MEMORANDUM

May 21, 1941

To: The Commission

From: Ganson Purcell
       Walter C. Louchheim
       Edwin A. Sheridan

Introduction

At the request of the Commission, we have made a detailed review of Mr. Neff’s report on “The Trading in American Securities on the British Market.” We have also spent several days in going over this report point by point with Mr. Neff, making suggestions and raising questions.

Having concluded this study and these conferences, it has become apparent that there are so many disturbing questions and such a large area of basic disagreement that we have felt the advisability of preparing the following report for the Commission. The revisions made by Mr. Neff do not solve the major difficulties which we have encountered.

General Observations

It is our impression, from discussions with the Commission, that its purpose in publishing the report would be primarily to demonstrate that the London Stock Exchange was more extensively regulated than our securities markets, to refute Mr. Yandell’s conclusions and indicate the advantages of the London jobber system over the New York specialist system. We do not find that these points are made in Mr. Neff’s report. We recognize the difficulties under which Mr. Neff operated, being very much the same as those of others who have attempted to obtain information on the British markets. We also appreciate that if Mr. Neff had been able to complete his assignment he may have been able to break down some of the barriers to accurate
information. In view of the circumstances of his visit and the nature of the subject he was, however, limited in the following respects.

1. An almost complete inability to obtain not only statistical data but also actual and accurate information upon such essential features of securities transactions as the volume, the price, the course of prices, the amount of credit involved and similar matters.

Mr. Neff admits that in describing in detail securities transactions in the London markets he has been unable to obtain accurate information on any of the above and other related matters and has had perforce to rely solely upon the opinions of persons engaged in the business for his knowledge of it. This limitation was also recognized in the report submitted by Mr. Lunsford P. Yandell, “Report on Foreign Dealings In American Securities,” and no doubt was given consideration in the Commission’s decision not to publish this report. The risk of relying on personal interviews with presumably well informed persons is one which is apparent to the Commission every day. In addition to such interested opinion Mr. Neff has placed reliance upon the usual books and published material descriptive of the workings of the London financial community and selected periodical and news items of English financial editors and correspondents. Much of this source material has been cited by Mr. Yandell and by most others who have previously written on the subject.

2. Not only is there no factual information on the subject of the London securities markets but there is also a complete lack of statistical data. This lack contrasts sharply with the substantial amount of such data to which we are accustomed relative to our own securities markets. As Mr. Neff points out, the lack of data relates not only to the details of trading but also to important factors involving publicly held corporations, the securities of which are listed upon the London Stock Exchange. This contrast with our own registered securities markets seems to cast doubt upon many of the comparisons which Mr. Neff makes between the London and our own organized exchanges and will be adverted to subsequently.

3. Another admitted limitation of the report is the fact that it is dated. All of the descriptions of the London securities market and its connection with other continental
markets such as Amsterdam and Paris as well as the exposition of its connection with our markets through the arbitrage mechanism are matters which have completely altered or ceased since Mr. Neff’s visit to England. In addition the connection of our domestic markets has so changed in the past few years that Mr. Neff’s discussion of the eras of stock exchange speculation of the 1920’s and even 1933 and 1937 (upon which much of his comparative discussion depends) is no longer predicable of our securities markets. This dated characteristic of Mr. Neff’s descriptions may not readily be remedied by altering the tense of the report for the reason that so much of his inferences and conclusions depend upon a condition which has no reality except as history. Indeed a current study of the same factors would lead to quite contrary results.

Comparison of London and New York Stock Exchanges.

Part I of the report is a description of the British market and a comparison of the London Stock Exchange and the New York Stock Exchange. Questions relating specifically to the description of the British market will be passed over although there are some doubts as to the accuracy of the opinions expressed and to the completeness and justice of the description itself. There is, however, graver doubt as to the fitness of comparing the London Stock Exchange and the New York Stock Exchange. The first part of the report is replete with such description. The results of the comparison moreover are used as a basis for contrasting the English securities markets with our entire market system although no effort has been made to draw comparisons with any other of our national securities exchanges or with our important over-the-counter markets. The doubt with respect to the fitness of the comparison between the London and New York Stock Exchanges arises largely because these organizations are not the same kind of entities. The London Stock Exchange is characterized by Mr. Neff as a locus for jobbers to transact business and to make contacts with brokers acting for customers. There is no dealing between brokers, there is no auction market, there is no price disclosure; indeed the London Stock Exchange has been on this account previously described as an over-the-counter market
with a roof on it. A comparison of London with our own over-the-counter markets might be more logical and fruitful than its comparison with the New York Stock Exchange. Mr. Neff’s failure throughout the report to relate London and our over-the-counter markets and to draw conclusions from such a comparison rather than from that with the New York Exchange is a serious omission. In addition, in some respects it would have been appropriate to make the comparison between the London Stock market and some of our regional exchanges. Should Mr. Neff do this, however, he would not be able to make the same sharp distinctions, for example, with respect to the investment character of London in contrast to our speculative market features. Surely the dealers in the over-the-counter markets would demur at a description of their transaction as predominantly speculative. Representatives of the San Francisco Stock Exchange have from time to time claimed that the markets on that Exchange were almost exclusively made up of investment transactions. These claims have not been challenged. The limitation of the comparison to the New York Stock Exchange, therefore, results in such distortions of the complete picture.

**Regulation in London versus New York.**

The contention that London is more regulated than New York is not borne out in this report. Mr. Neff has an apparently irresistable tendency when comparing the New York and London stock exchanges to criticize the former and congratulate the latter. This tendency is particularly noticeable in the use made of the rules and regulations of the respective exchanges. This feature of the report is important in the discussions of the relative merits of Government and self-regulation of exchanges and in appraising the features of each system.

In some cases this over-emphasis appears to be due to an unfamiliarity with the rules and practices of the New York Stock Exchange and at other times it appears to be purposely meant to prove the fundamental superiority of the English organization. Although Mr. Neff cites various rules and regulations of the London Stock Exchange, he does not indicate the degree of the enforcement of these rules. It is apparent that he did not interview the officials of
the London Stock Exchange on this subject and he admits that he did not do so. We submit that
the more existence of a rule or regulation is not evidence of its significance.

Though there are certain rules for the conduct of business applicable to members
of the London Exchange it is a fact not mentioned by Mr. Neff that there is practically no
supervision of the members or their firms and likewise no enforcement of these rules. The
Committee which is the governing body of the Exchange has no staff, no auditors or
investigators of any kind. No attempt is made to examine the financial standing of firms, the
conduct of their business, their relations with customers and employees or their conformity with
Exchange regulations. This fact must be set against the present situation with respect to our own
exchanges, many of which in addition to such supervision as the Commission exercises, maintain
a staff for the purpose of enforcing rules of the Exchange and of the Commission. It is submitted
that no amount of rules on the books of an organization should be taken to indicate a regulation
of its members if, in fact, such rules are not enforced.

Mr. Neff repeatedly calls attention to Rule 82 of the London Stock Exchange.
This Rule requires that members of the Exchange obtain the written consent of an employer in
order to transact speculative business for an employee. Mr. Neff has interpreted this Rule to
apply to all employees including corporate officers and in support of his interpretation has
quoted a half facetious article of the London Economist. Whether or not this interpretation is
justified the efficacy of such a Rule would seem to depend upon the adherence of the members
of the Exchange to its requirements. Some members may apply its terms strictly, others may
wish to take advantage of the ambiguity of such terms as “speculative business.” But over all
there is no authority enforcing the rule. It is important to notice this fact in view of the
importance which Mr. Neff places upon the rule, indeed it is quoted by him as being one of the
more important proofs that the English are less speculative markets than the American. On the
other hand, since no interpretation of the rule was given to Mr. Neff we believe that it might be
fairer to assume that each member interprets it as he wishes and for his own protection against
undesirable credit risks, and that it is only incidentally a public protection.
In contrast to this situation Mr. Neff has omitted to describe Rules 505 and 506 of the New York Stock Exchange. These Rules require that a partner of every member firm shall be thoroughly familiar with the facts relative to a new customer and shall personally authorize the opening of new accounts in writing. This Rule is enforced by means of periodic visits of the auditors of the Exchange as well as by the inspections made from time to time by investigators of the Commission. The Commission has recently been advised of a fine and censure levied against a member firm by the New York Stock Exchange in part due to a partner’s approving the opening of accounts without having learnt the essential facts about them and for his poor judgment in so doing.

Mr. Neff, in drawing his contrast between regulation of the London Exchange compared with that of the New York Stock Exchange gives distinctly inadequate emphasis to the comparison between “half commission men” and “customers men.” Mr. Neff emphasizes the absence of branch offices and other influences which might increase speculation in London and he mentions the half commission men in various contexts but he does not, it seems to us, give sufficient weight to their importance as inducers of speculation in the London market. It seems to me that more than mere mention should be given to the fact that except for the general commission rules of the London Stock Exchange these business getters are totally free from regulation and even from responsibility to the customer or to the broker. We need only to advert to the strict regulations surrounding the practice of customers men on the New York Stock Exchange and the other American exchanges and to the fact that at least an effort is made here to reduce speculation by the requirement that customers men must be paid on a salary basis rather than a commission basis to remove the incentive for excessive trading on customers’ securities.

In addition, it should be noted that the London Stock Exchange has no rules prohibiting or limiting short selling, nor any rules prohibiting or limiting manipulation or stabilizing. Furthermore, listed corporations in London are subject to no disclosure requirements, and the finance companies, which according to Mr. Neff make the markets in many securities, are subject to no regulation or supervision. In fact, Mr. Neff makes a point of
the fact that corporate figures are not available to investors generally and that several British
sources have admitted that frequently such corporate figures as are made public are purposely
“arranged” so as to produce a particular artificial impression in the market. For some reason,
which we fail to understand, he feels, nonetheless, that the listing requirements in London are
stricter than they are in New York. We can not believe that the examination and analysis given
by interested dealers for listing requirements in the London market can be as thorough, as
critical, or as impartial as the scrutiny given by the Securities and Exchange Commission here.

The “Jobber” System.

We are in complete and fundamental disagreement with Mr. Neff over his
comparison of the London Stock Exchange with the New York Stock Exchange. This
disagreement arises partly from the fact that the London Stock Exchange is the British market
while, the New York Stock Exchange is by no means the American market.

In describing the jobber system Mr. Neff has clearly brought out that it could only
function in a situation in which there was no disclosure of prices and where transactions might
take place simultaneously at different levels. As the system is described it more and more
resembles our own over-the-counter markets, merely substituting the dealer for the jobber. The
London jobber operates in secrecy exactly as our over-the-counter dealer now operates. The
jobber turn is the correlative of our dealer spread. The jobber system is naturally subject to the
same criticism as our over-the-counter markets such as its dependence upon private or concealed
transactions, the opportunity to profit unconsiously and the heavy cost to the public. The
merits or demerits of the jobber system are not clearly contrasted with the auction system in
which prices are made by public bids and offers and the prices at which transactions are effected
are promptly published on the tape and thereafter in the newspaper. Mr. Neff tends to deprecate
the value of the publication of prices and leaves the feeling that the tape is primarily an organ of
manipulation and speculation. We feel that price disclosure is valuable particularly since
through the Commission’s effort manipulation has been minimized.
The staff of the Commission has grown increasingly respectful of the safe-guards to the public which result from price disclosures on the tape and in the press and we are hopeful that similar information will soon be made available to the public as to the over-the-counter market. Price disclosure, the staff feels, is particularly valuable for its aid to the Commission in the elimination of manipulation. We question the advisability of the publication under the Commission’s auspices of a report which seems to indicate the contrary. We also question whether the Commission would want to appear to be putting forth an argument in behalf of segregation for which the cost would be a forfeiture of the present price and volume disclosures of the American exchanges. In short, we believe that the jobber system is both a weak and a dangerous argument for segregation and that the superficial comparison of segregation on the London Stock Exchange and lack of segregation on the New York Stock Exchange does not stand close examination.

Another aspect of Mr. Neff’s treatment of the jobber system is its contrast with the specialist system. In contrasting these two dealer systems Mr. Neff points out that the jobber is practically unregulated in the transaction of his business either by rules of the Exchange or by any other authority. The specialist, on the other hand, he shows to be subject to credit restrictions, short selling rules and various self-imposed limitations of exchange committees. It is to be questioned whether an uncontrolled dealer such as the London jobber would meet with the requirements of the Securities & Exchange Act or with standards which the Commission has imposed upon the exchanges. It is also questioned whether the jobber as described by Mr. Neff can be considered as a conducive argument in favor of the segregation of the broker-dealer functions. Mr. Neff quotes a respectable body of opinion in England to the effect that the jobber system has broken down should be supplanted by another. Again it is questionable whether there would be any advantage to the American public in the segregation of the broker dealer function at the expense of price disclosure. The jobber system and the private nature of transactions, however, are integral parts of the system according to Mr. Neff.
The Effect of American Regulation.

Throughout the report there are frequent references to the affect of government regulation of securities markets. This thought is developed at some length in conjunction with the comparison of the New York Stock market and London with respect to the relative stability of each. It is apparent from a comparison of the statistical averages that the London market is the more stable over a given period of time. This fact has frequently been adduced in the past five years by critics of the Commission as evidence of the undesirable effects of the regulation of securities markets. Mr. Neff’s discussion would give solace to those who claim that American laws (particularly the Securities Acts and the Capital Gains Tax) have driven trading in American securities abroad. There is, however, the same lack of factual support for the contention in Mr. Neff’s report as in those of previous writers, the relative effect of our regulations is a question upon which as yet there has been no satisfactory discussion.

Another aspect of regulation which Mr. Neff develops is the possibilities of evasion which the London market facilities may have afforded. Although Mr. Neff admits that there is no reliable information on the amount of dealings which may evade our Securities Acts he reaches the conclusion that it has at times been very substantial. He relies upon the opinions of persons with whom he discussed the subject and states that not only the Securities Act but also the anti-manipulative provisions of the Securities Exchange Act, the Commission’s short selling rules, Section 16(b) and other regulations have been evaded. In these sections of the report and in those portions relating to the effects of security regulation upon market liquidity Mr. Neff closely parallels the findings of Mr. Yandell. Neither commentator, however, has brought forward any evidence other than hearsay.

For example, in describing the evasion of the Securities Act, Mr. Neff has stated that on occasions distribution in England was accompanied by manipulation on the New York market from London. He has, however, not given a single instance either of an evasion of the Securities Act or of a manipulation. His estimate of the amount of short selling to evade the Commission rules is equally unsupported by factual data. As to manipulation from England he
merely brings out the fact that such an operation could be done. In citing possible evasion of Sections 16(a) and (b) he does not admit that transactions effected in London by an American would be equally under the provisions as though they were effected in a domestic market.

The London Trading in American Securities.

From a reading of Mr. Neff’s report, we concluded that the “American market” on the London Stock Exchange is the gambling casino of that Exchange. We also conclude that by working through the London Exchange, market operators may achieve the precise effects on listed New York stocks in New York that the Securities Exchange Act seeks to outlaw. They can manipulate securities on the New York Exchange, they can effect “bear” raids, and corporate insiders can evade our Section 16 requirements. They can also avoid registration under the Securities Act by phony private placements in London which are subsequently distributed in America through the inter-connections of the two exchanges.

Though Mr. Neff, again running up against the impenetrable wall of secrecy which prevails in London, cannot cite cases or give accurate volume figures, the unquestioned conclusion of his report is that not only can these things be done, but they are done frequently. We regret that it is impossible to prove the extent to which these devices have been employed. We feel, however, that, if Mr. Neff is correct, the Commission has a grave responsibility to do what it can to correct this situation.

Mr. Neff concludes that the nexus of the two markets is international arbitrage. He indicates that the situation can only be corrected if arbitrage between the London market and New York is much more stringently controlled, either by a mutual understanding between the Securities and Exchange Commission and the London authorities or by repeal of our arbitrage exemptions.

In this connection it should be noted that he apparently ignores the conclusions reached in the report prepared for the Commission by Mr. Michael G. Appel in August of 1938. The Commission employed Mr. Appel to make this report so that it might have a basis on which
to act in connection with its arbitrage exemptions and it was largely on the basis of Mr. Appel’s findings that the Commission decided to exempt pure arbitrage from the short selling rules. The investigation upon which this report was based was very carefully compared in conjunction with the reports of the staff of the Trading & Exchange Division and depended upon factual material provided by the principal arbitrage firms. One of Mr. Appel’s contentions was that while international arbitrage was a link between London and New York, its elimination would not materially effect the connection between the two markets. He went so far in his report as to point out how manipulation and evasion of our regulations could be accomplished directly from London without the intervention of arbitrage. We point to the existence of many correspondents and branch offices of New York firms abroad having direct cable connections with their New York principals and we submit that if there has been evasion of our laws, it is an open question whether such transactions have been effected preponderantly through arbitrage accounts or by the direct placing of orders on our markets by cable. Mr. Neff states he believes that cable is more expensive than arbitrage, but we can find no way of directly comparing the cost and we are not convinced that this is true. We are, further, not convinced that if arbitrage were eliminated, persons whose purpose was to evade our laws might not be willing to pay a higher charge for cables even if that method is more expensive.

We also find that in Mr. Neff’s treatment the effect of arbitrage is grossly exaggerated by adding to it the volume of all dealings in American stocks on the London Stock Exchange of which only the balance is transmitted to our markets. This is a statistical device which we feel is quite unwarranted. At present, however, it is apparent that arbitrage is a matter of history and it is improbable, considering the sale of American securities by the British and their financial strain, that the operation could become of importance for many years to come, if ever again. Thus, a published recommendation that arbitrage between London and New York be controlled by the Commission could, at this time, be merely a gratuitous irritant to the already harassed English financial community.
Conclusions

We conclude that Mr. Neff’s report should not be published in its present form:

(1) Because so much of it was necessarily based on hearsay.

(2) Because we believe that the comparison of the London Stock Exchange and the New York Stock Exchange is invalid.

(3) Because it adds little, if anything, to the already published and unpublished material on the subject, including the Yandell report.

(4) Because by implication it casts distinctly challengeable reflections upon the New York Stock Exchange and the American market.

(5) Because it gives unjustifiable ammunition to those who contend that American statutes have driven American securities trading abroad.

Recommendations

We recommend that, if consideration is to be given for publication of a report by Mr. Neff, he rewrite it to eliminate the above objections.

We suggest that the first part of the report, comprising over half the volume, be boiled down to one relatively short preparatory chapter for background purposes giving a brief description of the London market for British securities. Comparison with any phase of the American market should be left to the reader because it is almost impossible for an author to make comparisons without making inferential conclusions.

We propose that the bulk of the report should be devoted to British trading in American securities either on London or by use of arbitrage and cable on New York and the relationship between the two markets. This discussion should be largely a discussion of the mechanical interconnections and interrelationships. It might also include a discussion of the possibilities of this relationship.

(EASheridan)WCLouchheim,Jr:mmc