uses to which the funds in the account were put. One unregulated lender, for example, had arranged a loan directly with the Swiss bank. When the unregulated lender wished to rehypothecate securities, it would cable the Swiss bank a description of them and the bank, in turn, would cable instructions to the New York bank to receive the securities from specified brokers and make payment from the Swiss bank's account. The New York bank charges only an activity fee of $1.50 per transaction and offers no additional services to custodial accounts. It would not undertake to exercise discretion, and has never been asked to check margins. The New York bank assumes that all securities held in a custodial account are owned by the account. It did not think it should be expected to "police" such accounts.

With the exception of Stomar Corp., Ltd., in Detroit, which kept securities in a bank in Windsor, all of the interviewed lenders obtaining funds from foreign banks use a U.S. agency of some type. Modern communications may ordinarily make as active an agent as the foreign-owned New York bank described above unnecessary, but for a business of any appreciable volume the certificates must be readily available and at least a local depository appears requisite.

Banks, unlike brokers, are not prohibited by the credit regulations from arranging loans on terms different from those they themselves can offer and there is evidence that U.S. banks do in fact arrange loans with foreign banks for their domestic customers. One bank reported the case of an officer of a corporation who wished to exercise a large stock option and pledge the option shares as collateral for a loan of the needed funds. Under Regulation U the loan would have been a "purpose" loan. To avoid the regulation, the bank put the officer in touch with a foreign bank and helped him to arrange the loan there. The officer delivered the shares to the New York bank; the stock was placed in a custody account maintained with the New York bank by the foreign bank; and funds were disbursed to the officer from the custody account. As an integral part of the transaction, the New York bank then lent money to the foreign bank and the foreign bank used the option stock in its custody account as collateral. The stock was transferred to it by mere bookkeeping entries. Obviously, the effect of the arrangement was a use of the funds of the New York

---

[81] Unregulated lenders were able to borrow about 60 percent of the market value of the collateral and paid interest at the rate of about 9 percent per year.

bank to make a purpose loan and avoid Regulation U. Similar arrangements have been reported by unregulated lenders.

f. Extent and effect of unregulated lenders

(1) *Volume of unregulated lending*

It is extremely difficult to determine the aggregate amount of unregulated lending. Although most of the large unregulated lenders that deal with the general public are thought to be known, there was no attempt to find all those who were currently active. There is evidence of numerous unregulated lenders that operate quietly with a relatively small number of customers. Some of the latter are reported to have a large dollar volume of loans outstanding. The volume of direct borrowing by individuals from foreign sources is also thought to be large; specific data, however, are unavailable.

All of the lenders interviewed, except those that had been recently organized, reported that the volume of their loans was considerably greater, by two or three times, during 1961 than in March 1962, when they were interviewed. The amounts of loans and clearances outstanding at various times during 1961 for the 58 unregulated lenders for which some information is available aggregated over $62 million.[82] Nine lenders reported maximum outstanding loans at any one time of less than $100,000. Ten others reported maximum loans outstanding at one time of over $1 million. Five of the lenders reported maximum loans and clearances outstanding at one time during 1961 of about $5 million each, and two of these reported outstanding loans and clearances of about $10 million each. All of the figures refer to purpose or clearance loans on securities.

It should be remembered that loans made by unregulated lenders generally remain outstanding for little more than a month. There is, therefore, a rapid turnover of the money being lent. One lender, who had $2.5 million outstanding in June 1961, reported over $25 million in loans during the year. Another, who lent to Jack R. Dick (see below), was reported to have lent over $9 million in 2½ months although his total loans outstanding at any one time were never more than $800,000.

Of the aggregate amount of $62 million in loans outstanding at various times reported by the unregulated lenders, about $14 million was in clearance loans; turnover of such loans, which are outstanding for only 1 to 4 days, is very rapid. If reliable estimates of relative significance of banks' and brokers' loans on the one hand, and unregulated lenders' on the other, are to be made, data as to turnover rates are needed. It has not been possible to assemble this information.

The volume of loans and clearances declined in early 1962 primarily because of the downward turn of the market. An active bull market and relatively high margin requirements are needed to support the high interest charged by most unregulated lenders.

(2) *Effect on the market*

(a) *Increases in price fluctuation—market break.*—The dollar amount of unregulated lending appears to be substantial. Although its volume is small in relation to that of all security credit, its effects may be far greater than either level would indicate. The general prob-

[82] In a few instances the last available figure was that reported in 1960; if it was known that the lender was still active in 1961 an estimate was used.