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THE STOCK MARKET

Completely Revised and Enlarged in Collaboration with
G. L. AMRHEIN, PH.D., and C. A. KLINE, PH.D.

BY

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PRINTED IN U. S. A.

TO

THE MEMORY OF

MY MOTHER

PREFACE

This text book represents a complete revision, as well as a substantial enlargement, of its predecessor, published in 1922. The events of the past twelve years, and particularly during recent years, have produced a tremendous change in the administrative methods of our organized security exchanges, as well as in the nature and scope of the security market. The revision of this volume had, therefore, to be correspondingly extensive.

The purpose and general arrangement of this volume are similar to those described in the preface to its predecessor. It aims to present in a comprehensive and non-technical manner the numerous services of the organized stock market to the individual investor and to financial and other business enterprises. It also aims to bring together in compact and classified form those facts, principles and practices of the business which enable the student and layman to have a clear understanding of the nature of our organized security markets and the legitimate ways in which they may and should be employed.

To the uninformed, a stock exchange is little more than the spectacular scene that is witnessed from its gallery. This phase, however, by no means represents the real soul of the institution. From our exchanges there radiate numerous, far-reaching influences in the form of enforced regulations, and standardized practices and services, which not only influence vitally every angle of the stock and bond business throughout the nation, but which in their results, as has been well said, "are as broad as the business interests of the country, affect in their most important business relations all the people thereof, and make our exchanges an integral and inseparable part of the national financial system." The purpose of this volume is to present

these regulations, practices and services in their true setting, with a view to the clearing away of much of the misunderstanding that now exists. It should also be added that with respect to all important phases of the subject, this volume calls attention to the fundamental changes and requirements prescribed by the recent Securities Exchange Act of the Federal Government.

The twenty-five chapters of the text are grouped into four distinct parts, dealing respectively with the "Services of Organized Security Markets," "The Organization and Operation of the Market," "Factors Affecting Security Prices," and "Legal Principles and Usages Governing the Stock Exchange Business." The first of these four parts of the volume is devoted to a discussion of the services rendered by organized stock markets to the business community, a subject much misunderstood by the general public. Separate chapters are devoted to the "Nature and Scope of the Market," "Nature and Value of a Continuous Market," "The Discounting Function of the Market," "The Functions of Short Selling," "The Regulation of Brokerage Transactions and the Conduct of Brokers," "The Nature and Functions of Options," and "Arbitraging and Its Services."

Part II of the volume deals with the scientific phases of organization and operation. Under this heading the several chapters present the essential considerations connected with the legal status and organization of exchanges; the listing of securities; types of dealers and brokers and their work; types of offers and orders; the technique of short selling; the quotation service; stock exchange clearing house operations; the transfer of securities; the conversion of securities; and the nature and marketing of "rights."

Part III of the volume relates to a discussion of the fundamental factors which govern prices of securities. The chapters relate respectively to "The Money Market in Its Relation to Security Prices," "Financial Crises and Business Depressions,"

"Factors Influencing the General Level of Prices over Considerable Periods of Time," and "Manipulation."

The last part of the volume is devoted to an analysis of those legal principles and usages governing the stock and bond market with which all who deal with brokers are most apt to come into contact and with which they should be acquainted. Separate chapters are devoted to a discussion of the "Principles and Usages Pertaining to the Execution of Orders," "The Legal Nature of a Speculative Purchase," "Legal Principles Pertaining to the Repledging of Stock," "Extent to Which Customers' Margins and Securities Are Protected," and "Identification of Securities."

In the preceding volume special acknowledgment was made to my departmental colleagues, Professor Robert Riegel and Professor H. J. Loman, for their generous assistance. In so far as this volume remains the same as its predecessor, this acknowledgment is again extended. With respect to the present volume, the author wishes to acknowledge his obligation to the many persons who assisted in explaining practices and in the furnishing of other information. But special acknowledgment is due to my departmental colleagues Dr. George L. Amrhein and Dr. Chester A. Kline. Dr. Amrhein revised and re-wrote chapters 13, 14, 22, 23, 24 and 25; while Dr. Kline undertook the revision and rewriting of chapters 6, 7, 11, 15, 16 and 18. Both also read the entire manuscript and gave generously the benefit of their criticism.

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PART I

SERVICES OF ORGANIZED SECURITY MARKETS

CHAPTER I

NATURE AND SCOPE OF THE STOCK MARKET

Stocks and Bonds Contrasted.—With the development of large-scale production and transportation and other services it was only natural that there should be a transition from the system of individual ownership or private partnership to that of corporate organization, depending for its financial existence and support on the sale of stocks and bonds. The several types of markets in which such sales are conducted constitute, collectively speaking, the so-called "stock and bond market."

The modern corporation has made it possible to combine the small savings of the millions into huge sums for the creation of mammoth enterprises, capable of performing services entirely beyond the reach of an individual. Where the funds have merely been lent to the corporation, the owner is given a certificate, a so-called bond,[1] to indicate that he is a creditor. Where, however, the funds have been invested permanently in the corporation, with a view to the individual's participation as part owner of the enterprise in its success or failure, the investor is given a receipt, a so-called stock certificate,[2] to indicate the extent of his ownership. Few facts deserve to be impressed more upon the investing public than this fundamental distinction between bonds and stocks. Stocks are inherently speculative in character. Bonds are credit instruments and, with few exceptions, give a definite promise as to the payment of interest and the return of the principal, although in many

[1] For a sample form of bond certificate see Appendix IV.

[2] For a sample form of common stock certificate see Appendix II, and of a preferred stock certificate see Appendix III. For a classification and description of stock certificates see Appendix I.

instances the promise turns out to be impossible of fulfillment. Stock certificates, on the contrary, promise nothing at all financially. They merely constitute an evidence of ownership, a certification of the holder's privilege to share in risk, that is, to participate in the varying fortunes of the business enterprise.

National Wealth Represented by Securities.—Available figures, although necessarily only approximate, clearly indicate the great importance of stocks and bonds in our financial life. Estimates of the national wealth will vary greatly, of course, depending upon the stage of the industrial cycle in which the nation might happen to be at a given time. Thus in the prosperous year of 1929, the national wealth was roughly placed at $400,000,000,000. At the beginning of that year the total market value of shares of stock listed on the New York Stock Exchange stood at approximately $67,500,000,000, while the market value of bonds listed on this Exchange amounted to nearly $47,500,000,000, or a combined total of $114,000,000,000. At the peak of this year (September, 1929) the market value of these stocks and bonds totaled respectively, $90,000,000,000 and $47,000,000,000, or a combined total of $137,000,000,000. In other words, on this one major exchange alone, the market value of its listed stocks and bonds amounted to about 30 per cent of the aforementioned national wealth of four hundred billions. On the other hand, at the bottom of the 1930–34 depression (July, 1932), the market value of the shares and bonds listed on the New York Stock Exchange stood at $16,000,000,000 and $37,500,000,000, or a combined total of $53,000,000,000, or less than half the figure prevailing in 1929. But in this connection it may be assumed safely that the dollar value of the nation's total wealth experienced an approximately equal decline.

To the aforementioned total, however, there must be added (1) the large volume of stocks and bonds listed on the New York Curb Market, the second largest American security mar-

ket, (2) the stocks and bonds listed on some twenty-four other local American exchange markets located in Baltimore, Boston, Chicago, Cincinnati, Cleveland, Colorado Springs, Columbus, Detroit, Hartford, Indianapolis, Los Angeles, Louisville, New Orleans, Philadelphia, Pittsburgh, Providence, Richmond, Salt Lake City, San Francisco, St. Louis, Seattle, Spokane, Washington and Wheeling, (3) the vast mass of unlisted bonds issued by our states, cities, and other political divisions, (4) the billions of unlisted real estate bonds which have been issued during the past decade, and (5) the stocks and bonds of several hundred thousand minor corporations, too small to have their securities listed upon some exchange, it being estimated that only about 2,000 corporations out of some 500,000 are large enough to avail themselves of the listing privilege. Combining all of the aforementioned groups it would seem reasonable to conclude that stock and bond certificates represent over half of the nation's wealth.

Exclusive of the numerous holders of Government bonds, there are probably 15,000,000 persons who are shareholders and bondholders in American corporations. "Corporations are no longer owned by a few rich men and rich families, but by the small shareholder, the small investor . . . by a multitude of small, or odd-lot, holders of securities." [3] This is especially true because of the policy of many important corporations, pursued energetically during the years 1922–29, and by many even earlier, to have their employees become interested as owners of the shares of their employer corporations through the systematic application of installment plans of purchase. In other instances a wide distribution of stock was effected through the medium of salesmen.

Indicative of the wide distribution of shares, it may be pointed out that six large corporations announced in 1931 a total of 2,203,000 shareholders, namely, the American Tele-

[3] Testimony of William C. Van Antwerp before the Committee on Banking and Currency. *Hearings on S. 3895,* p. 117.

phone and Telegraph Company, with a total of 645,000, the Cities Service Company with 602,000, General Motors 313,000, United States Steel Corporation 247,000, Pennsylvania Railroad Company 246,000, and General Electric with 150,000. In 1932 the Standard Statistics Company returns [4] for 94 major reporting companies showed a total of 6,724,000 stockholders, compared with only 4,760,000 at the end of 1929, an increase of 41.2 per cent. Another publication [5] reported 25 corporations, each of which had more than 100,000 shareholders and a combined total of 4,570,000. According to this particular list 132 corporations have each in excess of 10,000 shareholders, while 102 of the companies were reported as having a total of 7,675,143 stockholders. Thirty-three public utilities were mentioned as having more than 10,000 shareholders each, ten with more than 100,000 each, and one (Associated Gas and Electric Company) with 207,448. Seven railroads were listed which had more than 50,000 shareholders each, and three whose stockholders numbered more than 100,000 each.

The foregoing data with respect to the distribution of American securities become all the more important when it is remembered that the number of stockholders does not represent individual holders in all cases, but often includes corporations and depository institutions. One railway company may be the holder of a portion of the stock of another railway corporation, and may itself represent many stockholders; or large blocks of securities may be owned or held by trust companies, brokerage offices, life, fire and casualty insurance companies, investment trusts, savings banks, and other investment companies which in turn represent the investments or deposits of an enormous number of persons, the great majority belonging to the poorer classes. How far this process of subdivision must be carried in order to determine accurately the extent to which the population of the country is involved in the ownership of

[4] Reported by *The Business Week*, April 9, 1932.
[5] *Forbes Magazine*, May 1, 1932.

its corporate securities is difficult to judge. Suffice it to say that enormous blocks of securities are held in this way and that this indirect form of investment is constantly increasing.

Until the outbreak of the World War, there was also a remarkable tendency for investors of foreign countries, especially European, to enter our security market in addition to their own. At that time, for example, 13 per cent of the stockholders of the Pennsylvania Railroad, and 18 per cent of the United States Steel Corporation, were residents in foreign countries, and these were by no means isolated cases. Estimates made at the time placed foreign investments in American securities at from $5,000,000,000 to $6,000,000,000. Because of the World War, and financial conditions abroad, many of these investments returned to the United States. In 1932, for example, the foreign holdings of the common and preferred stock of the United States Steel Corporation stood, respectively, at 3.42 and 2.18 per cent. The return of more normal conditions, will likely again bring a large participation of foreigners into the ownership of American securities. On the other hand American participation in the ownership of foreign securities, or the securities of American companies operating abroad, has shown a very notable increase during the past decade. As of January 1, 1934, the shares of the United States companies operating abroad and listed on the New York Stock Exchange aggregated 33,637,775 shares with a market value of $627,690,796, while the shares of foreign companies listed on this Exchange represented another 37,328,355 shares with a market value of $707,129,233. On the same date, the bonds of United States companies operating abroad and listed on the New York Exchange had a par value of $413,429,500, the bonds of Asiatic and Australasian companies (listed in New York) $212,269,339, of European companies $823,139,100, of North American and West Indian companies $1,111,197,600, and of South and Central American companies $88,613,500. In addition to the foregoing, 104 issues of Foreign Government bonds are listed

on the New York Stock Exchange with a combined par value of $5,778,687,306. As has been said, the security market is "undergoing the same internationalizing as commerce."

Types of Markets.—The term, "the stock market," is very comprehensive and may be regarded in the United States as embracing the purchase and sale of stock certificates and other corporate securities (1) by salesmen, advertisement, or "over the counter" offices; (2) at street markets, commonly designated as "curb markets"; (3) at public auctions; and (4) on stock exchanges, which operate under strict and comparatively uniform rules. Of these several types of markets the last is by far the most important.

"Over-the-Counter" Transactions.—While the sale of bonds and stocks by direct solicitation, i.e., through salesmen, advertisements in the press, office circulars, and other similar methods, represents a large and important branch of dealings in securities, this method is confined mainly to the original distribution of issues and is used only to a limited degree thereafter with respect to high-class and well-known stocks. Investment houses pursue this method in distributing the stocks of numerous comparatively small corporations whose issues are not listed on any regular exchange, and, following the original distribution, undertake to create an over-the-counter market for their clientele. Within the last ten years numerous promoters of oil, mining, motor, and other highly speculative promotions have distributed an enormous volume of securities to the American public through actual canvass by salesmen or through advertising. Unrestricted by any of the disciplinary rules enforced by our regular exchanges and unhampered in many states by adequate supervisory legislation, the operations of many of these promoters reached scandalous proportions. Too often the unknowing confuse this phase of the stock market with the infinitely more legitimate practices of the organized exchange markets or of high-grade investment houses,

with the result that these are constantly obliged to encounter a great deal of unmerited criticism.

Curb Markets.—Curb markets obtain their name from the fact that the brokers connected therewith conduct their operations in the open street, instead of being housed in a building. While various cities have such markets, usually of a very limited character, the leading market by far of this kind in the United States is the New York Curb Market, which has been in existence for over fifty years, and which affords a market place for such securities as meet the more limited listing requirements of this particular market and, at the same time, are not listed on the New York Stock Exchange.[6] The importance of this market may be judged from the fact that security issues of 1,552 different corporations, some of them of great importance, are admitted to trading thereon. Eleven hundred and seventeen of these corporations have listed on this market some 783,582,441 shares, with a par value of $5,661,151,748, as well as millions of more shares without a par value. The shares of some forty-nine foreign companies, numbering over 345,000,000 are also listed on this market. Some 639 bond issues, in some instances of very considerable size, are also dealt in on the Curb. In the amount of business transacted in the United States the New York Curb is second only to the New York Stock Exchange, and is the second largest organized market in the Western Hemisphere.

There is a real need for this type of market. The New York Curb Market is essentially one for mining, oil, and industrial securities, which either cannot, or will not, comply with the stricter listing requirements of the regular exchanges. As has been stated, this market is "the great crucible in which are

[6] In 1921 the New York Curb Market was moved to a building, and strictly speaking, should now be referred to as an Exchange. The daily press, however, continues to refer to this market, owing to its distinctive character, as the New York Curb Market.

tested the thousand-and-one hasty stock flotations of each new era of expansion in the country." It also affords an opportunity for dealing in securities prior to their being listed on a regular exchange or even before they are issued. In the latter case the contracts go under the name of "when, as, and if issued" contracts, such contracts becoming due and payable the day after the final payment on them has been made under the terms of the corporation's circular.

Many stock-exchange houses have regular representatives on the curb, and probably 85 per cent of the orders executed on the New York Curb Market come from stock-exchange houses. The close relationship between the New York Curb Market and the New York Stock Exchange is indicated also by the fact that the curb market, as expressed in its rules, permits dealing only in securities not listed on the New York Stock Exchange. It is understood that when any security traded in on the curb is listed on the New York Stock Exchange the brokers on the curb shall at once cease to deal therein. The hours of trading of the New York Curb Market as well as all holidays are the same as those of the New York Stock Exchange.

Curb markets have found it necessary to adopt regulations for the proper conduct of business. Referring to the New York Curb Market, the governing control is vested in a Board of Representatives, and in standing Committees, in a manner and for purposes quite similar to those which will be explained for the regular exchanges. Membership is restricted to persons who meet with the approval of the association. Even where a curb market is operated in the open street, and where it may be asserted that the market is thus legally "open to all who choose to trade therein," it is usually agreed among most of the members that "no one is obliged to accept any contract which is not acceptable." There are also regulations relating to the types of orders for buying and selling, types of bids and offers, the time and method of delivering securities, the transfer

of securities, commission charges, and listing requirements. In many of these respects the New York Curb Market has seen fit to imitate closely the business procedure of the New York Stock Exchange. As a general proposition, however, curb-market listing regulations have fallen far short of the high standards enforced by the regular exchanges.

Auction Markets.—Many unlisted stocks and bonds are sold at public auctions which are organized solely for the marketing of securities, and the quotations for transactions made at such auctions in New York, Boston, and Philadelphia are published regularly in the newspapers and financial journals. An examination of the transactions shows that the stocks sold at these auctions are chiefly those of banks, trust companies, insurance companies, and minor industrial and mining corporations. Frequently, however, stocks listed on the regular exchanges change hands at these auctions. The auction affords a convenient place to market (1) securities which are not listed on any exchange or curb market, and (2) securities which, although listed elsewhere, have been deposited as collateral without the pledgee having reserved the right to sell the same on an exchange. In law, stock exchanges are regarded as places of private sale; therefore, the securities referred to above can only be sold by the pledgee in satisfaction of the debt at a public sale, in accordance with the law of pledgor and pledgee.[7] Stocks listed on exchanges and enjoying an active market thereon usually command a price at these auctions but slightly below the current price on the exchange, chiefly for the reason that arbitraging[8] may be practiced by buying the security at auction and promptly selling it on the exchange, and partly because the purchaser at an auction usually pays no commission.

As a rule the person desiring to sell a security at an auction

[7] For a full discussion of the application of this law see Chapter XXIII.

[8] For an explanation of this practice see Chapter VII.

must notify the auctioneer by a stipulated time of his intention and the auctioneer will then advertise the security for sale in the press as well as in his so-called "catalogue." This catalogue, which is usually issued twice before the day of the auction (auctions are usually held once or twice a week at a stated hour), furnishes a complete list of the securities offered and is given a wide distribution among brokers and the auctioneer's clients in all parts of the country. It usually divides the securities offered for sale into various classes, such as, "for account of whom it may concern," "executor's sale," "trustee's sale," "administrator's sale," and "for other accounts."

According to the terms of the auction sale, which are fully detailed in the catalogue, cash payment must be made before delivery or transfer at a stipulated hour on or before the day following the sale. As far as applicable, stock exchange conditions are usually observed. Stocks are sold flat, and bonds at "price and interest," except income or defaulted bonds, or those on which there are special rulings by the New York, Philadelphia or Boston exchanges.

Unless announced to the contrary, purchasers may take all or a part of the items advertised in the catalogue; and the auctioneer reserves the right, unless stated to the contrary, to sell the listed items privately. No commission is charged the purchaser as a rule. The seller is charged an entrance fee for each week. This fee includes the cost of advertisement in the catalogue or elsewhere. A commission is also charged for any security advertised by the auctioneer, where the security is sold privately outside of the auction and, therefore, is withdrawn from sale.

As a rule the catalogue states that securities listed therein for sale are not owned or sold on behalf of the auctioneer, but are owned by, and sold for, the client for whom the house acts as *auctioneer and agent, and not otherwise.* It follows, therefore, that sales at auction are made subject to consummation. The right is reserved by the auctioneer to require a deposit at

the time of the sale, whether so advertised or not. Sellers are also given the privilege of specifying a "withdrawal price," which is in the nature of a limited stop order, i.e., in case the bid price at the auction is not equal to this withdrawal price the security is withdrawn from sale and may be re-advertised for a later auction.

General Nature of Organized Stock Exchanges.—As compared with the preceding types of markets, the regular exchanges are by far the most important. The securities of nearly all of the larger and better known corporations are dealt in on these markets. Aside from the New York Stock Exchange and the New York Curb Market, other stock exchanges are located in twenty-four different American cities. During 1933 the shares sold on the New York Stock Exchange totalled 655,835,821, and bonds $3,365,342,000 par value. But in a year of extraordinary prosperity, like 1929, the shares sold on the New York Exchange reached the stupendous total of 1,124,608,910. To this enormous turnover there must be added the business of the numerous other exchanges of the country. Sales on the New York Curb totalled 100,736,000 shares during 1933, while during the prosperous year of 1929 the total volume of sales on this market reached 473,770,970 shares.

So large a volume of business on a single floor, coming from the corners of the earth, necessarily means a highly perfected system of operation. Thus with respect to the New York Stock Exchange,[9] there were at the close of 1932 609 stock exchange firms, with a total of 3,510 partners, of whom 1,092 were out-of-town partners. These firms, it should be pointed out, also operated 1,178 branch offices, 990 of which were located outside of New York City and scattered throughout the United States, with 26 in Canada and 19 in England. In addition there were also a total of 3,767 non-member correspondents' offices.

[9] The following information secured from *New York Stock Exchange Year Book* 1931–32.

Among other points of interest, it may be noted that as of October, 1932, there were 2,006 members' private wires to the floor of the New York Stock Exchange, that approximately 70,000 miles of telephone and telegraph wires were in use in the Exchange building, that at times nearly 2,000,000 calls were transmitted on a five-hour day on the private wires connecting members' offices with the floor of the Stock Exchange (averaging 15 for each 5 minutes of the day), on the more than 2,000 telephones, that 1,600 telephone clerks handled orders on the floor, and that the New York Quotation Company and the Western Union Telegraph Company operated 4,531 stock tickers and 653 bond tickers, located in 330 cities, 45 states and territories, Canada and Cuba. Another matter of interest is the Exchange's statement that during the active year of 1929, when sales exceeded the billion share mark, "approximately 5,340,000,000 feet of ticker tape, or more than 1,000,000 miles, were consumed on the stock tickers alone."

Operations of the New York Stock Exchange are equally interesting from the standpoint of financial volume. Thus during the active year of 1929, if we multiply the volume of sales of 1,124,608,910 shares by the average price per share of $89 for that year, it appears that one year's transactions on this Exchange involved a monetary worth of over $100,000,000,000. To this figure must be added another three billions to cover the bonds which were sold on the Exchange during that year. Even in a normal year, like 1927, when we multiply the number of shares sold by the average price per share for that year we find that the sales would exceed a monetary valuation of $40,000,000,000. The largest month in the history of the New York Stock Exchange was October, 1929, with a volume of sales equal to 141,668,410 shares with an approximate value (using the previous basis of computation) of nearly $13,000,000,000. The largest week was that ending November 2, 1929, with a total of 43,449,540 shares, with an approximate dollar valuation of $3,871,000,000. The largest single day on record

was October 29, 1929, with 16,410,000 shares valued at approximately $1,460,000,000.

So huge is the volume of business on our exchanges that this type of market is usually construed as synonymous with the "stock market." A congressional committee has stated with respect to our stock exchanges that "their results are as broad as the business interests of the country, and affect in their most intimate and important business relations all the people thereof," and a keen critic of our exchanges has referred to the New York Stock Exchange as "an integral and inseparable part of the national financial system, as important as any part of the whole system, as important as the banks themselves," and that its quotations "are taken by banks all over this country as a basis for loans on securities. Courts of Justice in every section of the country figure their damages on the quotations of the New York Stock Exchange. These quotations constitute evidence of value." [10]

The fundamental purpose of organized exchanges, to quote the preamble of the Constitution of the New York Stock Exchange, is to "furnish exchange rooms and other facilities for the convenient transaction of their business by its members, as brokers; to maintain high standards of commercial honor and integrity among its members; and to promote and inculcate just and equitable principles of trade and business." Later chapters will explain at length the drastic manner in which exchanges supervise the conduct of their members, and the detailed way in which they regulate all phases of brokerage transactions. Through their efforts the moral tone surrounding security markets has been raised immeasurably beyond what it otherwise would be. To the uninformed the New York Stock Exchange represents little more than the spectacular scene that may be witnessed from its gallery. This phase, however, by no means represents the real soul of the institution. From

[10] Testimony of Samuel Untermyer before Committee on Banking and Currency, United States Senate. *Hearings on S. 3895*, 1914, pp. 13, 42.

our exchanges there radiate influences, in the form of enforced regulations and standardized practices, that vitally influence every angle of the stock and bond business, even to the remotest parts of the country. Thus, the entire personnel connected with the exchanges, including all branch offices of members, is brought under a rigid disciplinary control. All phases of the conduct of brokerage transactions, such as the types of orders, settling of contracts, commissions, making of bids and offers, distribution of quotations, advertising, etc., are standardized in the interest of speed, economy, efficiency, and justice. To have their securities admitted to dealing, all corporations must observe a detailed set of requirements imposed by the exchange in question.[11] All phases connected with the transfer of securities are carefully controlled.[12] Moreover, as already observed, curb and auction markets adopt stock-exchange practices as far as reasonably applicable. These are merely some of the ways, and others will be referred to in later chapters, in which our stock exchanges exert a powerful influence for uniformity of practice and a high standard of honor in a business that otherwise would be susceptible to the greatest irregularities in both of these respects. In brief, our stock exchanges constitute the coördinating force that tends to bring all of the many separate elements of the stock and bond business into an honest and smoothly running system.

But aside from this service, organized stock exchanges also constitute continuous markets, i.e., places where nearly all stocks and bonds admitted to dealing can be bought or sold at a moment's notice, the only question being that of price.[13] Later chapters are devoted to a discussion of functions of exchanges so important that without their presence the financial life of the nation would well-nigh come to a standstill. Yet all of these important services, as will be pointed out later,

[11] See Chapter IX on "Listing of Securities."
[12] See Chapter XV on "Transfer of Securities."
[13] See Chapter II on "Nature and Value of a Continuous Market."

are fundamentally dependent upon the existence of a continuous market and such a market, in turn, is dependent upon the existence of a large group of speculators and the practice of selling short.

Speculation and short selling have been subjects of much criticism by many writers. Our exchange markets are organized with a view to facilitating a two-sided market. The two elements in the market contending over prices are known as the "bulls" and the "bears." The bulls strive to produce a rising market (the name having probably been derived from the fact that a bull fights by tossing his victim upward), while the bears seek to depress the market (the name having probably been derived from the fact that a bear fights by crushing his victim downward). These two terms, however, simply represent an interesting way of referring to the old law of supply and demand. When the bulls are in the ascendency, that is, when the demand for stocks is greater than the supply, prices rise, and the market is characterized as "strong" or "rising," or as a "bull market." When the bears are in the majority, that is, when the supply of stocks exceeds the demand, prices decline, and the market is labeled in the press as "weak" or "declining," or a "bear market." When bulls and bears are about evenly matched, that is, when the supply of stocks about equals the demand, such terms as "firm" or "unchanged" are used. Other terms commonly applied to the market to indicate its condition are "dull," "stagnant," "listless," "mixed," "active," and "panicky."

It is difficult to trace the motives of the numerous interests composing the "bull" and "bear" groups. There are investors and speculators. There are those who buy or sell outright, those who buy on credit, and those (short sellers) who sell what they do not possess, in anticipation of a price decline, with a view to repurchasing the same stock later at a lower price. To the uninformed, speculation and short selling may seem useless and harmful practices. Needless to say, there are many persons

so poorly equipped financially and so little informed about values that their financial salvation lies in the direction of never engaging in any kind of speculation, not only in the security market, but also with respect to real estate, commodities, or any sort of business enterprise. "Legitimate speculation," it has been said, "involves anticipation of the needs of the market and power to assume risks in making contracts to meet those risks." [14] That certainly is not a business in which simpletons may properly engage. Later chapters will undertake to show the necessary relations that legitimate speculation bears to many of the foremost functions of organized markets. Viewed from that standpoint, any impartial student of the subject will agree with Professor Leroy-Beaulieu's conclusion that "the evils that speculation prevents are greater than those it causes."

Financial Importance of Stock Exchanges.—Attention has already been called to the existence of stocks and bonds in the United States, representing probably 50 per cent of the nation's wealth; also that of this huge total New York Stock Exchange listings alone represent probably a fourth of the national wealth. Nearly all of the securities of the best known corporations are listed upon some exchange. Thus 809 companies have 1,209 issues of stock listed on the New York Stock Exchange; likewise 790 issuers (nearly all companies) have 1,568 bond issues listed on that market. In the case of the smaller exchanges the listings also comprise the stocks and bonds of hundreds of comparatively small corporations, often of a purely local character. Unfortunately it is impossible to obtain detailed data for all of America's exchanges, but the following table for the New York Stock Exchange, comprising the years 1925 to 1933, will serve to show the vastness of the wealth represented by the securities listed on that Exchange, the comprehensive manner in which the listings reach

[14] Pratt, Sereno S., *The Work of Wall Street*, p. 81, quoting President Hadley's definition of speculation.

out to cover almost every important type of industry, and the extraordinary size of the volume of transactions:

FINANCIAL IMPORTANCE OF THE NEW YORK STOCK EXCHANGE

(Compiled from the New York Stock Exchange Bulletin)

Volume of Sales

Year	No. of Shares	Bonds (par value)
1925	452,211,399	$3,398,346,045
1926	449,103,253	3,029,684,699
1927	576,990,875	3,321,545,600
1928	920,550,032	2,939,627,750
1929	1,124,608,910	3,020,316,700
1930	810,632,546	2,779,009,350
1931	576,765,412	3,085,794,000
1932	424,800,642	2,971,965,650
1933	655,835,821	3,366,402,950

Volume of Listed Stocks

(As of Jan. 1 for each year)

Year	No. of Shares	No. of Issues	Market Value	Average Market Price
1925	482,234,920	1023	$53,430,655,337	$69.32
1926	564,961,163	1076	37,034,394,712	65.55
1927	648,398,740	1092	48,526,525,537	74.84
1928	741,680,869	1161	66,113,255,317	89.13
1929	1,117,126,726	1292	63,589,338,823	96.76
1930	1,296,845,244	1316	55,025,710,617	42.43
1931	1,318,731,573	1281	31,105,267,133	23.59
1932	1,312,014,965	1242	22,259,137,174	16.96
1933	1,295,017,925	1211	32,542,456,452	25.13
1934	1,293,299,931	1209	33,094,751,244	25.59

Volume of Listed Bonds

(As of Jan. 1 for each year)

Year	Bonds (par value)	No. of Issues	Market Value	Average Market Price
1925	$35,457,811,674	1332	$33,611,817,346	$94.79
1926	36,995,089,533	1367	35,509,211,458	95.98
1927	37,900,053,650	1420	37,167,607,468	98.06
1928	36,881,320,122	1491	36,874,717,458	99.98

Volume of Listed Bonds (Continued)

(As of Jan. 1 for each year)

Year	Bonds (par value)	No. of Issues	Market Value	Average Market Price
1929	48,588,549,854	1534	47,379,028,502	97.51
1930	49,058,099,434	1543	46,892,458,780	95.59
1931	50,072,879,897	1607	47,384,805,889	94.63
1932	52,360,023,801	1601	37,848,488,806	72.29
1933	41,304,596,305	1549	31,918,066,155	77.27
1934	41,828,968,115	1568	34,861,038,409	83.34

CLASSIFICATION OF SECURITIES LISTED ON THE NEW YORK STOCK EXCHANGE AS OF JANUARY 1, 1934

(Compiled from the New York Stock Exchange Bulletin)

	No. of Companies	No. of Issues	Total Shares Listed	Total Market Value
Stocks:				
Automobile Industry	53	63	105,604,758	$ 2,497,815,580
Finance	34	46	55,763,887	823,432,138
Chemical Industry	55	80	71,593,061	3,615,566,312
Building Industry	22	35	15,605,154	278,426,859
Electrical Equipment	11	16	40,882,407	796,225,838
Food Industry	49	75	74,054,905	2,243,550,784
Farm Machinery Industry	7	12	12,309,906	400,238,291
Machinery and Metal Industry	56	87	47,980,425	1,021,043,599
Amusement Industry	14	18	13,830,122	134,321,857
Land—Realty	6	8	4,968,485	38,320,586
Mining Industry	37	53	54,861,944	1,135,844,899
Petroleum Industry	43	56	183,120,509	3,940,079,727
Paper and Publishing	20	27	16,806,843	171,638,727
Retail Merchandising	59	93	60,704,208	1,617,241,273
Railroad Industry	100	159	115,211,767	3,704,770,998
Steel and Iron	35	50	39,361,358	1,450,707,794
Textile Industry	27	40	11,210,714	210,308,873
Airplane Industry	7	9	19,534,281	187,088,508
All Utilities	62	110	213,487,372	5,299,501,664
Tobacco	18	35	25,921,324	1,317,665,704
Grand Total (Stocks) (including many other minor companies)	809	1209	1,293,299,931	33,094,751,244

CLASSIFICATION OF SECURITIES (*Continued*)

Bonds:			(par value)	
Government (American)	6	64	16,381,466,182	16,371,853,877
Government (all foreign)	104	231	5,778,687,306	4,634,845,838
Automobile Industry	3	4	62,571,650	51,457,886
Finance	9	11	90,060,200	76,881,907
Chemical Industry	6	6	103,530,000	70,369,336
Food Industry	15	15	228,329,000	195,926,468
Amusement Industry	7	10	83,021,800	38,022,617
Mining Industry	20	28	255,504,766	152,935,736
Petroleum Industry	20	28	616,234,500	566,474,088
Railroad Industry	287	672	10,674,934,390	7,149,405,507
Steel and Iron	24	30	440,414,620	326,450,403
All Utilities	114	192	3,741,242,743	3,138,456,451
Tobacco Industry	3	5	79,692,400	84,498,558
Grand Total (Bonds) (including many other minor companies)	790	1568	41,828,968,115	34,861,038,409
Grand Total (Stocks and Bonds) (January 1, 1934)		2777		67,955,789,653

HIGHEST AND LOWEST MARKET VALUES OF STOCKS AND BONDS LISTED ON THE NEW YORK STOCK EXCHANGE

	Market Value	Average Market Price
Combined Highest:		
Stocks (Sept. 1, 1929)	$89,668,276,854	89.13
Bonds (Sept. 1, 1929)	46,741,171,208	95.34
Grand Total (Stocks and bonds combined)	136,409,448,062	
Combined Lowest:		
Stocks (July 1, 1932)	15,633,479,577	11.89
Bonds (July 1, 1932)	37,353,339,937	71.71
Grand Total (Stocks and bonds combined)	52,986,819,514	

The Organized Security Market a World Market.—To an ever increasing extent capitalists, bankers, brokers, and arbitragers are utilizing the services of foreign stock exchanges, and many large corporations have their securities listed on the leading exchanges of several countries. The telegraph and cable have annihilated distance, and through these agencies the various exchange markets have been placed in almost immediate touch with one another.

So intimate is this international relationship between the great exchanges that the quotations of our security markets reflect not merely the general judgment concerning local and national events, but also conditions prevailing throughout the civilized world. No better illustration of this can be found than that which presented itself at the commencement of the World War, when the exchanges of the world were forced to close, some of them for the first time in their history. July 28 and 29, 1914, witnessed the closing of the exchanges at Madrid, Vienna, Budapest, Brussels, Antwerp, Berlin and Rome. On July 30 the exchanges of Leningrad, Montreal, and nearly all South American centers ceased operations, and by July 31, the Paris Bourse and London Stock Exchange had also suspended operations. The New York Stock Exchange alone, of the great exchanges, remained open, and, as stated by a member of the Board of Governors of that Exchange, "Everybody wanted to sell in New York because there was no other place to sell. Over-night orders revealed a frantic state of mind and this was especially true of cables. There was no price limit. 'Sell at the market' was the word, and utter demoralization the prospect." Accordingly, at ten o'clock on July 31, the New York Stock Exchange was also closed, and this action was immediately followed by the closing of the New York Curb Market, and practically every other stock exchange in the country, thus furnishing a most striking illustration of the interdependence of the security markets of the world.

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CHAPTER II

NATURE AND VALUE OF A CONTINUOUS MARKET

Meaning of "Continuous Market."—Attention has already been called in the previous chapter to the continuous character of the market furnished by our organized security exchanges. A continuous market may be defined as one where any security listed in that market may be bought or sold at any time during business hours at comparatively small variations from the current price. Where the security is "active," that is, where numerous speculators are engaged in the buying or selling of that security, such a market implies that large quantities may be bought or sold almost instantly at very slight concessions from the last quotation. Where the security is "inactive," that is, where comparatively few speculators are interested in making a market, immediate sales are usually effected only at greater concessions in price. But whether the security be active or inactive, a continuous market implies one where a sale may be promptly made, at a reasonable concession, the only question being that of price.

Factors Producing a Continuous Market.—To have a continuous market it is necessary that there be present at all times during business hours a sufficient number of buyers and sellers. While the purchases and sales of the investing public contribute substantially to this end, this factor alone falls far short of the desired purpose, and at times is almost negligible. To make the market continuous it is essential that there be (1) a group of speculators so large that some will always be ready to buy or sell a particular stock; and (2) the privilege of short selling, so that a demand for any particular stock may

be supplied immediately by some seller who may not possess that stock at the time of the sale, but who is willing to make the sale on the assumption that the continuous character of the market will enable him to obtain the particular security later for purposes of delivery.

Speculation and short selling are usually the objects of much criticism, yet it is important to remember that these two factors are essential to the existence of a continuous market, and a continuous market, in turn, is essential to the successful fulfillment of any of the functions attributable to organized exchange markets. Suppose that, with respect to any one of the functions of exchanges discussed in this and other chapters, the question be asked: What are the fundamental factors which make the service or practice possible? The answer must always be: A large group of speculators, short selling, and as a result of these, a continuous market. Later chapters will show that floor traders,[1] odd-lot dealers,[2] specialists,[3] and arbitragers,[4] all aid materially in making the market much more continuous than it would be if reliance had to be placed solely on the public demand or supply. Each group pursues its own object and renders its particular service, yet the combined effect of their efforts is a huge increase in the volume of transactions in the market, as well as a much greater continuity in the regularity of the sales. Moreover, all of these groups, as will be explained later, depend for success in their calling upon short selling and the continuous market. Each group is assisted by the others; all depend upon the continuous character of the market which they themselves help to create; and the continuous market, in turn, is largely the product of speculation and short selling.

Benefits Derived from a Continuous Market.—Numer-

[1] For a detailed account see pp. 172–4.
[2] For a detailed account see pp. 174–6.
[3] For a detailed account see pp. 176–80.
[4] For a detailed account see Chapter VII.

ous advantages to the business community are directly attributable to the continuous character of our organized security markets. In the last analysis this continuous feature is really a means of insurance to owners and creditors against unnecessary loss. The following represents a summary of the advantages referred to, although, owing to their intricate nature, a detailed discussion of some of the benefits must be reserved for later chapters.

1. *Gives Mobility to Property Represented by Stocks and Bonds.*—By assuring a ready transfer of securities from hand to hand, the creation of corporations is greatly facilitated. Large corporations are anxious to have their stocks and bonds listed on one or more of the leading exchanges with a view to increasing their marketability and to enhancing their value as collateral for borrowing purposes. Investors look more favorably upon stocks or bonds that possess these two important attributes. Corporations and underwriters of securities are well aware of this fact, as is evidenced in many advertisements of new issues by some such statement as "application for listing on the (name of exchange) exchange has been made."

2. *Gives Constant Quotations for the Benefit of Security Owners and Creditors.*—Owing to the elaborate quotation service of our organized markets, owners of nearly all listed securities are enabled to know the price from day to day. In the absence of exchange markets, transactions would be private and prices would certainly not be representative of the general judgment. Even if recorded, prices determined in private offices might easily be designed to mislead. On our exchanges, however, all transactions are made in the open market, under proper regulations, and quotations are immediately broadcast, first by the ticker and news services and immediately thereafter by the daily press.

3. *Constitutes the Chief Reliance of Holders for Prompt Conversion of Stocks and Bonds into Cash, or*

Vice Versa.—Marketability is one of the very desirable attributes of stocks and bonds as it is of other property. Investors or speculators are loath to tie up funds in property which is not readily salable. One of the first thoughts which occurs to the average prospective purchaser of a stock or bond, even though it be of the highest grade, is: Have I assurance that in case of necessity, this security can be sold at a moment's notice and without much sacrifice in the price? The existence of a continuous market gives reasonable assurance on this point. It also gives reasonable assurance that the price realized was determined under equitable conditions, in a regulated market, and represents the general judgment as to the present and future value of the security in question. Ready marketability is equally important to our large investment institutions such as savings banks, commercial banks, trust companies, and insurance companies. Large corporations and business concerns generally are also enabled to build up sinking funds as well as surplus emergency funds through investment in listed securities, with the knowledge that these securities are readily convertible. To an ever increasing degree all these institutions must rely upon the investment of their enormous funds in listed securities. In fact, their huge holdings in bonds and stocks serve as a secondary cash reserve, since their value may be converted into cash almost immediately through sale in the continuous market if occasion requires.

4. *Constitutes the Chief Reliance of Creditors for the Prompt Liquidation of Collateral.*—Exchange quotations are used by banks everywhere as a basis for collateral loans. Such quotations, moreover, constitute legal evidence of value, since the courts of justice recognize them as the basis for measuring damages.

With the increase in the proportion of the nation's wealth represented by stocks and bonds there has followed an increase in the use of such evidences of wealth as security for loans. But lenders of money are loath to accept collateral which

cannot be sold readily, or, if they make loans under such conditions, the assumed value of the collateral must exceed greatly the amount of the loan. With a continuous market at hand, however, bankers will lend money readily on most listed securities in the customary ratio of $80 cash to $100 market value of securities deposited as collateral, unless prevented by law.[5] They do this because they know that, in case the borrower should allow his account to become impaired, a few minutes will suffice to enable them to sell the collateral on some exchange for an amount still in excess of the loan. At the outbreak of the World War all the great stock markets were closed for several months, with the result that it was impossible for the holders of stocks to know their market value. Many will recall the absurdly low prices at which securities were often sacrificed at some of the improvised and unofficial markets. Still more will recall the limited amount that could be borrowed on good securities simply because the banks possessed no current market quotations upon which to base their loans, and furthermore, were fearful because of the absence of any continuous market at the time of their ability to dispose of the collateral should the borrower prove unable to protect his loan. During the money-trust investigation by Congress in 1914

[5] Although this has been the prevailing ratio on active listed securities for many years, statutory requirements may set up a different artificial standard. Thus Sec. 7 of the Securities Exchange Act of 1934 makes it unlawful for any member of a national securities exchange to extend credit to any customer on any security (other than an exempted security) registered on a national securities exchange in an amount exceeding, "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 thirty-six calendar months, but not more than 75 per centum of the current market price." The Federal Reserve Board, however, is empowered, "where it deems such action vitally essential to the accommodation of commerce and industry and with regard to its bearing on the general credit situation of the country, by rules and regulations to permit lower margin requirements for particular securities or transactions or classes of securities or transactions for particular periods." For the full statement of Sec. 7 of this Act see Appendix IX, p. 541.

much was made of the fact that leading witnesses regarded some of the most speculative stocks as among the best bank collateral for loans simply because they were extremely active in the market. They emphasized the fact that lenders of money were concerned quite as much with the regularity with which collateral was quoted in the market, and the extent of fluctuations between sales, as with the so-called intrinsic worth of the security itself.

5. *Makes Arbitraging Possible.*—Reference is had to the practice of making two transactions at about the same time, one a purchase in the low market and the other a sale in the high market, with a view to clipping the difference between the two prices.[6] The two transactions may be made in two different exchange markets. Or the arbitrager may be (1) buying "rights" (subscriptions to new stock) and selling the equivalent amount of old stock,[7] or (2) buying convertible bonds and selling an equivalent amount of the stock into which the bonds are convertible.[8] But whatever the nature of the arbitrage transaction, it is vital that the purchase and sale be effected almost simultaneously if the arbitrager is to be reasonably sure of the profit he started out to clip when he made the first of the two transactions. If much time elapses between the purchase and sale, prices may so change in the two markets as to cause a loss instead of a profit. The arbitrager proceeds on the theory that when he detects a difference in prices he will find the two markets so continuous that his two orders (one to buy and the other to sell) will be immediately executed at about the prices he had in mind when placing the same. Other factors, like short selling, are necessary to successful arbitraging, but none are more vital than the existence of a continuous market.

[6] For a detailed discussion of the subject see Chapter VII on "Arbitraging."

[7] For a detailed discussion see Chapter XVII.

[8] For a detailed discussion see Chapter XVI.

6. *Enables Odd-Lot Dealers to Operate.*—Like arbitragers, odd-lot dealers require a continuous market if they are to accommodate small investors in the prompt sale of lots of less than 100 shares.[9] The function of these dealers is to supply or take such lots promptly and at an eighth or a quarter (depending upon the security) from the current quotation for 100 shares. Yet if asked to buy, they will take odd lots with a view to reselling them in the open market upon having received 100 shares of the stock from different sources; and if asked to sell, they will sell the odd lot short in anticipation of buying it in the open market immediately upon having disposed of odd lots in the stock aggregating 100 shares. Being obliged to give or to take the stock at a price so near the current quotation for 100 shares, it follows that the open market must be sufficiently continuous to enable odd-lot dealers to sell immediately what they have accumulated, or to buy in promptly what they have sold short. Like arbitragers, odd-lot dealers operate on the theory that their transactions in the open market can be executed at about the prices they had in mind when called upon by other brokers to give or take odd lots.

7. *Makes the Use of Stop-Loss Orders Feasible.*—A discussion of the continuous market would not be complete without reference to the various forms of so-called "stop orders." [10] A "stop" or "stop-loss" order is one that orders the broker to sell or buy a stock as soon as the market price reaches a designated figure. Thus, with United States Steel stock selling at 80 the broker may be instructed to "sell at 76 stop," in which case the broker may not undertake to sell the stock until an independent transaction in the market has been made at 76 or lower. When, however, this price has been reached, the stop order becomes an "at the market" order, and the broker is obliged to sell the stock immediately for what it will bring. The general assumption, however, is that, owing to a continuous

[9] For a detailed discussion see Chapter X.
[10] For a detailed discussion see pp. 189–93.

market, the stock will be sold at either 76 or only slightly under this figure.

Stop-loss orders may be used advantageously by both owners and creditors, and serve as a means of protecting profits or of cutting losses. Thus an owner having a profit in a given stock, which he expects to increase, and not being able to keep in constant touch with the market, may protect this profit by placing a stop order to sell the stock slightly below the current price. Should the price increase the stop order will not be executed. But should the price decline to the stipulated figure, the order will be promptly executed at about the indicated quotation.

A banker who has difficulty in securing more collateral from a borrower may simply instruct him that he has placed a stop-loss order with respect to the collateral. This is a warning that if the price declines to the figure named in the order, the collateral will be sold immediately at the market price. The same practice is also commonly resorted to by brokers when customers fail properly to replenish their collateral on speculative transactions. But in all such cases bankers and brokers must proceed on the theory that the market is sufficiently continuous to assure the prompt execution of the stop order at a figure that will still leave the proceeds of the sale in excess of the amount of the loan.

8. *Exerts a Favorable Influence upon the Money Market.*—The ownership by any country of a large mass of securities which are listed on the leading exchanges, and thus enjoy a ready market, is a strong safeguard against financial panic. If confidence becomes shaken and a demand for money suddenly makes itself felt, causing creditors to insist on cash settlements, the banks are forced to call in loans and accumulate cash. But stocks and bonds to an increasing extent serve as collateral for loans, and, by virtue of the fact that such securities can be sold much more readily than other property, because of the continuous market for them, bankers first look

toward the stock market for the application of corrective measures. The first blow, when money becomes dear, nearly always falls upon the stock market, that is to say, the first loans called are usually those protected with stock and bond collateral; and it frequently happens that a period of forced liquidation in this market sufficiently corrects the money situation so as to leave other business practically unmolested. Crises are prevented, when they can be thus prevented, through the liquidation of securities, and in case they cannot, the security market discounts them, and breaks their force into a succession of reasonably small declines, instead of a huge collapse. And even suppose the crisis is so far-reaching that aid must be sought from abroad, if our bankers are the holders of many active stocks, listed on the foreign markets of England, France, and other countries, their sale may be effected within a day or two through cable orders, and the proceeds of the sale at once forwarded to this country in the form of gold.

The extent to which credit is made available between different markets, all of which can be brought into touch with one another through the telegraph or cable, has been demonstrated by many examples of such a character as to make unnecessary any advance preparation for the coming trouble. The San Francisco conflagration, for example, involved an enormous and sudden waste of capital which had to be replaced by underwriters within a short time. Yet it is astonishing to observe how domestic and foreign fire-insurance companies were able to dispose of the securities, in which they had invested their funds, in order to supply the millions necessary for the payment of claims.

What may seem so apparent in the case of important crises, it should be remembered, occurs almost daily in a less sensational way. A corporation desires to secure $50,000,000, and the funds are readily obtained in the most available market by the sale of securities, or by depositing them as security and borrowing thereon. From week to week the pressure on the

money market is largely transferred to the borrower on demand loans, who has deposited stocks and bonds as collateral; and frequently a severe contraction or expansion in money rates is thus avoided. If there were not a large mass of salable securities, and large markets where they could be sold promptly, we would have the spectacle of banks charging eight or nine per cent for time loans one month, and then four or five per cent another month. Since stock markets, however, make it possible for credit to be placed almost instantly at the disposal of one market or another where most needed, time-loan rates fluctuate but little over comparatively short periods. Commercial borrowers continue to pay a rate of five or six per cent with the serene confidence that they need fear but little variation during normal times.

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CHAPTER III

THE DISCOUNTING FUNCTION OF EXCHANGE MARKETS [1]

Exchanges as Clearing Houses of Current News.—Next to the furnishing of a continuous market, the discounting function of exchanges is probably their greatest service. Stock exchanges have come to be recognized more and more as agencies for the collective expression of human judgment concerning the present and prospective value of securities. Communication by wire and radio has not only brought all the leading exchanges into immediate touch with current happenings everywhere, thus making them news agencies of national and international scope, but has so connected the various investment and speculative markets of the nation and the world as to make them practically one. A few minutes will suffice to enable investors throughout a large territory to give expression to their opinions of current market news in the form of actual purchases and sales at prices that, in turn, are immediately transmitted to all investment centers and are soon thereafter made available to the general public by the daily press. Exchange markets may thus be regarded as pivotal centers where thousands of minds concentrate to express their judgment concerning prices. They represent the collective mind of the investment world as to values, present and prospective. And in this connection it is all important to remember that the collective judgment is much more reliable than the judgment of an individual. As individuals, we may make serious errors

[1] In the preparation of this chapter liberal use was made of my article on "The Scope and Functions of the Stock Market," *Annals of the American Academy of Political and Social Science*, vol. 35, May, 1910.

in our purchases or sales; but collectively, as will be indicated later, the market has proved its worth as a remarkably accurate discounter of the future. Explained in greater detail, the value of this prompt expression of the collective judgment is threefold, namely:

1. *Protects the Holders of Securities and Harmonizes Quoted Prices and Actual Values.*—Without an organized market the average holder of corporate securities, owing to the absence of sources of information, would stand in a most defenseless position. He would be unable to learn their price from day to day, because transactions, if private, would not be recorded, might be designed to mislead, and certainly would not be representative of the general judgment. He would be exposed to many times the fraud of to-day. He would be at the mercy of every rumor. He would be unable to place a correct estimate of the importance of current events upon the price of his securities. He could be misled easily by unscrupulous counselors into selling his securities far below their fair value, and would never be certain of honest treatment in the execution of his orders. To-day however, the honesty of brokers is secured through a rigidly enforced system of rules, and every newspaper of any importance gives daily the quotations of leading securities, thus protecting the holder against deception as to prices. Practically every daily newspaper worthy of the name, throughout the length and breadth of the land, furnishes a financial page to its readers, and current quotations are thus conveyed to the nation's population through the medium of a published circulation probably exceeding 10,000,000 copies. A few minutes also suffice to convey quotations by thousands of tickers to brokerage houses, banks, trust companies, investment houses, insurance offices, etc., located in practically every city of importance.

Moreover, these exchange quotations represent the combined judgment of many minds, which is given concrete expression in actual transactions on the floor of the exchange.

Through the wide publicity of stock exchange quotations the the world over, the holders of securities are given *gratis* the combined opinion of the most competent financiers as to the value of those securities at present and their prospective value in the future. Since these financiers always have in mind the future, rather than the present, their initiative in making purchases and sales will tend to discount the effect of coming events on any given security. It is for this reason that the price of a stock often bears no definite relation to the present earnings of the corporation or to the dividend paid. A non-dividend-paying stock may seem to command an apparently unwarranted price, yet upon the declaration of a dividend the price will usually fail to advance much and may actually decline. Similarly, a dividend paying stock may apparently sell much too low, yet upon a cut in the dividend the stock will usually fail to decline appreciably and may actually advance. Receiverships of corporations are generally indicated a year or more ahead of the actual event by the extraordinary decline in the price level of the corporation's stocks and bonds. Similarly, the drastic effect of so important an event as the recent devaluation of the dollar was translated into the quotations of stocks and bonds months in advance of the event, very favorably with respect to such groups as the "metals" and "motors," and very unfavorably as regards certain other groups such as the "banks" and "public utilities."

In other words the market—the collective judgment of the investment world—is always in advance of the present. It is concerned primarily with the future, and bad news or good news is discounted in advance. When the facts become the common property of the rank and file of the population, their effect is lost because the discerning mind of the speculative community has approximately measured their importance in advance, and by its sales and purchases has brought about an adjustment of the price to a lower or higher level. The holder of stocks and bonds is free to disregard current quotations

if he chooses; but if their trend is pronounced they should serve as a guide by which he may regulate his own action relative to the holding or selling of his securities. For the time being prices and intrinsic values may seem far apart, yet in the long run, owing to the desire of speculators to anticipate the future, quoted prices and inherent values as judged by future earning power are brought into approximate harmony with one another.

2. *Standardizes Values and Directs the Flow of Capital from Unprofitable to Profitable Channels.*—The stock market also serves a most useful purpose in directing the flow of capital from channels where least needed into those where it can be most profitably employed. Daily fluctuations in security prices may have but little significance, yet it is an axiom of the financial world that pronounced changes in the earning power of corporations are reflected, in the long run, by pronounced changes in the prices of their securities. It is equally true that relatively low quotations for the stocks and bonds of corporations in a given line of industry, if continued month after month, are indicative of the unprofitable character of that type of investment. Consequently it soon ceases to be attractive to investors. The quotation table proclaims its unworthy character to the owners of capital more effectively than any other argument. New enterprises along the same line will be discouraged, for what reason is there to undertake the extension of an industry already unprofitable, when the same quotation table gives evidence of other lines of business whose high and advancing prices of shares, as a result of large and increasing returns, will serve as a guide to capitalists in directing the flow of their uninvested funds? If the shares of steam railroads and street railways are relatively low, and show an unfavorable movement, it is a warning to the holders of capital that they should exercise caution in giving financial support to the promotion and extension of this type of enterprise. If, on the other hand, the stocks of equipment, iron and steel,

copper, or motor companies are selling high and show an advancing tendency, it is an indication that further development and increased production are desirable and that the flow of capital into these channels is warranted.

By thus standardizing the profitableness or unprofitableness of many groups of industries to a common basis, and presenting the same in a table of quotations that is easily understood and accessible to all the world, stock exchanges serve to prevent the misdirection of funds into unnecessary ventures. They may be described as clearing houses for all news of business significance. All information, political and industrial, is there studied and weighed by experts, who by buying and selling, gratuitously give their conclusions to the world in the recorded quotations. These recorded transactions, representing the combined judgment of many trained minds, relieve the mass of small investors of the trouble and expense, even granting that an investigation could be made, of familiarizing themselves with the many intricate factors underlying the operation, management, and future prospects of corporations, possibly situated thousands of miles away. Unworthy classes of investments are thus differentiated from the worthy, and investors are attracted to the latter. "Through the publicity of knowledge and prices, the bringing of a multitude of fallible judgments upon this common ground, to an average, there is afforded to capital throughout the world an almost unfailing index of the course in which production should be directed." [2]

It remains to be said that by standardizing values the stock exchange is a creative agency for the upbuilding of business since it tends to bring investors and worthy investment opportunities together. "Just as the banks represent the organization of capital for the making of loans," it has been said, "so the stock exchanges in America, England, and continental Europe represent the organization of capital for the purpose of investment." Their members and affiliated firms are inti-

[2] Conant, Charles A., *Wall Street and the Country*, p. 29.

mately associated with the largest banks, corporations, promoters, and private capitalists. So intimate has this association become that directly or indirectly promoters with propositions to finance, or corporations with large issues of securities to float, must usually consult banking, investment and brokerage houses which have stock exchange affiliations and which are thereby able to gauge the possibilities and success of the project, to formulate the plans by which the capital is to be raised, and to lay it properly before the investing public. These houses base their judgment concerning investment conditions largely upon the activity and price movements prevailing on the exchanges. In brief, the whole investment business of the world, as one writer aptly expresses it, is "attuned to the tone of these exchanges and reflects the confidence or doubt of the collective public mind to which they give expression."

3. *Discounts Future Business Conditions.*—Besides affording a valuable protection to the holder of securities and directing the flow of capital, stock exchanges serve the further useful purpose of "discounting the future trend of business." In this respect they afford a register of prospective values for property other than that dealt it on the exchanges and constitute a "barometer of future business conditions." Speculation, as already pointed out, deals with the future and not the present or the past. Corporate stocks and bonds constitute so large a proportion of the world's wealth, and represent such a variety of industries, that a marked advance or decline in the general level of prices is the surest indication, in fact an almost unfailing index, of coming prosperity or depression. And the all-important fact is that such changes of prices on the exchanges nearly always precede, that is, discount the event, and do not follow or occur concurrently. Without an exception every major business depression or boom in this country has been discounted by our security markets from six months to two years before the dull times or the prosperity became a reality.

The financial and business panic of 1907 will serve as an

illustration in this connection. The business conditions of 1906 and 1907 were equal to the best that this country had ever enjoyed up to that time. Factories were running overtime, crops were abundant, railroads were congested with traffic, and real-estate operations were booming. The press was filled with the most optimistic descriptions and predictions. Yet, despite the excellent news, security prices showed little gain following the month of August, 1906. The earmarks of coming financial and business distress were at hand. The stock market was serving its purpose as the pivotal center where thousands of the leading minds of the world were acting on judgments that had reference to the future and not the present. Stocks were for sale by those who reasoned correctly concerning the future, and were purchased by those who based their judgments on the rosy present. They were even sold at a sacrifice, and as a knowledge of the coming state of business affairs percolated from one stratum of intelligence to another, the selling movement increased in momentum until in March, 1907, the market experienced its first panic. A rebound in prices occurred, but stocks were still for sale, and by November of 1907 an unusually low price level was reached. In the meantime, however, business was excellent, and the press of nearly the whole country wondered what all the trouble was about, and why the Wall Street gamblers were thus losing their senses. The business depression of 1908, however, followed the stock market collapse of 1907, and when it was a reality to even the most ignorant, the stock market had clearly discounted the event, and prices of securities refused to yield further. Securities were now regarded as a desirable purchase from the standpoint of the future. Accordingly we witnessed the spectacle of rapidly ascending stock-market prices at the very time when business was at its worst, complaints the loudest, and the public press as pessimistic as it had previously been optimistic. The stock exchange was again the pivotal center where thousands of the best minds of the country were expressing their judgment

of the future, and were willing to convert cash into securities because of an anticipated improvement in values. It may truly be said that major stock-market movements run contrary to what is seen, read, and heard.

The same discounting or forecasting service is equally noticeable in the next great major price movement, namely the market of 1914–15 when the effect of abnormal war conditions was reflected truly for each of the leading groups of American industries. Upon the reopening of the market in December, 1914, there developed almost immediately a violent reshifting in the prices of the various groups of securities. Industrial stocks, taking a list of 47 leading corporations representing all important types of manufacture, showed a price advance of 117 per cent during the first year of the war. A selected list of 27 leading industrials that figured largely in the manufacture of war orders showed an appreciation of 229 per cent during the same time, while in the case of ordinance stocks the advance was even greater. Bonds, however, showed scarcely any appreciation at all, while railroad and public-service corporation stocks, owing to the increase in operating costs and the inability to increase the price of their service correspondingly, appreciated only 20 per cent and 23 per cent, respectively. As regards each of the aforementioned groups the relative market appreciation approximately measured in advance the future prospects of profits. Later, when the reader had constantly paraded before him the acceptance of huge orders at fabulously profitable prices, the market ceased to display its buoyant upward tendency. It should be remembered that the "bull" market following the declaration of war reached its culmination on the average as early as the close of 1915. By the beginning of September, 1916, although the country enjoyed unexampled prosperity, the aforementioned appreciation in our list of 47 industrials had declined from a high of 117 per cent to 87 per cent, in the list of strictly war stocks from 229 per cent to 164 per cent, and in the list of railroad and public-

service corporations from 20 per cent and 23 per cent to 11 per cent and 17 per cent, respectively. Beginning the latter part of 1919, and through practically all of 1920, the market underwent further drastic declines, and any examination of market quotations for representative groups of stocks makes apparent the fact that the serious business depression of 1921–22 was discounted months in advance. Subsequently the business revival, following 1922, was clearly foretold by the rapidly rising stock market during practically all of that year.

With respect to the major depression of 1929–34, the stock market again registered true to form as a discounter of general business conditions. By September, 1929, practically all industrial barometric indices had reached their highest level in history, and the huge mass of explosive (the accumulated speculative error) was ready for the shock, and only required some event to touch it off. The explosion occurred in October and November of 1929 in a memorable stock market panic of six weeks duration, which carried price quotations, on all of America's exchanges, down by some fifty billions of dollars. Then, as always, after the stock market debacle, the business depression began to assert itself and progressively continued until it had run its course. As usual, much of the public opinion was not disposed to attach significance to the early stock market decline in view of the excellence of business, and much was heard about "fundamental conditions being sound," that "this time everything is different as compared with previous experiences," that "the stock market does not represent business," etc. But that line of thinking could not alter true conditions. The stock market precedes business conditions and does not follow. If business preceded the stock market, all could become rich easily. All that would be necessary would be to observe the progress of business, easily ascertainable from current published statistics, and then, when a decided movement was recorded, merely place buying orders in stocks and subsequently cash in the profits since, under this fallacious theory, the stock market

must rise when business has improved. The truth is that business follows the stock market and does not precede.

The bottom figures for the depression of 1929–34, for both business and the stock market, were reached in June of 1932. Thereafter the stock market began a rise (culminating its first movement in July, 1933), which, as regards its first stage, constitutes one of the most extraordinary bull markets on record. Between June, 1932, and July, 1933, railroad common shares (Babson's list) averaged an increase in price of approximately 320 per cent, while for the industrial and copper groups the average appreciation for a single year amounted approximately to 153 per cent and 302 per cent. In the meantime business conditions remained very bad, bankruptcies were occurring on a stupendous scale, and the entire banking system had ceased to function, until in March of 1933 official moratoriums were established in the banking and insurance world, as well as with respect to the gold standard for monetary purposes. Yet despite all of the black news the market kept forging ahead. Just as the downward march of the depression was characterized by nine successive new lows in the stock market (the ninth low occurring in June of 1932), so the upward march out of the depression will be marked by a series of successive market highs. As always, the market precedes business, and acts contrary to what is seen, heard and read in the present. When business conditions were the best in 1929, the stock market was certainly a sale. Again, when business conditions were the very blackest during the last half of 1933, the stock market was certainly a wonderful purchase.

It is the failure to understand this fundamental law of price movements that has been the cause of enormous losses to the unthinking and unknowing, whose judgments are based on what is seen, read, and heard at the time. When the good news, whether it be big crops or large earnings, becomes common property, it has been discounted by the market; and similarly when the bad news is apparent to all it has likewise been dis-

counted. It is only natural, therefore, that the rank and file should regard the stock market as a most incomprehensible affair, always going contrary to what is so perfectly evident at the time. It is quite natural that they should always blame their losses on the working of the market rather than on themselves, although in reality their trouble is attributable to their failure to realize that major market movements anticipate and therefore precede the future.

Again, one should remember that the stock market is not distinct from other markets. The manufacturer, the merchant, the produce dealer, and the real-estate operator, all have an interest in its primary price movements since they have an important bearing on their own transactions. Many of the market's fluctuations, especially those of a few days or weeks, have little significance since they may represent only some particular local cause or the whim of some speculator. But if the market steadily and rapidly declines, many business men who know its "discounting" significance will assume a waiting attitude as regards their planned undertakings or will curtail their production; and this waiting attitude, since all business is closely interrelated, will react upon all other forms of business effort. On the other hand, if the market rises steadily and rapidly discerning business men will take courage with respect to the future prospects of business, and will manifest a desire to lay and complete their plans for increased production.

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CHAPTER IV

THE FUNCTIONS OF SHORT SELLING

General Nature of the Short Sale.—In any treatment of the functions of organized stock markets, considerable emphasis should be placed upon the operations of those who speculate for the fall of stocks through the process of selling "short" that which they do not possess with the object of buying back later at a lower price and then fulfilling delivery on their sales. By way of introduction the general nature of such a sale may be explained briefly.[1] Believing that a particular stock, let us say United States Steel common, will fall in price, a speculator sells 100 shares short in anticipation of the decline. His desire is to postpone delivery of the shares to the buyer until some later date when he hopes to be able to buy the shares for purposes of delivery at a price lower than that received on his sale. But this he cannot do, since the rules of the exchange require delivery on the second full business day following the sale. Fortunately for him, all United States Steel common stock is the same for delivery purposes and any 100 shares of it are as good as any other 100 shares. Accordingly, he borrows 100 shares from some one and delivers the same in fulfillment of his sale. The purchaser, quite unconcerned as to the source of the stock, pays the purchase price to the short seller, who in turn transfers the market price of the stock to the lender as security for the temporary loan. Now should the price decline sufficiently to induce the short seller to take his profit he will buy 100 shares (that is, "cover" his sale) in the open market,

[1] For an explanation of the technical aspects of short selling see Chapter XII on "The Short Sale."

return the same to cancel his temporary loan, and receive back from the lender of the stock the money deposited as security. Since the price at which he bought the stock in the open market was less than the price at which he originally sold, his profit will be equal to the difference, minus such expenses as may have been incurred in conducting the operation. Should the stock advance beyond the original sales price, however, our short seller will be confronted with a loss and will have to suffer the consequences of his poor judgment.

Many condemn and few sympathize with the short seller in the market, because of the belief that it is wrong to sell that which one does not possess; that no economic good is performed by the practice; and that short selling artificially depresses security prices. To many short selling seems to be a pernicious practice that ought to be suppressed. They seem to regard short sellers as a nuisance and a menace, as a group deliberately bent upon injuring the best interests of legitimate investment. In fact, many have urged the prohibition of short sales, and numerous attempts have been made at legislation with this object in view.

A moment's reflection, however, will show that these conclusions have little basis in fact. These opponents forget that short selling is a common practice in many leading kinds of business. The manufacturer is expected by the wholesaler to sell his finished wares at a definite price for some definite future delivery; and to assure the delivery of his goods at a stipulated price and time, the manufacturer expects the commission man or produce broker to sell the raw cotton, grain, metal, etc., for future delivery at a definite price, even before the crop has been harvested or the metal obtained. In fact, it is becoming increasingly clear that American producers, if they are to compete successfully in foreign commerce, must be in a position to enter into contracts for the future delivery of their goods in distant markets, at definite prices, and at agreed times. To accomplish this purpose, and at the same time eliminate the

element of gamble, it is necessary to secure quotations in advance on the requisite raw materials, marine insurance, foreign exchange and steamship space. As a matter of fact dealers in commodities, marine-insurance companies, foreign-exchange dealers, and steamship companies are usually willing to obligate themselves to the future delivery of their commodity or service at fixed quotations, thus enabling the exporter to determine in advance all the primary costs that enter into his venture. Contractors, likewise, in contracting for work at a definite price, are constantly selling labor and materials "short." The general practice of "hedging" on our commodity exchanges by those handling our important staples must also necessarily involve a short sale.

In business generally, therefore, short selling seems to be regarded as a necessary means of insurance against speculative losses. If recognized by all these business interests, it certainly cannot be maintained that it is wrong in the stock market to sell something that one does not now possess but intends to buy later.[2] Short selling is not responsible for the unwise buying and the unwise credit commitments and the world forces that cause our periodic ups and downs. Speculation, whether on the long or the short side, merely reflects the bearing of those fundamental factors upon values. It passes its collective judgment upon those factors and seeks to appraise them in the form of price quotations. The speculator, be he buyer or short seller, is interested in the correctness of his judgment with respect to

[2] Concerning the morality of short selling, William C. Van Antwerp makes the following statement: "If it is immoral to *sell* for a purpose, it is equally immoral to *buy* for a purpose; in each case the purpose is the hope of a profit. Buying for a profit is approved by everyone; why not selling? In both instances you have bought or sold for a difference in price; the *sequence* of the events in no way involves a question of morals, since there is no ethical difference and no economic difference between buying first and selling last, and selling first and buying last. Moreover, in selling short you do no injury since you sell to a buyer, at his price, only what he wants and is willing to pay for." *The Stock Exchange from Within*, p. 89.

the future course of prices. He aims to anticipate the future as regards business conditions. From a practical standpoint, speculators as a group are no doubt anxious to see prices higher rather than lower—at least sufficiently high to please the community—because they know that unusually low prices spell public criticism and endless trouble. When entering upon his commitments, the speculator has no reason to prefer declining over rising prices. There is no reason whatever for him to be a proverbial bear, or to be obsessed with a malicious desire to see values decline. Either side of the market will net him the same gain—furnish to him the same motivating force—and his only problem is to consider and interpret facts and to appraise correctly the factors which govern the future movement of prices.

The Stabilizing and Discounting Functions of Short Selling.—Critics are also wrong in contending that short selling does not perform an economic good, and that it actually depresses the prices of securities. The short sale in the stock market, and the same is also true of commodity markets, is often the greatest benefactor in repressing rampant speculative enthusiasm on the one hand, and in checking the effect on security prices of excessive pessimism on the other. Short sellers do not determine prices. By selling they simply express their judgment as to what prices will be in the future. If their judgment is wrong, they will suffer the penalty of being obliged to go into the market and cover their sales at higher prices. In making their sales they are just as open-minded in their reasoning as those who purchase because they believe the market will advance. With few exceptions their motive is not a malicious one. They simply hope to make a profit by correctly interpreting the market bearing of economic and political events.

Nine-tenths of the public, it is said, are by nature "bulls" and the higher prices go the more optimistic and elated they become. If it were not for a group of short sellers, usually

greatly in the minority but, as a class, superior in intelligence, who resist an excessive inflation, it would be much easier than now to raise prices through the roof; and then when inflation becomes apparent to all, the descent would be abrupt and likely unchecked until the basement was reached. The operations of the "bear," however, make excessive inflation extremely expensive, and likewise tend to prevent a violent smash, because the short seller, to realize his profits, must become a buyer for amounts equivalent to his sales. The writer has been told by several members of the New York Stock Exchange that they have seen days of panic when practically the only buyers who were taking the vast volume of securities dumped on the Exchange were those who had previously sold short and who now turned buyers as the only way of closing their transactions. They were curious to know what would have happened in those panic days, when everybody wished to sell and few cared to invest, if the buying power had depended solely upon the real investment demand of the outside public. In such times of distress the short seller becomes, as he has well been called, "the market's best friend." The "bull," it is true, will help the situation with his purchases. But the short seller renders the *double service* of retarding an unwarranted advance by his sales and of checking an unwarranted decline by his purchases.

In reply to the prevalent opinion that short selling unduly and artificially depresses security prices, it should be stated that short sellers are frequently the most powerful support that the market possesses. It is an ordinary affair to read in the daily press that the market is sustained or "put up" at the expense of the "shorts," who, having contracted to deliver at a certain price, can often be easily driven to "cover." Short selling is thus a beneficial factor in steadying prices and obviating extreme fluctuations. It constitutes a stabilizing force in the market at all times. Largely through its influence, the discounting of serious depressions does not take the form of a shock or convulsion, but, instead, is spread out over a period

of time, thus giving the actual holder of securities ample time to observe the situation and limit his loss before ruin results. Indeed, there could be no organized market for securities, worthy of the name, if there did not exist two sides, the "bull" and the "bear." The constant contest between their judgments is sure to give a much saner and truer level of prices than would otherwise exist. "No other means," reports the Hughes Committee for the investigation of exchanges, "of restraining unwarranted marking up and down of prices has been suggested to us."

But some may argue: We are not concerned with the services of short selling in normal times; instead during our recurring periods of business depression short selling serves greatly to aggravate the fearful decline in prices. To say that short selling is a substantial cause of the huge decline in security values during a depression period is to forget the fundamental factor causing such declines, namely excessive speculation during the boom years just preceding the smash—fanned to fever heat with the new-era idea and backed up with the dangerous extension of unwise credit—not only in the stock market, but in real estate, mining, oil production, manufacturing, and wholesaling and retailing. It is hard to believe that the vast moneyed interests of this great nation and the innumerable people with means could not literally swamp the short interest in the market—representing but a few million shares, and not more than about 5 per cent of current transactions—at any time that they really wanted to if they so desired.

In regard to the stabilizing function of short selling, fundamental economic factors may exert substantially the same ultimate effect as regards the total range of the price decline during a major business depression, irrespective of the presence or absence of short selling. But the real question is: How does the decline take place and what does short selling accomplish as a stabilizer during the time required by the market to pass from the high to the low price limits? The distance of the

downward movement may be the same, but it is one thing to drop abruptly from a precipice through a given distance, and quite another to descend an equal distance by rolling gradually down the hill. Short selling tends to break the downward price movement into gradual installments over a considerable period of time, rather than to have it occur with demoralizing abruptness.

To illustrate, the bear market of the 1929–34 depression has passed through nine successive new lows. With the exception of the first decline (particularly severe because of the virtual absence of a worthwhile short interest in ever so many stocks) all of the succeeding eight downward movements were fairly orderly and free from demoralization despite the blackness of the news. Each successive decline was halted, in large part by the buying of short sellers who had sold previously and who were desirous of taking profits following the decline, and so stage by stage through nine distinct movements, spread over a four-year period, the market gradually moved, without demoralization except in the first instance, to the ultimate level to which it was destined to go in any case because of fundamental economic conditions. In the meantime plenty of opportunity was given to individuals, bankers, and investment institutions to observe the situation and to limit losses before ruin resulted.

Other Functions of Short Selling.—The usefulness of short selling is by no means limited to the discounting of important events that affect the market, to the resisting of excessive inflation of the general price level of the market as a whole or of the price of any particular security, to the checking of unwarranted declines in times of panic and business depression, and to the steadying of prices by causing declines or advances to be gradual instead of violent. These general functions of short selling are supplemented by a large number of specific uses, each of which fills a distinct economic need, and all of which, considered collectively, make an organized market

much more serviceable to the community than would otherwise be the case. Owing to their intricate nature, a detailed discussion of most of these specific uses of short selling must be reserved for later chapters. It is considered desirable at this time, however, in order to give the reader a collective view of the subject, to enumerate these uses. Briefly summarized, short selling, in addition to the previously described functions, renders the following eight services:

1. *Enables Owners of Securities, Unable to Deliver at Once, to Sell the Same and Borrow for Purposes of Delivery.*—The investor with securities in his safe-deposit box is thus in a position, no matter how far he may be from home, to sell promptly whenever the price seems advantageous or when cash is urgently needed, and is spared the inconvenience and possible hardship that might result if immediate delivery of the particular shares sold was necessary. He is, therefore, spared the necessity of carrying securities with him on his journey. His order to sell may be transmitted by wire; the delivery will be effected by his broker through a loan of the security; and this loan will later, at his convenience, be canceled by a delivery of the shares held in the vault. Similarly, securities held in foreign countries may be sold, pending their transportation to the market where sold. Finally, sales may also be made against securities that have not yet been given deliverable form by the corporation but which the seller knows will be delivered later. In this way sales are sometimes effected in large volume before the security in question has been actually issued, thus giving a broad market, with its accompanying benefits, to investors, the banking community, and the corporation, much sooner than otherwise would be the case.

2. *Makes Possible the Hedging of a Dangerous Market Position.*—A new security, for example, may be carried by a promoter, investment banker, or broker with a view to selling the same from time to time as market conditions permit. Future

unforeseen market changes, however, may involve the holder in a huge loss. Accordingly, prudence may dictate the desirability of hedging this dangerous long account by selling short a sufficiently wide and well chosen range of other securities, of a similar nature, at current prices on the theory that fundamental changes affect the entire market more or less. Now should adverse circumstances arise, there may be a serious decline in the price obtainable for the new security, but this loss will be largely, if not altogether, offset by the profits realized on the short sales. Should market conditions be favorable to rising prices, the short sales, it is true, will net a loss, but as against this the favorable movement of the market will likely enable the promoter to accomplish his purpose of marketing his new issue at a substantial profit. Here short selling serves as a means of insurance with a view to reducing the hazard connected with a dangerous position in the market. To obtain the benefits of financial stability, freedom from worry, and greater certainty of average profits, the distributor of this new issue will regard a possible loss on his short sales, or a possible reduction of gross profits on the venture because of such sales, in the same light that business men view the payment of premiums for fire, marine, and other forms of insurance protection.

3. *Makes Possible the Operations of Odd-Lot Dealers.*—Probably 20 per cent or more of the total purchases and sales on the New York Stock Exchange consists of transactions in odd lots—lots of 1, 2, 10, 50, or some other number of shares less than the regular lots of 100 shares or multiples of 100. In their number these odd-lot transactions exceed the total number of regular transactions. They represent the purchases and sales of the millions of our ordinary people, who should be given the same opportunity for an immediate market, at small variations in price, as is accorded to the wealthy. This opportunity is furnished to the millions through the operations of odd-lot dealers, whose business it is either to buy or sell at

once, as the case may be, any odd lot which is offered or desired, and at variations of only an eighth or a quarter from the price prevailing for full 100-share lots.

But imagine the risk and difficulty to the odd-lot dealer in filling such small orders in the absence of short selling. A broker receives an order from his customer to buy 13 shares of a given stock. To avoid delay in finding a seller of this odd amount of stock, as well as the labor and inconvenience altogether out of proportion to the commission charged, the broker goes straight to an odd-lot dealer, who automatically sells the stock at a small fraction above the current price for 100 shares. The odd-lot dealer does not, of course, possess the stock, and cannot be expected to do so. All day long he sells odd lots in numerous stocks, i.e., offers them automatically as they are asked for and at prevailing prices. The poor are therefore given a market just as continuous and just as good—making allowance for a small fraction of a point—as the well-to-do.

Almost invariably the odd-lot dealer sells the stocks short, and only because of short selling can he render the service. He sells the odd-lot short in anticipation of disposing before long of a total of 100 shares in the given stock. Then he hopes promptly to cover his short sales with the purchase of a 100-share lot in the open market at a price which will yield a profit of about one-eighth. Speed is the very essence of his business. He relies upon the continuous market for the 100 shares, and in all probability manages to purchase the same, before too much time for an adverse price change has elapsed, from some one who sells the same short to him. Thus a short seller, in the open market, helps to protect the odd-lot short seller himself. If that odd-lot dealer were dependent for his 100 shares upon an offering from the outside, where the seller actually owns the stock, he would certainly have to be wary about the risk assumed and would increase greatly the margin between the price at which the odd lot was given and the prevailing price for 100-share lots.

Similarly, if the broker wishes to sell 13 shares for a customer, the odd-lot dealer will promptly take the same at a small fraction of a point below the price for 100-share lots. Again he anticipates the accumulation of 100 shares before long. Having done so, and not desiring to remain the owner of the shares, he proceeds to the open market to sell the same in the hope that there has been no unfavorable change in price. Here again the continuous market is his insurance. Dependence upon a buying order from the outside would certainly be risky. But in all probability the 100 shares are promptly taken by a floor speculator who desires to cover his short sale in the same stock, made some time previously. It is difficult to see how the present odd-lot system, so beneficial to the mass of our people, could operate without short selling. Risk must be borne by some one, and the odd-lot dealer, in the absence of an immediate market guaranteed by short selling, would not be disposed to take or to give the stock at an eighth or a quarter below or above the prevailing price for 100 shares. The marginal difference would have to be increased greatly against the public, assuming even that the odd-lot dealer would care to continue in his business.

4. *Facilitates the Work of Specialists.*—One of the functions of the specialist is to give a continuous market in those stocks that are comparatively inactive.[3] Specializing in one or a few stocks, a specialist stands in much the same position to those securities that he handles as the odd-lot dealer stands to the odd-lot business. Always ready to buy or sell, he makes a ready market at the best prices. At the same time, and this is highly important in the case of inactive securities, he is instrumental in reducing greatly the range of price fluctuations. If called upon to sell, he will in all likelihood not have the stock on hand. Instead, he will promptly accommodate the buyer by selling the stock short, and will later cover his sale in order to effect delivery. Put an end to short selling and to speculation and the specialists' work will be rendered difficult indeed, with the result that inactive

[3] For a fuller discussion see Chapter X.

securities will be less easily bought and sold, and will be subject to price fluctuations much greater and much more uncertain than is now the case.

5. *Makes "Arbitraging" Between Different Markets Possible.*—In the stock market this term refers to the practice, made possible when a security in one market happens to sell higher or lower than in another, of buying a stock in the low market and immediately selling the same in the high market with a view to making the difference in price. The practice is beneficial in a number of ways. It tends to level securities to a common price throughout the nation as well as with respect to the markets of foreign countries. It is also valuable in facilitating foreign exchange transactions. Moreover, arbitragers help to make the market more continuous, their buying and selling adding to the demand and supply which meet the needs of others. But while arbitraging itself aids the continuous market, it is also entirely dependent upon a continuous market if the two transactions are to be made simultaneously in the two different markets without an appreciable variation in the prices prevailing in those markets at the time the arbitrage transaction was undertaken. Moreover, as already pointed out, the continuous market upon which the arbitrager relies, is largely due to the practice of short selling. Again, the arbitrager is himself a short seller in the high market, and cannot operate if short selling is prohibited.

6. *Makes Possible the Practice of Arbitraging in "Rights."*—Stockholders in American corporations are very frequently offered the privilege of subscribing to new stock at some price below the current market quotation. This privilege—called a "right" in market terminology—has a computable value which may be realized by selling the rights in the open market long before the new stock is issued by the corporation. Probably the majority of outstanding stock in America has come into existence via this method, many corporations having increased their original outstanding stock tenfold or more, in this man-

ner. Moreover, probably the majority of stockholders desire to sell their rights at a fair price, rather than take up the new stock at the subscription price set by the corporation, possibly because they lack the funds and do not desire to borrow, but more probably because they do not wish to overload their investment basket with too much in a single issue.

The matter of selling these rights is therefore an important problem. Yet it is important to know that arbitragers furnish the continuous buying power that accommodates the thousands upon thousands of stockholders in such giant corporations as the Pennsylvania Railroad, the United States Steel Corporation, and the American Telephone and Telegraph Company, when they are all endeavoring in the course of a few weeks or months to dispose of their rights in the market. As the arbitragers buy the rights at a price slightly below their mathematical value, as compared with the price of the old stock, they sell an equivalent amount of the old stock short at the market price and borrow shares temporarily to fulfill delivery.

The slight difference in price—usually only an eighth or a quarter—constitutes their profit, and a small payment it is for the stockholder to make in view of his relief from trouble and the immediate receipt of the cash. When the new stock is finally issued by the corporation, possibly some six or twelve months later, having been paid for by the arbitrager in accordance with the terms specified by the corporation, the arbitrager will deliver the shares in fulfillment of the loan transaction entered into when the short sale was made. However, if the possessor of rights so wishes, he may sell old stock short for an amount equal to the new shares to be received later from the corporation. In the meantime he has borrowed shares on a short sale, but returns the loan upon the receipt of the shares from the corporation.

7. *Makes Arbitraging in Convertible Securities Possible.*[4]—Where a bond, for example, is convertible into stock, it is ap-

[4] For a detailed discussion see Chapter XVI.

parent that the two securities should sell in proper relationship to one another. What that relation should be will depend upon the terms of the conversion privilege. Suffice it to say here that an arbitrager can determine the mathematical equivalent of the two securities. Should one sell out of line as compared with the other, he will buy the low-priced security and sell short the high one. If the prices again move to their natural positions, he may sell his purchase and cover on his short sale, thus obtaining a profit that will depend upon the extent that the two prices come together. In other instances, where the circumstances permit, he may actually convert the security purchased and deliver the new securities obtained from the corporation in fulfillment of his short sale. By their constant watchfulness for small profits, arbitragers will cause convertible securities to sell in proper relation to the price of the securities into which they are convertible. By their numerous transactions they also make the market for convertible securities more continuous. Moreover, should a security rise in price because of its convertible feature, the holder may realize his gain without going through the process of effecting an actual conversion, that is, he may simply sell at the current price which, owing to the operations of arbitragers, is certain to include the gain referred to.

8. *Greatly Increases the Continuous Character of the Market.*—To be of greatest value to the community a stock market should be immediate and continuous in its availability for any stock as regards either buying or selling. Stated in another way, the market should be so organized as to enable buyers or sellers to obtain or to dispose of a given stock at any time, even in fairly large amounts, and with comparatively rare exceptions at a price varying but slightly from the last previous quotation. Such a market, as already explained, is of great value to the community in many respects. It gives to securities listed on the exchange the quality of liquidity, i.e., makes them practically synonymous with money. At a moment's notice the security

may be converted into cash, if need requires, and creditors and debtors may therefore look to the organized market as a dependable type of credit insurance. Enormous credit may thus be extended on the basis of a reasonably small margin as between current market value and the size of the loan. This creditors are willing to grant because of their knowledge that the collateral may be sold promptly in a dependable market which fluctuates but slightly in the course of an hour or a day. Similarly, holders of money may readily convert the same into securities for investment purposes. There is also assurance of a fairly continuous price quotation service to both creditors and owners, publicly and gratuitously available to all interested parties.

But the factor which gives this dependable continuity is the presence of an ever sufficient group of speculators always ready to buy or sell at any time during business hours. We all know the lack of dependability of an auction market, with its absence of short selling, and the great variations in price between sales at such a market. To prohibit short selling would tend greatly toward making an auction market of our organized stock market. Dependence upon actual demand or supply in any given stock from the outside public would certainly prove dangerous to the existence of an immediate and continuous market. But fortunately there is a large group (consisting of floor dealers who make speculation their life's work) containing a sufficient number at almost any time to meet the need of either demand or supply at reasonably small variations in price. If only owned stock could be sold, a purchasing broker would often find on the exchange no order to sell the amount desired. Much time would be wasted and the price would probably have to be raised considerably before attracting outside attention. Instead, however, the buying broker's bid is usually met promptly by some short seller, present on the exchange, at a small variation in price, and who just previously probably had little thought of making such a sale. Similarly, a sale of stock often could

not be made except with the loss of much time and a considerable concession in price, if dependent upon an order to purchase from the outside. However, this sale is likely to be made promptly, and at a small variation in price, to some floor speculator who concludes to cover his short sale in that stock made some time previously. Short selling thus greatly increases the selling and buying opportunities in the market. It makes for an immediate and continuous market. It helps to make a market free from auction handicaps.

Functions of Short Selling in the Commodity Market.—The preceding discussion is confined to the functions of short selling in markets that relate to invested capital. Yet much of the criticism of short selling has had its origin in the prevalent use of the practice on organized commodity exchange markets. In such markets, however, the practice is of even greater importance, indeed is absolutely indispensable to the modern requirements of the business community. Here, short selling serves the further all-important purposes (1) of enabling dealers, manufacturers, and exporters to enjoy the fullest benefits of so-called "future contracts"; and (2) of making it possible for the same classes to "hedge" their *trade profits* against loss through price fluctuations. Owing to the very general opposition to short selling in all types of markets and the repeated attempts to legislate the practice out of existence, a brief explanation of these two additional functions may not be out of place.

The first refers to the general practice in grain, cotton, coffee, metal, and other commodity exchange markets of buying and selling for "future delivery," that is, at any time during trading hours dealers and speculators are willing to enter into so-called "future contracts" for the delivery of a stated amount of produce at an agreed price within some designated future month. The value of such contracts to millers, manufacturers, exporters, and others, dependent upon a regular supply of produce, cannot be over-emphasized. The miller, for example, may

serve as a typical illustration. He may receive an order to deliver flour six months from date at a stipulated contract price, and, not possessing the wheat, may wish to know if he can safely accept the order. Or, his elevator capacity being small, he may desire to make sure of a regular supply of wheat from month to month, and at prices that will make it profitable to keep his mill fully employed. Without a continuous market in "futures," this miller would not be able to secure his supply months in advance and at definite prices, and every order for the future delivery of flour at a fixed price would be a speculation, unless he actually held the necessary wheat (a most inconvenient arrangement) at the time his contracts were accepted.

Under present conditions, however, the purchase of wheat and its storage prior to the acceptance of orders for the future delivery of flour is entirely unnecessary. As soon as the miller receives his order, he may at once ascertain the present price of wheat to be delivered to him at some future month best suited to his convenience. The existence of a broad continuous market will assure the prompt execution of such "future" purchases to practically any amount, and such a market exists, in turn, because of the presence of a large number of short sellers. In all probability the wheat purchased for future delivery has not yet been harvested, the short seller depending upon the continuous market as the source of supply from which he must later obtain the wheat necessary to fulfill delivery on his sale. Now if the miller finds the price of wheat satisfactory, and if we assume that he knows his other manufacturing costs, he can at once accept the contract for the delivery of the flour, let us say, in October, at the same time giving his order for the purchase of the requisite amount of September wheat at the prevailing price. Having concluded the two orders, the miller is certain of his trade profit—his milling profit—irrespective of future fluctuations in the price of wheat. We have here an instance where a short seller in the speculative market enables a manufacturer to become a short seller himself, that is. he is

enabled to accept contracts for the future delivery of the finished product at a definite price and with the assurance of a reasonable trade profit. In other words, the speculative market is used to eliminate speculation in business, the hazard of speculative price fluctuations being thrown upon those whose business it is to assume such risks.

But of equal, if not greater, importance to the business community is the practice, adopted by all leading interests in the grain, cotton, and various other organized commodity exchange markets, of "hedging" against the loss of trade profits through price fluctuations. And this important practice, it should be emphasized, is again absolutely dependent upon short selling and a continuous market, which market, in turn, is dependent upon the existence of numerous short sellers.

Hedging may be defined as the practice of making two contracts at about the same time, of an opposite though corresponding nature, the one in the actual *trade market,* and the other in the *speculative market.* Thus a purchase in the *actual grain market* of a certain amount of wheat at a certain price is promptly offset by a short sale in the *speculative market* on some large exchange of the same amount of grain for some convenient future month's delivery, with a view to avoiding any losses that might result from fluctuations in price. As soon, however, as the *trade* transaction is terminated by a sale, the *speculative* short sale must also be terminated, that is, covered by a purchase on the exchange. Both contracts are entered into at about the same time, and both must be terminated at about the same time if the hedger wishes to avoid speculation. But it must be clearly understood that the grain purchased in the trade market will not be used to fulfill delivery on the short sale made in the speculative market. Except for hedging purposes, the two transactions are independent of each other; that is, the grain purchased in the trade market will be resold to consumers, while the short sale in the speculative market will be covered by a purchase in that market.

Having hedged his wheat, it is apparent that whether the price rises or falls, our dealer is always substantially even. If wheat declines 20 cents per bushel, the dealer loses that amount on his trade wheat (four to five times the total profit he expects to make out of the actual handling of the wheat), but the amount lost here will be offset by the 20 cents' gain on the short transaction. Whatever the dealer makes by price fluctuations on the wheat he holds is lost on his short sale in the speculative market, and *vice versa.*

The question will at once be asked: How does the dealer make a profit since he is always even, irrespective of price fluctuations? Here we must distinguish clearly between the *trade profit* and the *speculative profit.* Our dealer wishes to avoid speculative risks and therefore makes use of the speculative market for the purpose of hedging. His business consists, let us say, in conveying grain from Chicago to New York, and it is in the handling and the transportation of grain between these two markets that he expects to make a *trade profit,* which is the result of his knowledge of the business and his ability to render this particular service in competition with other dealers. For example, let us assume that the differential in price between Chicago and New York is 10 cents, this difference including the cost of transportation, the cost of handling, and—very important from our standpoint—the profit that those in the grain shipping business between these two centers expect to make. Let us further assume that when the time for shipment arrives, the wheat in Chicago, purchased at $1.50 per bushel, has declined 20 cents. But through the operation of arbitragers, in turn dependent upon the right to make short sales, prices of wheat all over the country go up and down together. Fluctuations on the Chicago Board of Trade will be reflected promptly, therefore, in the New York Market. In other words, if wheat in Chicago drops to $1.30, the price in New York, under normal conditions and in view of our illustration, will be $1.40. Yet there is still the difference of 10 cents between the Chicago and

New York quotations, and this difference includes the *trade profit*. By hedging, our dealer is thus enabled to sell his wheat in New York irrespective of any decline in the price.

When denouncing speculation, short selling, and exchange markets, the critic should bear in mind the fact that dealers and exporters handling the nation's leading staples hedge nearly all their purchases, and that many manufacturers, likewise, do so extensively. Over 90 per cent of the grain held in the leading Western centers, we are informed, is thus protected on the exchanges of Chicago, Kansas City, Minneapolis and St. Louis. Nearly all of the cotton shipped to Liverpool is hedged there and in New York or New Orleans. Nothing is so common as the statement that the entire wheat crop of the country is sold several times over on the Chicago Board of Trade in the course of a year, and that most of the transactions must therefore be fictitious since they do not involve the actual delivery of the grain. But this large volume of transactions need cause no surprise when we reflect that the same grain in passing successively to the commission man, the elevator owner, the exporter, and finally the miller, is hedged by each one of these interests. Many illustrations may be cited where the same grain, in passing from the farmer to the consumer, is hedged half a dozen times, each hedging transaction involving two deals on the exchange, first a short sale, and later a covering purchase.

Let critics also bear in mind that British banks as a rule refuse to lend money on grain or cotton that is not hedged, and that in many instances American banks are calling attention in their advertisements to the attractiveness of hedged collateral. Even the farmers, who, as a class, are usually loudest in their complaints against operations on exchanges, are among the greatest gainers from the practice of hedging. Were it not possible for large elevator companies and exporters to hedge their holdings, the farmer would be unable to dump his large crops, as at present, on the market within the three or four months of the crop-moving season and receive cash therefor. No class

of middleman could be induced, at present small trade profits, to take a year's harvest within so short a time and hold it for gradual distribution during the balance of the year; and if any cared to be such reckless gamblers it is doubtful that bankers would care to finance their operations. Without the hedging privilege, elevator owners and grain dealers would be obliged to discount the enormous risk assumed in buying and storing large quantities of grain, and, to be on the safe side would have to make allowance for the worst contingency anticipated by offering the farmer a much smaller price than is now given. It is generally maintained by the leading interests in the market that without the hedging privilege farmers would receive an average price of at least 10 per cent under that prevailing today. Fundamentally, therefore, hedging is insurance against a real hazard in business. Leading commodity exchanges, such as the Chicago Board of Trade and the New York Cotton Exchange, render in this respect a function as legitimate and useful as our life, fire, and marine insurance companies; in fact, they should be regarded as among the greatest insurance institutions in existence. Here, by means of short selling, a type of risk is assumed by speculators so dangerous that no private insurance company has ever ventured to underwrite the same.

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CHAPTER V

REGULATION OF BROKERAGE TRANSACTIONS AND THE CONDUCT OF BROKERS

Importance of Such Regulations.—Great importance attaches to the safeguards that organized stock exchanges give to stock and bondholders by regulating brokerage transactions and by maintaining a standard of commercial honor among brokers, much higher than would otherwise exist. It is not at all surprising that in the free buying and selling of such a vast amount of mobile and easily transferable corporate securities, many questionable practices should have arisen. In this connection the constitution of nearly every stock exchange, as already pointed out, defines the purpose of the exchange as follows: "Its object shall be to furnish exchange rooms and other facilities for the convenient transaction of their business by its members, as brokers; to maintain high standards of commercial honor and integrity among its members; and to promote and inculcate just and equitable principles of trade and business."

No person elected to membership may be admitted to the privileges of the exchange until he has signed the constitution of the exchange, and by such signature he pledges himself to abide by it, as well as by all subsequent amendments thereto. The value of such an organized market becomes apparent when we take account of the gigantic frauds that have been perpetrated upon investors through advertising campaigns of persons unaffiliated with any recognized exchange, or by certain members of unorganized curb markets. While by no means perfect, the value of stock-exchange regulations, and most ex-

changes have similar regulations, to the investing public is so evident that more than a brief mention of them is unnecessary. Only the most important regulations will be noted, therefore, and these may be classified, using the New York Stock Exchange for illustrative purposes,[1] under those relating to requirements for admission to membership, supervision of insolvencies, regulation of partners and branch offices, rules governing the general conduct of business, rules against fictitious transactions, fraud and manipulation, supervision of advertising, market letters and other publicity, supervision of the execution of transactions, supervision of the conduct of accounts, and the general disciplinary rules.

Admission Requirements.—The greatest care is exercised by the important exchanges in admitting new members. To be admitted an applicant must exhibit his property holdings and show an adequate financial equipment. In this respect any misstatement upon a material point in the application, either for membership, or reinstatement, or an extension of time, may at any time subject the guilty party to suspension or expulsion. No application for the readmission of a person who has lost his membership on the Exchange through the violation of its rules, or for the reinstatement of a member who has been suspended because of insolvency or failure to meet his engagements, can be considered unless the applicant has secured the consent of two-thirds of the members of the Committee on Admissions of the Exchange. When a member, suspended for insolvency or failure to meet contracts, applies for reinstatement, he must furnish to the proper committee a list of all creditors, a statement of the amounts originally owing, and the nature of the settlement in each case (p. 41). Such proof of settlement with all creditors must appear satisfactory before the application for reinstatement can be balloted on by the Committee on Ad-

[1] Future references in this chapter, unless otherwise indicated, relate to pages of the Constitution and Rules of the New York Stock Exchange, as revised to October 10, 1933.

missions, and be referred to the Governing Committee. It should also be noted that the Constitution of the Exchange provides that "whenever the Governing Committee shall adjudge that a member prior to his application for membership has been guilty of a fraudulent or dishonest act and that the facts and circumstances thereof were not disclosed to the Committee on Admissions on his application for membership, the Governing Committee may expel such member" (p. 44).

Supervision of Insolvencies.—Any member who is insolvent or fails to perform his contracts, or who is a partner in a firm which is insolvent, is obliged to furnish prompt notice of that fact to the Exchange. He thereby becomes suspended from membership until reinstated by the Committee on Admissions, which cannot be effected until there has been an approved settlement with the creditors (p. 39). Following suspension for insolvency, the member "shall immediately afford every facility required by the Committee on Admissions for the investigation of his affairs, and shall after the announcement of his suspension file with the Secretary of the Exchange a written statement covering all information required by the Committee on Admissions, including a complete list of his creditors and the amount owing to each" (p. 40). Failure to settle with creditors within one year, or within such future time as may have been granted by the Governing Committee, will result in the disposition of the membership (p. 40). Should the Governing Committee decide that the suspended member "has been guilty of irregularity or unbusinesslike dealing," said member may be declared ineligible for reinstatement (p. 42). It is also important to note that the suspended member "may be proceeded against by the Governing Committee for any offense committed by him either before or after the announcement of his suspension, in all respects as if he were not under suspension" (p. 42).

Regulation of Partners and Branch Offices.—All important exchanges also regulate carefully the branch offices of members, and provide that all such offices "must be in charge of a

partner or of a manager or clerk acceptable to the Committee on Quotations and Commissions," and shall be subject to such rules as this Committee may prescribe (p. 57). The Committee is also empowered to require "the name, remuneration, term of employment, and actual duties of any employee," and at its discretion may "disapprove of said employment, remuneration, or term of employment" (p. 57). Except with the written approval of the Committee, all employees can be remunerated only with "a fixed salary not varying with the business" (p. 57).

All partners in firms registered with the Exchange "must have a fixed and determinable interest in its entire business" (p. 58). Nor may a partner, at any one time, be either a general or special partner in more than one firm registered with the Exchange. Nor may he form, or continue in, a "partnership with a suspended member of the Exchange, nor with any person who has been expelled therefrom, nor with an insolvent person, or a person who may have previously been a member of the Exchange and against whom any member holds a claim, arising out of transactions made during the time of such membership, and which has not been released or settled" (p. 59). Any member who is a general partner in a firm represented on the Exchange "is liable to the same discipline and penalties for any act or omission of said firm, as for his own personal act or omission" (p. 60). Moreover, the Governing Committee is empowered to dissolve any partnership or require the discontinuance of any business connection whenever it feels that "a member has formed a partnership, or established an office or headquarters, or is individually or through any member of his firm, interested in a partnership or business, or has formed any business connection whatever, whereby the interest or good repute of the Exchange may suffer" (p. 60). The Committee may also require a member to discontinue any business connection with a corporation or association, existing either directly or indirectly, when it appears that said corporation or

association "dominates the business of the member or firm or controls the policy of such business" (p. 60). Nor may a member or firm registered on the Exchange act as broker for any corporation or association if it "is controlled through stock ownership or otherwise by such member or firm or by a member or members of such firm and is itself engaged in the business of buying and selling securities as broker for others" (p. 61).

Rules Governing the General Conduct of Business.—These rules relate to a large variety of subjects and, among other matters, define and regulate the practices relating to commission charges, the kinds of bids and offers permitted, maturity of contracts, comparison of contracts to avoid misunderstandings, clearing and settlement of transactions, payment for and delivery of securities, closing of contracts in case of insolvency or failure to meet business obligations, deposits on contracts, and transfer and registry of securities. All of these regulations, subject as they are to the strictest enforcement, again serve to insure the regularity of purchases and sales and thus greatly benefit the vast number of investors and dealers dependent upon brokers when purchasing or selling securities.

All exchanges also provide for the arbitration of disputes that may arise between members, and if the non-member is willing, between members and their customers (p. 17). A non-member agreeing to arbitrate, may be required to execute an agreement providing for compliance "with such terms and conditions as the Committee may deem proper, and obligating himself to abide by the decision" (p. 18). All complaints of non-members charging members of the Exchange with wrong doing are promptly dealt with by the appropriate committee. Other sections of the New York Stock Exchange's Constitution provide for the prompt settlement of disagreements over the terms of contracts, the settlement of contracts, and practically every other dispute that might arise to interfere with the expeditious handling of business.

Rules Against Fictitious Transactions, Fraud and Manipulation.—As previously stated, one of the primary purposes of an exchange is "to maintain high standards of commercial honor and integrity among its members, and to promote and inculcate just and equitable principles of trade and business." To accomplish this purpose a very large proportion of the rules of the New York Stock Exchange, and the same may be said of other exchanges, are directed against fraudulent and unbusinesslike practices in the buying and selling of securities. In the first place the rules require the completion of every sale and purchase on the Exchange by actual delivery of the securities and payment therefor, and prohibit fictitious transactions, —"matched" orders and "wash" sales. Fictitious transactions have been forbidden on practically all exchanges for many years, and the New York Stock Exchange in February, 1913, in an endeavor to clarify the situation, adopted a resolution to the effect that "no stock-exchange firm shall give, or with knowledge execute, orders for the purchase or sale of securities which would involve no change of ownership." At present the rule reads: "A member who shall be adjudged by a majority of all the existing members of the Governing Committee guilty of making a fictitious transaction or of giving an order for the purchase or sale of securities the execution of which would involve no change of ownership, or of executing such an order with knowledge of its character, shall be suspended or expelled as said Committee shall determine" (p. 43). A further rule provides that: "Purchases or sales of securities or offers to purchase or sell securities, made for the purpose of upsetting the equilibrium of the market and bringing about a condition of demoralization in which prices will not fairly reflect market values, are forbidden, and any member who makes or assists in making any such purchases or sales, or offers to purchase or sell with knowledge of the purpose thereof, or who, with such knowledge, shall be a party to, or assist in carrying out any plan or scheme for the making of such purchases or sales or

offers to purchase or sell, shall be deemed to be guilty of an act inconsistent with just and equitable principles of trade" (p. 43).

Nor may any member be associated by any method whatsoever with any "bucket shop" or organization engaged in merely dealing in differences of quotations in the actual market, without a *bona fide* purchase or sale of the security or commodity involved. The Exchange rule on this subject reads: "No member shall be directly or indirectly interested in or associated in business with, or have his office directly or indirectly connected by public or private wire or other method or contrivance with, or transact any business directly or indirectly with or for (1) any bucket shop, or (2) any organization, firm or individual making a practice of dealing in differences in market quotations, or (3) any organization, firm or individual engaged in purchasing or selling securities for customers and making a practice of taking the side of the market opposite to the side taken by customers" (p. 110).

It is important at this point to distinguish between the real and the unreal in brokerage transactions, i.e., between the *bona fide* broker's office, from which orders are sent to the great exchanges of the country to be executed according to the usages and customs of the market, and the fictitious office where only bets on price fluctuations of stocks or produce are made between the customer and the proprietor of the so-called bucket shop. While many states have enacted laws prohibiting the operation of bucket shops, yet the disguises under which bucketing of orders is practiced have been so varied and clever that they exist even in localities where their operation has been declared illegal. Not only are the bets very one-sided and the "customer's" chances of losing much greater than of winning, but too frequently the patron's disadvantage is further increased by dishonest practices on the part of the *pretending* broker, such as manipulating the actual market to bring the price of a given stock to the point where the bets may be closed out,

or closing the shop through voluntary suspension should, perchance, a considerable number of patrons be winning. Moreover, the patron of a bucket shop is unprotected, because as soon as the price of the given security reaches a point where the customary small margin becomes exhausted (one single transaction in the actual market may bring the price to this point) all transactions at that price in the given bucket shop are declared closed. It should also be noted that the bucket shop proprietor renders no service whatever. He has made no actual purchase or sale and therefore has earned no commission or interest on money supposed to have been advanced to the patron. The pretended purchases or sales (bets) have no effect whatever on the prices of securities or commodities in the actual market, because they do not represent a supply of, or demand for, the actual stock or commodity.

Supervision of Advertising, Market Letters and Other Publicity.—Many nefarious practices in the security market have been associated in the past with the distribution of false information through the medium of advertising, circulars, market letters, and rumors. According to the rules of the New York Stock Exchange all advertisements of its members must be of "a strictly legitimate business character," and unless they are "in the general form approved by the Committee on Business Conduct, must receive the approval of this Committee before publication is allowed" (p. 102–3). Likewise, "every advertisement of a member offering to make purchases or sales of listed securities, must, before publication, in addition to the approval of the Committee on Business Conduct, receive the approval of the Committee of Arrangements" (p. 103).

All market letters issued by any member or registered firm must have received the approval of such member or firm by signed endorsement of the member, as well as the author, on an exact copy of the letter. This copy must then be made a part of the permanent records of the member or firm for at least three years (p. 103). Exchange rules also forbid "the direct or

indirect employment of representatives of the press by a member, for the purpose of obtaining 'advance or confidential information'" (p. 114). Members or registered firms are also prohibited from giving any compensation or gratuity for services rendered or to be rendered by any employee of any financial institution, newspaper, news service, etc., without the employer's consent and without having filed written notice of such consent with the Committee of Arrangements (p. 114). The circulation of rumors of a sensational character by members, even though not constituting fraud or conduct inconsistent with just and equitable principles of trade, is forbidden as "an act detrimental to the interest or welfare of the Exchange" (p. 115). All members are also ordered to "report to the Secretary of the Exchange any information which comes to their notice as to the circulation of such rumors" (p. 115).

Supervision of the Execution of Transactions.—Regulations under this heading are very extensive, especially with regard to the making of bids and offers, all of which must be observed, subject to a penalty for violation of not exceeding $250 fine, or suspension for not more than sixty days. Three rules, however, should be referred to specifically, namely,

(1) "When a member has an order to buy and an order to sell the same security, he must offer such security, if bonds at ⅛ of 1%, and if stocks at ⅛ of one dollar, higher than his bid before making a transaction with himself" (p. 81).

(2) "Members of the Exchange and firms registered thereon, . . . shall cause to be kept in their offices a record of the time of day at which all transactions take place in securities admitted to dealings on the Exchange" (p. 81).

(3) "It shall be the duty of every member to report each of his transactions as promptly as possible at his office, where he shall furnish opportunity for prompt exchange of tickets or comparison" (p. 81).

Supervision of the Conduct of Accounts.—Under this im-

portant heading, some nine regulations should be mentioned as being distinctly in the interest of clients, *viz.*:

(1) Acceptance and carrying of accounts for customers at an improper or inadequate margin is construed by the Exchange as "an act detrimental to the interest or welfare of the Exchange" (p. 108).

(2) "The improper use of a customer's securities is inconsistent with just and equitable principles of trade" (p. 108).

(3) "Reckless and unbusinesslike dealing is inconsistent with just and equitable principles of trade" (p. 108).

(4) The declaration by the Exchange that an agreement between member and customer whereby the member is authorized "to pledge securities, either alone or with other securities, carried for the account of the customer, either for the amount due thereon or for a greater amount or to lend such securities, does not justify the member in pledging or loaning more of such securities than is fair and reasonable in view of the indebtedness of said customer to said member" (p. 108).

(5) "No form of general agreement between a member and a customer shall warrant the member in using securities carried for the customer for delivery on sales made by the member for his own account, or for any account in which the firm of said member or any general or special partner therein is directly or indirectly interested" (p. 108).

(6) In connection with installment buying by customers. payment to be made by a series of partial payments, the declaration is made that any arrangement by a member, "under which the charge for purchasing and carrying any such securities is unreasonable, is an act detrimental to the interest or welfare of the Exchange" (p. 108A).

(7) The rendering of a statement of financial condition at least twice a year when members carry margin accounts is required in the form prescribed by the Committee on Business Conduct (p. 117).

(8) Authorization of the Committee on Business Conduct is required to fix the minimum amount of margin to be required by members accepting margin accounts.

(9) Members are required to report "all substantial pools, syndicates or joint accounts trading in specific securities listed on the Exchange in which such member or firm is, directly or indirectly, interested or of which such member or firm has knowledge by reasons of transactions executed by or through such member or firm," the Committee on Business Conduct having authority to disapprove such connection when the pool, syndicate or joint account is felt "to be contrary to the best interest or welfare of the Exchange or to be likely to create prices which will not fairly reflect market values."

General Disciplinary Rules.—As a further precaution against fraudulent or unbusinesslike practices most exchanges have adopted certain general rules that are far-reaching in their effects since they may be extended to cover every practice that may be regarded as contrary to just and equitable dealing. Thus Article XVII, Section 2, of the New York Stock Exchange's Constitution, provides that "a member adjudged . . . guilty of fraud or of fraudulent acts shall be expelled." Section 7 of the same Article provides that "a member who shall be adjudged . . . guilty . . . of conduct or proceeding inconsistent with just and equitable principles of trade may be suspended or expelled"; while Section 8 stipulates that "any member who may be adjudged guilty of any act which may be determined by the Governing Committee of the Exchange to be detrimental to the interest or welfare of the Exchange" may be suspended for a period not exceeding five years. As a still further precaution the Exchange established a Committee on Business Conduct. This Committee is charged with the duty of considering matters relating to the business conduct of members with respect to customers' accounts and of keeping in touch with the course of prices of securities listed on the Exchange,

with a view to determining when improper transactions are being resorted to.

From time to time, as events justify the same, various acts, practices, or omissions are declared to come within the scope of one or the other of the three aforementioned general rules. The significance of the aforementioned three rules as a means of maintaining a high standard of honor in a business that, almost more than any other because of the conditions under which transactions must necessarily be conducted, can easily lend itself to sharp practices on the part of unscrupulous persons, has been well stated in the following words: [2]

"The rules making acts contrary to just and equitable principles of trade a ground for expulsion enable the Exchange to hold its members to a standard of business integrity far higher than the law does or could require. A member may be expelled for doing that which, according to the standard of the most honorable of his own business associates, is deemed contrary to fair dealing, irrespective of the question whether or not it amounts at law to fraud or positive wrongdoing. He may be punished for reckless and unbusinesslike conduct, and even for errors of judgment. In all his transactions he has to conform to a standard which the law does not undertake to prescribe. Whatever he does has to be in accordance with 'just and equitable principles of trade'—a standard unknown to any system of law. Whether any particular act of his violates those principles is determined, not by any outside body of laymen like a jury and the application of technical rules of evidence, but by a select body of members of the Exchange chosen to uphold just and fair dealing, who ascertain the facts with businesslike directness, and who are empowered to expel, which is the ruin of a man's career as a broker, or to suspend, which is a deep

[2] John G. Milburn's "Brief on Behalf of the New York Stock Exchange," p. 724 of *Hearings before the Senate Committee on Banking and Currency on S. 3895, 63rd Congress, Second Session,* 1914.

humiliation. These rules are an illustration of the disciplinary efficiency of the Exchange."

Requirements of the Securities Exchange Act of 1934.—Under this legislation the Securities and Exchange Commission is virtually given complete control over registered stock exchanges with respect to all important matters pertaining to the discipline of its members. To be registered with the Commission, the exchange must agree to comply with the provisions of the Act, and, in so far as is within its powers, to enforce compliance upon its members. It must also agree to furnish copies of all of its rules and regulations, and any subsequent amendments, to the Commission, as well as any other information desired by the Commission. Registration is also conditioned upon provision by the exchange "for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade," and the declaration by the exchange "that the willful violation of any provision of this title or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade" (Sec. 6. lb).

Section 7 of the Act empowers the Commission to require such reports as it may prescribe, and gives the Commission access, through its representatives, to any part of any national securities exchange. Section 18 (a) covers false or misleading statements by any official, member or expert of the exchange "with respect to any material fact." Liability to the person injured for such false or misleading statements is declared to consist of "damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading."

The Act further provides that "any exchange is free to adopt and enforce any rule not inconsistent with this title and the rules and regulations thereunder and the applicable laws of the State in which it is located." It is also worthy of note that the proposed legislation extends disciplinary control to over-the-

counter markets. Section 15 makes it "unlawful, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest and to insure to investors protection comparable to that provided by and under authority of this title in the case of national securities exchanges, (1) for any broker or dealer, singly or with any other person or persons, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of making or creating, or enabling another to make or create, a market, otherwise than on a national securities exchange, for both the purchase and sale of any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills, or unregistered securities the market in which is predominantly intrastate and which have not previously been registered or listed), or (2) for any broker or dealer to use any facility of any such market." The Commission is authorized to establish rules and regulations "for the regulation of all transactions on such markets, for the registration with the Commission of dealers or brokers making or creating such a market, and for the registration of the securities for which they make or create a market."

Method of Trial and Effect of Suspension or Expulsion.—When a member is charged with having committed an offense, the accusation must be in writing and signed by the accuser. The accused is then given ten days to answer the charges in writing and to file the same with the Secretary of the Exchange. The Governing Committee then proceeds to consider the charges, the accused being "permitted in person to examine and cross-examine all the witnesses produced before the Committee, and also to present such testimony, defense or explanation as he may deem proper" (p. 48). But no member is allowed representation by professional counsel "in any investigation or hearing before the Governing Committee or any Standing or Special Committee" (p. 49). In all trials the finding of the Governing Committee (either by expulsion or suspen-

sion) "is final and conclusive" (p. 48). Where the accusation involves an offense punishable with a fine of not exceeding $250 or suspension not exceeding sixty days, the "Committee may proceed summarily," the accused being "summoned before the Committee, informed of the nature of the accusation against him and afforded an opportunity for explanation by personal or other testimony" (p. 49).

Refusal of a member to subject his books and papers, or the books and papers of his firm to the Governing Committee, or to any Standing and Special Committee, when requested, may cause suspension or expulsion as the Governing Committee may determine. The same is also true if the member refuses "to furnish any information to or to appear and testify before any Committee," or causes any of his partners or employees to fail to appear and testify (p. 46). It should also be noted that if the Governing Committee "deems that it is to the interest and welfare of the Exchange, or to the public interest, or in the interest of just and equitable principles of trade, to facilitate the examination by the authorities of another exchange of any transaction in which a member of the Exchange has been concerned and that the testimony of such member, his partners or employees, or his books and papers, or the books and papers of his firm or any partner therein, are material to such examination, and shall direct such member to appear and testify, or to cause any of his partners or employees to appear and testify," and there be non-compliance with the direction, the member "may be adjudged guilty of an act detrimental to the interest or welfare of the Exchange" (pp. 46–7).

"Suspension" means that the suspended member "shall be deprived during the term of his suspension of all rights and privileges of membership, except those pertaining to the Gratuity Fund, but he may be proceeded against by the Governing Committee for any offense other than that for which he was suspended" (p. 49). "Expulsion" of a member means a termination of "all rights and privileges arising out of his member-

ship, except such rights in respect to the proceeds of the transfer thereof" as may be allowed to him under the rules of the Exchange (p. 49).

Progressive Development of Disciplinary Regulations.—Despite criticism that has been directed from time to time against certain practices of American exchanges, there can be no doubt that the numerous aforementioned regulations governing brokerage transactions and the conduct of brokers, when considered collectively, are of incalculable value as a means of safeguarding the thousands of investors who, in buying securities, must engage the services of brokers who, if unregulated in their conduct and if free to do as they please, could easily misrepresent transactions to their clients. Perfection is not claimed for these regulations, but it is clear that without an organized market for corporate securities the average investor would stand in a most defenseless position and would be exposed to much fraud and misrepresentation. While there is always room for improvement, each year, fortunately, sees the adoption of new and more stringent rules by the several exchanges and the stricter enforcement of those already in existence.

The reasonable efficacy of existing rules for securing regularity and honesty in purchases and sales is apparent when judged from the standpoint of an exchange as large as the New York Stock Exchange. Despite the thousands of transactions daily, involving millions of dollars and effected in nearly all instances by a mere word or gesture, disputes rarely occur between contracting parties that are not promptly settled without resorting to litigation. As stated in the brief on behalf of the New York Stock Echange,[3] "the fidelity of the members of the Exchange to their customers is attested by the fact that, notwithstanding the unusual risks and temptations of the business, only 78 failures occurred in the last 13 years, or 6 a year. Thus, the annual ratio of members who failed during that period to the total membership was slightly more than one-half of one per cent;

[3] *Hearings on S. 3895, 63rd Congress, Second Session,* p. 724.

and half of those who failed settled with their creditors. It seems scarcely probable that any rules could be devised to produce a better showing." That statement was made in 1914. The solvency record of the New York Stock Exchange members since that year is set forth in the following table, and in comparison with banks and other business firms. That record it should be noted includes such depression periods as 1921–23 and 1929–32. It may safely be asserted that there is probably no group of business men among whom good faith in the fulfillment of business obligations and the strict observance of usages and customs are so proverbial, and the repudiation of contracts so practically unknown, as among the membership of a large exchange.

THE SOLVENCY RECORD OF NEW YORK STOCK EXCHANGE MEMBERS

(New York Stock Exchange Year Book 1931–32. p. 127)

The figures represent percentages of failures to outstanding totals

	New York Exchange Members	All U. S. Banks	National Banks	Commercial Houses
1915	0.09	0.49	0.26	1.32
1916	0.00	0.18	0.10	0.99
1917	0.36	0.15	0.06	0.80
1918	0.54	0.07	0.02	0.58
1919	0.27	0.17	0.02	0.38
1920	0.45	0.39	0.08	0.49
1921	0.72	1.31	0.49	1.02
1922	0.81	0.91	0.35	1.19
1923	0.45	1.91	0.93	0.94
1924	0.36	2.08	1.48	1.01
1925	0.09	1.60	1.36	1.05
1926	0.00	2.16	1.25	1.00
1927	0.09	1.47	1.38	1.07
1928	0.09	1.42	0.91	1.08
1929	0.16	1.72	0.87	1.04
1930	0.44	3.88	2.22	1.21
1931	0.59	6.57	5.82	1.33
1932	0.21	7.60	4.49	1.53

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CHAPTER VI

OPTIONS AND THEIR FUNCTIONS

Types of Security Options.—A full statement of the functions of organized security markets requires an explanation of the nature and uses of the various kinds of security options. Options on securities are usually of four types: privileges in the form of "puts," "calls," and "double options"; purchase warrants attached to bonds and stocks at the time of issue; options on authorized but unissued stock; and privileged subscriptions or "rights." The several types of contracts coming within these classes afford a way of operating in securities through the means of options similar to those which are used frequently in the business world. The holder of the option obtains the right to require the seller to deliver to, or to receive from him, as the case may be, a specified amount of securities at a designated price, within a specified time, according to the terms of the agreement. In all cases if the holder of the option does not wish to exercise his privilege he merely loses the consideration which he paid for it.

Security options falling within the four mentioned classes should not be confused with "seller's options," as used on the stock exchange and which will be described later,[1] or with "futures" as used on the organized commodity exchanges, which call for the delivery of specified amounts of a commodity within some future month. They differ essentially from these types of contracts in that the terms of "seller's options," and "futures," require that delivery must be made within a certain period,

[1] Chapter XI.

whereas a security option, as far as the holder of the same is concerned, may or may not be exercised at his discretion. In other words, under certain circumstances the holder of a security option will want the other party to comply with its terms, while at other times he may find it advantageous to allow the agreement to expire without demanding fulfillment.

The first three types of security options will be discussed in the order mentioned above. Because of its importance the fourth type will be discussed in a separate chapter.[2]

PRIVILEGES, OR PUTS, CALLS AND DOUBLE OPTIONS

The types of contracts coming under this class not only afford a way of operating in stocks through the use of options, but constitute, and this is their true economic function, a means of insurance to those who may have undertaken commitments on either the "long" or the "short" side of the market. The legitimate uses of privileges, however, are very often ignored, and too frequently such contracts serve as little more than a convenient means of betting on the trend of the market. Owing to the abuses to which privileges lend themselves, restrictions, as explained hereafter, have been placed by law and the stock exchanges against their use. However, such prohibitions should not cause us to overlook the economic and entirely moral uses of these types of contracts.

Types of American Privileges Explained.—Privileges, options, or papers, as they are variously called, are of two main types: namely, "calls" and "puts." Two other kinds of privileges, the "spread" and the "straddle" are sold, but these are merely combinations of "calls" and "puts" in each case. The latter two kinds of contracts are also called "double options," and "double privileges," and for convenience the first of these terms will be used frequently in this chapter. These four kinds

[2] See Chapter XVII on Privileged Subscriptions or "Rights."

of privileges, as sold in this country, may be described briefly as follows:

1. A *"call"* may be defined as an option that, in consideration of the premium paid, gives the purchaser the right to compel the seller (writer, or maker) to deliver to him a given number of shares of a named stock within a given time at a stipulated price. The price is usually placed somewhat higher than the prevailing market price at the time the "call" is purchased. The following is a copy of the contract as used by a prominent firm which specializes in options in New York:

CALL

New York, ...

On.....Shares.....@.....

For Value Received, the Bearer may **CALL ON ENDORSER** on one day's notice except last day when notice is not required

for.....Shares of the.....

Stock of the.....

at.....Dollars per share

any time in..... .days from date.

All dividends for which Transfer Books close during said time, go with the stock.

Expires.....

.....

.....M.

Delivery on C. H. Sheet of N. Y. S. E. or next day according to S. E. usage. This paper will not be accepted after it has expired. It must be presented to the Cashier of the firm it is endorsed by before the time limit on the day of expiration or on a previous day. Suggestion—deposit paper with your broker. Thus avoid loss or delay.

2. The *"put"* [3] is the reverse of the "call," and gives the purchaser, in consideration of the premium paid, the right to make the seller (writer, or maker) take from him a given number of shares of a named stock within a given time at a stipulated price, which is usually somewhat below the prevailing market price of the stock at the time the "put" is purchased.

3. A *"spread"* is a combination of the "call" and "put" and entitles the purchaser, in view of the premium paid, either to demand delivery from, or to deliver to, the seller of the "spread" a certain number of shares of a named stock within a given time at a stipulated price. The delivery prices in the "call" and "put" are again placed respectively higher and lower than the prevailing market price of the stock at the time the "spread" is purchased, but the amount above and below need

[3] The following is a copy of ε "put" contract as used by a New York firm, but not the one mentioned above:

This contract must be presented to the cashier of the firm it is endorsed by, before the expiration of the exact time limit.—It will not be accepted after it has expired and cannot be exercised by telephone.

Put No. C 4596

New York, ...*19*

For Value Received, *the Bearer may* DELIVER ME *on one day's notice except last day when notice is not required,*.....*Shares of the*.....*Stock of the*.....*Company, at*..... ....*Dollars per share any time in*..... .....*days from date.*

All dividends for which Transfer Books close during said time, go with the stock.

Expires.....*19*

.....*M* .....

Delivery on C. H. Sheet of N. Y. S. E., or next day according to S. E. usage.

not be the same. It should be noted, too, that either the "put" or "call" feature may be exercised before the expiration of the option period and that the closing of the "put" will not affect or cancel the "call" feature, or vice versa.

4. A *"straddle"* is similar to the "spread" in that it is a combination of a "call" and "put," but it differs in that the "straddle" permits both the "call" and the "put" to be exercised at the same price, which is approximately the market price of the security at the time the "straddle" is written. For example, the "straddle" price may be the price at which the last sale was made in the stock involved.

Definitions and Terms of Sale.—Certain terms and practices used in connection with the above contracts should be explained. The seller of the privilege is also called the *writer* or *maker*. The safest privileges are those *endorsed* by members of the New York Stock Exchange. When so endorsed the privilege can be exercised only by presentation of the option itself before expiration to the firm executing the endorsement. The endorsing firm receives and pays for securities that are "put" and delivers securities that are "called" and receives payment therefor. The money paid by the purchaser of the option as consideration is called the *premium*. The premium charged by practically all dealers for thirty-day "puts" is $137.50 per hundred shares. The premium for a thirty-day "call" is $137.50 per hundred shares, plus a tax of $5.00. Some of the best firms which specialize in privileges will not, as a rule, make offers for lots of less than 100 shares. Other reputable concerns, however, offer 50 share lots or other fractional amounts of 100 shares at prices proportionally higher to the buyer. Most of the options sold at the present time are for 30 day periods, but occasionally offers are made for periods as long as six months, and as short as 1 to 15 days.[4] "Puts," "calls" and "spreads" are sometimes written at the current market quo-

[4] Members of the New York Stock Exchange are not permitted to endorse options which are written for less than seven days.

tation prevailing for the stock at the time the privilege is sold. Such privileges are sold for considerably higher premiums than those charged for options in which the specified price is some points away from the prevailing quotation. For example, when "puts" and "calls" on U. S. Steel common are offered at three points away from the market price for 30 day periods at a premium of $137.50 per 100 shares, the same contracts will be offered "at the market" (the "put" and "call" price being placed at exactly the last price quoted on the exchange) for a premium of $375 per 100 shares.

The privileges used in this country always contain the provision that "all dividends for which Transfer Books close during said time, go with the stock." This means that if the holder of a "call" exercises the option he will be credited with any dividends, rights or bonuses of any kind for which the stock is quoted "ex" during the option period. Similarly, if a "put" is exercised, the holder thereof will be debited with dividends of any kind for which the stock sells ex-dividend during the period. Privileges, when endorsed, also contain the provision that the holder, in order to exercise his option, must present it "to the cashier of the firm it is endorsed by, before the expiration of the exact time limit. It will not be accepted after it has expired and cannot be exercised by telephone." This provision is plain and it is rigidly enforced. Therefore, it is advisable that the option be left in the custody of the owner's broker. Stock exchange firms are willing to hold options and to exercise them by presenting them to the endorsing firm, if so instructed by the owner. The regular commission charge is made for this service.

The following are the first ten offers contained on a quotation sheet of recent date sent out by a well known "put" and "call" firm: [5]

[5] Capitals in parentheses are ticker tape symbols of the stocks. The points above and below the market price at which the options are written change from day to day, and the above are given merely for illustrative purposes.

Latest Thirty Day Privileges

Points Below the Market		Points Above the Market
PUT	STOCK	CALL
10	Air Reduction (ADN)	15
15	Allied Chemical (ACD)	15
8	American Can (AC)	9
4	Amer. Smelting Co. (AR)	6
6	American Sugar Co. (ASP)	7
8	American Tel. and Tel. (T)	9
6	American Tob. "B" (ATB)	7
1	Anaconda Copper Co. (C)	1½
7	Atch., T. & Santa Fe (A)	8
12	Auburn Auto. Co. (AAC)	12

American and London Options Contrasted.—In view of the importance of London privileges in the American market, a brief explanation of them is in order. Such options are sold by reputable London houses which in most instances confine themselves largely to the option business. Through their American representatives, the London firms periodically publish quotation sheets giving the current prices, or premiums for "puts" "calls" and "straddles," on various American stocks dealt in on the London Exchange. The quotations are usually given for various periods, such as one, two, three, or more months. Although sold in the American market, some London privileges are governed by the rules of the London Stock Exchange and, accordingly, an option good until the end of a certain month is understood to mature "on the day before the 'making-up' day of the last settlement for that month, which generally comes three to six days before the last day of the month, and is fixed by the London Exchange Committee about two months in advance." Should the owner of the option intend to exercise the privilege, notice must be given on this day. Numerous London options, however, are sold in New York on the same basis as New York options, that is, they may be called any time during the option period. London privileges are

always executed at the current market price, called "at the market," and not "points away" as are the American options.

Legitimate Uses of Privileges.—The insurance function is the most legitimate feature connected with the use of privileges. The justification of a speculative group in our organized markets has already been discussed. If this contention is correct, it follows that speculators and others having entered into transactions in the security market, should be free, if they choose, to utilize a type of contract that will tend to lessen the hazards involved. Persons who are in the market on the long or short side may use privileges as a means of protection. The holder of stock who buys a "put" or the short seller who buys a "call" thereafter knows the exact extent of his risk, irrespective of market fluctuations. Thus, the owner of stock, when he purchases a "put" knows that even if the market price of the stock moves downward, his loss is limited absolutely to the amount of the premium plus the difference between the current price of the security at the time the option was purchased and the agreed price at which the security can be "put" to the seller of the option.[6] On the other hand, if the market price moves favorably, the holder of the option has offered to him the possibility of a profit larger than the amount paid for the privilege, in which case he will allow his option to lapse.

Privileges, when used for insurance purposes, serve the same general purpose as stop-loss orders, namely, to limit losses on market commitments, at the same time leaving open the possibility of increased profits. In one important respect, however, privileges have an advantage over stop-loss orders when used

[6] Another expense is the broker's commission, which, as previously explained, is charged when an option is exercised through a brokerage house. When a "put" is exercised the broker is ordered to buy the shares in the market and deliver them to the seller of the "put." Likewise, when an option holder closes a "call" he usually orders his broker to receive the shares from the seller of the "call" and to sell them on the market. Thus, there are two commissions and a tax on the sale of the shares in the market.

for insurance purposes. Suppose, for example, that "A" and "B" each buys 100 shares of General Motors at 50 and that "A" protects himself with a "put" at 47, while "B" decides to place a stop order to sell at 47. If the market reacts and General Motors sells at 46, "B" will be sold out at or near 47, since a sale at 47 or lower causes his stop order to become an at-the-market order. "A", who is protected by his "put" can afford to wait until the end of his option period with the hope that a subsequent rally will occur and permit him to sell his stock at a profit. Stop orders terminate when executed and do not give the user thereof the benefit of future favorable price movements.[7]

A few other illustrations will serve to make the insurance function of privileges clearer. Let us assume that, with a stock selling at 90 a hundred shares are sold short, and that the short seller, while believing that the stock will decline, nevertheless desires to protect himself against a substantial rise. This may be accomplished through the purchase of a "call," which is obtained for a premium of $137.50, plus $5.00 tax, or $142.50. Under the terms of the "call" the holder has the privilege, during a period of 30 days, of calling the stock from the seller of the option at a price of four points above the market, or at 94. If the price declines to 85, the short seller can cover in the market with a profit of $500 on the short sale. His net profit will be $500 less the $142.50 premium for protection, commissions to his broker on the sale and purchase, and the government tax on the sale of the stock. If, on the other hand, the price rises to 100 the short seller, provided he has not secured the protection of a "call," will suffer a loss of ten points if he purchases the stock for delivery on his short sale. The possession of the "call," however, gives him the privilege of calling the stock at 94, thus limiting his loss to the difference of four points ($400) between the sale price of 90

[7] See Chapter XI for a discussion of customers' orders.

and the call price of 94, plus the premium of $142.50 and the broker's commissions.

Frequently, and in a manner similar to the foregoing illustrations, "puts" and "calls" are used by those who already are fortunate enough to have a considerable profit on their purchases or short sales, which they do not desire to take because of a further expected rise or decline, but which they nevertheless wish to protect against violent price fluctuations. In such instances privileges serve the purpose of protecting profits rather than limiting losses. Although rarely used for this purpose, "puts" sold by reliable firms have been accepted by brokerage houses in lieu of further margins, in order to protect a customer's loan against the contingency of an indefinite market depression of the collateral deposited as security.

The legitimate uses of privileges, however, are by no means confined to the insurance function as just described. Privileges provide a ready means of operating in stocks in a speculative manner, which is as legitimate if carried out properly, as the speculative use of options in the real estate market or in any other field of business. Thus, let us assume that a considerable advance is expected in a given stock and that a speculator does not care to hazard a large sum or does not desire to take the risk of purchasing the stock by depositing the customary margin against a speculative purchase and assuming the liability of further margin calls in case of a decline. Instead of undertaking a margin transaction, this speculator may follow the plan of procuring a "call" for a period of, say, 30 days for a premium of $137.50 plus a $5.00 tax, with the call price a few points above the current market price. Now, whatever the course of the market in the future, the option holder's liability is limited to the cost of the "call." Should the stock, however, advance sufficiently above the "call" price to make it seem advisable to take a profit, the option holder may sell short in the open market, and then exercise his right of calling the

stock for purposes of delivery against his sale. In this connection, it is important to note that it is never wise to exercise an option before the due date. If, for example, the above "call" is exercised as soon as the short sale is made the trader thereby ends his rights to a possible further profit. The reason for not exercising the option at once should be evident. If, after the short sale, the price of the stock continues to advance the trader can always resort to his "call" to obtain the stock to cover his short sale. Should the price fall, however, his profit might be greater by a purchase in the market. Furthermore, after a purchase is made in the market to cover the short sale, and while the "call" still has some days to run, the price may rise again sufficiently to permit the trader to sell short the second time, with the assurance that his option can always be exercised to give him a profit. When a trader makes more than one transaction in the market against an option in the manner just explained he is said to be "trading against his option."

Because of its importance some further explanation may be given regarding "trading against options." Often the holder of a "put" or "call" may wish to take advantage of market movements and make several turns during the life of his option. Thus, suppose a "call" is purchased on a stock at 105, which is three points above the prevailing market price. If thereafter the price of the stock should advance so rapidly as to warrant a belief that a reaction in price will follow, the holder of the "call" may sell the stock short in the open market "against his option." Suppose this sale is made at 110. Then, should the stock decline in price as expected, to say 102, it may be purchased at this figure, and still leave the speculator in possession of his option. Possibly before the expiration of the "call," the fluctuations in the stock may enable the making of one or more additional sales and repurchases. If at any time, when a sale has been effected, the stock should not decline as expected, but instead continues to rise, the holder of the "call' has his option to fall back upon and he will be pro-

tected in the manner previously indicated. A like procedure of trading against his option, it is apparent, may be followed by the holder of a "put." Similarly, a "double option" (spread or straddle) may be used as a means of protecting a dealer who makes numerous trades in a given stock and wishes frequently to change his position in the market. "Double options" are bought when the buyer feels that the market is apt to show considerable fluctuation during the option period, or when a trader, believing that a big market movement is imminent, does not know whether the movement will be up or down, but wants to have the opportunity of profiting therefrom, no matter which way it goes. After a "double option" is purchased, the trader may proceed to trade against his option as often as opportunity permits, but should the dealer at any time be caught by a market rise following a sale, he may fall back upon the "call" feature of his option. Likewise, should the market decline following a purchase, he will be protected by the "put" feature. Traders, as we have seen, serve to make a market more continuous in character. In this respect their calling may, if they choose, be rendered less hazardous, since "puts," "calls" and "double options," may be used as a means of insurance against excessive loss. From this standpoint privileges may be described as term insurance policies, which in consideration of a definite cost, change a speculator's position from one of great uncertainty to one of approximate certainty.

Abuses of Privileges.—No discussion of privileges is complete which does not refer to the common practice of using privileges purely for betting purposes. This unfortunate *misuse* to which the American option so easily lends itself, because it may be exercised at any time during the option period, has been the cause of much adverse criticism. It, together with other abuses to be mentioned, has led to the adoption of anti-option laws and stock exchange prohibitions, and has been responsible chiefly for the general failure to appreciate the legitimate functions. The practice referred to consists of the

use of "puts" and "calls" as bets upon price fluctuations without any intention of effecting an actual delivery of securities. For example, a person not wishing to sell a stock in the open market may, as we have seen, purchase a "put" instead. Now should the price of the stock fall sufficiently it is assumed that the option holder will purchase the requisite number of shares in the open market at the prevailing price, and upon delivery of the stock to the seller of the option, will net the difference between the "put" price and the lower market price at which the stock was bought, less the cost of the option and the commissions charged by the broker. Similarly, a "call" may be purchased in anticipation of a rise in price, thus enabling the holder to call the stock with a view to selling it in the market at a higher price. Very often, however, actual purchases or sales in the market are not effected by those who purchase privileges, and, in fact, the parties to the agreement never intended that there would be an actual delivery of the stock. Instead, the settlement consists of a payment of the difference in prices, thus making the option a pure bet on price fluctuations.

The individual who is not thoroughly familiar with options and their uses should not only investigate carefully the possibilities connected with the uses of options for his particular purposes, but he should use great caution in the selection of firms from whom he wishes to purchase options, if he decides they will be of service to him. The ease with which a firm may establish and conduct an option business, so long as things run smoothly, has naturally caused firms of questionable standing to enter the field. Firms of the questionable type mail attractive literature to all parts of the country offering to sell options at attractive prices and describing in glowing terms the ease with which profits can be made in buying them. Such firms, when the market goes against them and they begin to lose money, often try to get their money back by giving their clients a "credit" on their books, or selling other op-

tions in return for accumulated profits. Should losses continue a convenient receivership is arranged, or the firm disappears. The best firms have their options guaranteed by members of the New York Stock Exchange and the buyer should insist upon such a guarantee before any purchases are made. Furthermore, the purchaser should insist that the option be in his possession since under such circumstances he will have a good option, even though the seller or maker fails.

The use of privileges may also be abused at times by manipulators who desire to influence the opinion of the speculative community. Offering "puts" freely at small premiums and at prices near the market price would seem to indicate confidence on the part of the option seller in a future rise in the price of the stock under consideration; while a willingness to sell "calls" on liberal terms would seem to indicate the contrary. By their apparent readiness or unwillingness to sell privileges, large operators have at times sought to mislead the Street as to their true market position. At other times "puts" or "calls" have been freely sold by leading operators because they were anxious to accumulate or distribute certain lines of stocks and, therefore, were willing to receive premiums on privileges and have the stock delivered to them in case of "puts" or called from them in case of "calls." In other instances, the free sale of "puts" has constituted an important part in the operation of a corner.[8]

Legal Status of Privileges.—The frequent misuse of privileges has naturally caused their legality to be questioned many times in the courts. In the absence of statutes prohibiting privileges, the courts have enforced such contracts where the facts did not clearly show that the agreements were mere wagering arrangements. Thus in one case the court said: "Such contracts

[8] As illustrating this use of privileges, in this case a "put," see *in re* Chandler, 13 Am. L. Reg. (U.S.) 310. The case relates to a corner in oats, and Chandler, in order to impress the market with his ability to maintain the inflated price, freely offered to sell "puts" on extremely liberal terms.

are not illegal, unless there is no intent to deliver, but merely an intent to settle and pay the differences according to the rise or fall of the market." [9] In another case the legality of a "straddle" was considered, the defendants contending that the contract violated the statute against gambling. In its decision the court said, in part: "One may pay for an option to take at a future day, at a certain price, a farm, or any article of personal property. There is always uncertainty as to what the property will be worth at the day named, and if it should then be worth less than the price named, he will not take it. In all this there is not necessarily a bet or wager. It is an ordinary business transaction. And the case would not be altered, if instead of paying for an option to buy, he pays for an option to sell at a future day. Most contracts for the purchase or sale of merchandise at a future day are made with a view to the market price on the day of performance. There is always an element of speculation and uncertainty as to that, and yet it has never been supposed that there is any betting by such contracts. Here the option to buy or sell was put in the same contract. On the face of the contract the plaintiff provided for the contingency that on that day he might desire to purchase the stock, or he might desire to sell it, and in either case there would have to be a delivery of the stock or payment of damages in lieu thereof. We should not infer an illegal intent unless obliged to. Such a transaction unless intended as a mere cover for a bet or wager on the future price of the stock, is legitimate and condemned by no statute; and that it was so intended was not proved." [10]

The Securities Exchange Act of 1934 contains provisions relating to privileges which are intended to prevent manipulation of security prices. Section 9 (b) states that "It shall be unlawful for any person to effect, by use of any facility of a national securities exchange, in contravention of such rules

[9] Frankfurter *v.* Silverman, 124 *Misc.* 751.
[10] Story *v.* Salomon, 71 *N.Y.* 420.

and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors—(1) Any transaction in connection with any security whereby any party to such transaction acquires any put, call, straddle, or other option or privilege of buying the security from or selling the security to another without being bound to do so, or (2) any transaction in connection with any security with relation to which he has, directly or indirectly, any interest in any such put, call, straddle, option, or privilege, or (3) any transaction in any security for the account of any person who he has reason to believe has, and who actually has, directly or indirectly, any interest in any such put, call, straddle, option, or privilege with relation to such security." Section 9 (c) makes it unlawful for any exchange member, in contravention of the commission's rules, "to endorse or guarantee the performance of any put, call, straddle, option, or privilege." Section 9 (d) makes it clear that the above provisions are not to apply to "any registered warrant, right or convertible security."

Writing and Selling Privileges.—In contrast with the rules of the European markets which permit trading in stock options on the exchanges, the rules of the New York Stock Exchange provide that "no offers to buy or sell privileges to receive or deliver securities shall be made publicly on the floor of the Exchange." [11] This rule does not restrict the activities of members off the floor with respect to privileges. As stated before, however, members confine themselves to the endorsement of privileges written by others, and to the exercising of options for customers when such requests are made.

Privileges may be written by any person or firm. Thus, an individual who owns stock outright, or carries it on margin, may at any time issue a "call" against his holdings. Or, the individual may issue a "call" without having such holdings, and if the "call" is exercised, the stock may be borrowed for

[11] Rules of the New York Stock Exchange, Chapter I, Sec. 11.

delivery, and the writer will then be in the same position as a short seller in the stock. "Puts" may be issued in a similar manner against a short position in the market, or when the writer is willing to assume a long position should the option be exercised and the stock delivered to him. In all such cases of issuing an option, the writer, if he gives proper security, may have his options endorsed by a member of the exchange.

Most writers of options may be classified roughly into two classes: the firm or business class composed of writers such as investment trusts and banks; and the individual speculator or operator class composed of individuals writing for their own account. The investment trust may write "calls" against its portfolio, thereby marking down the cost of its securities by the premiums received. If the "calls" are exercised, a profit will be obtained equal to the difference between the market and the "call" price, and "puts" may be sold immediately with the hope of regaining the securities. The individual speculator may write options in the manner previously described.

In order to bring sellers and buyers of privileges together there exist firms known as "option brokers," "put and call" brokers, etc. These firms act principally as brokers, but they also at times buy and sell options, since such contracts are made out to "the bearer" and may be assigned from one holder to another. With respect to the brokerage functions one house states: "We are never the principals in option transactions. We are brokers between the two principals and as brokers, we consider it our duty to obtain the best market possible for the customer who pays us our commission. . . ." Another firm states, with reference to the dealing function: "We buy options and we sell options; we do not write papers, and in every way, avoid a prejudiced position. If you have writings or if you are a prospective purchaser, we shall be pleased to have you submit your bids and offers." A small number of firms thus specializing in options have been in business in New York City since the beginning of the present century.

Factors Determining the Price of Options.—To have their business yield reasonably dependable profits, sellers of privileges should be careful to avoid a hit or miss policy and should follow a fairly scientific plan of determining the cost of the options they offer. Their line of reasoning should resemble that followed by insurance companies in arriving at their premiums. Naturally the premium which should be charged for a "put" or "call" written "at-the-market" will depend largely upon the length of time during which the option is to run and the activity of the stock named in the contract. The shorter the period and the more inactive the stock the less likely is the buyer of the option to exercise the rights under the agreement.

To determine the premium which should be charged for an option written "at-the-market" it is desirable for the seller to arrive approximately at the past *average* fluctuations of the stock under consideration during the period of time the option is to run. The average fluctuations correspond to the average loss ratio as determined by insurance companies, and the cost of meeting these average fluctuations corresponds to the "net premium" in insurance. Just as insurance companies must add to the net cost in order to allow for expenses and profits, so the seller of privileges should arrive at his premium for options written "at-the-market" by adding (1) a fair margin of profit, and (2) an allowance for contingencies. In the insurance business it is also highly desirable to secure a sufficiently large number of risks and to distribute them properly in order to reap the benefits of the law of average. Correspondingly, the seller of privileges should seek not only to do a sufficiently large business but to scatter the risks over many different stocks.

When the option is written at "points away," as most American options are, the premium, as stated before, remains the same regardless of the length of the option or the activity of the stock. The risks of fluctuation for any option period are

adjusted to the premium through the number of points away from the market as set forth in the contract. This number of points away should correspond to the average fluctuation for the period, as mentioned above. The regular premium charge, therefore, should be sufficient to provide for the risk incurred by the seller, plus a fair profit.

STOCK PURCHASE WARRANTS

Definition and Purpose.—In recent years many issues of bonds and preferred stocks have been sold to investors with warrants attached. The bond or preferred stock may carry one or more warrants, and each warrant gives the holder the right to purchase a certain number of shares of common or preferred stock of the issuing corporation at a certain price. The purchase price is always some distance above the current market price of the security which can be purchased, but it is generally placed low enough to evidence the possibility that the warrant may become valuable at some future time. The attachment of a warrant thus furnishes a speculative appeal which aids the corporation in the sale of its securities. As stated elsewhere,[12] bonds and preferred stocks with warrants attached have become so numerous in recent years that they now rival in popularity the number of issues of bonds and preferred stocks with a convertible privilege included. Both the warrant and the convertible feature are speculative features designed to make the securities in which they are included more attractive to the investor. They differ, however, with respect to the procedure to be followed when the right is to be exercised. The convertible security must be sold or turned in to the corporation in order to obtain the profit which has resulted therefrom. On the other hand, the holder of a security with warrants attached in most cases has the right to detach the

[12] See Chapter XVI, pp. 288–89.

warrants and sell them on the market, or exercise them, thus retaining his original securities.

Quotations of Warrants.—Since some warrants are not detachable a distinction must be made in the market quotations for securities which have been issued with warrants attached. Quotations for such securities, therefore, will be designated as "with warrants," and "without warrants," or, "ex-warrants." Where the warrant is not detachable the holder, if he wishes to exercise his right, must send the bond or stock to the corporation where the warrants will be detached, or a new bond or stock without warrants will be issued.

Provisions Protecting Investor.—Most warrants contain provisions protecting the holder against the payment of extra dividends in the form of cash, stock, rights, or any other act on the part of the corporation which would result in a lower price of the stock which may be purchased under the warrant agreement. If the security to which the warrant is attached is callable, the holder is usually protected by a provision which requires the corporation to give notice of redemption, the advance notice in most cases being 60 or 90 days. Such notice permits the holder to exercise his warrant, or sell it, if it is valuable. Where a warrant is detachable, provision is usually made that delivery thereof will vest title in the transferee "to the same extent, for all intents and purposes, as in the case of delivery under similar circumstances of a negotiable instrument, payable to bearer." Sometimes a warrant may not be detached for a certain period, in which case it is transferable only when attached to the security in its original form.

Stock purchase warrants should not be confused with "rights," [13] or the warrants which are issued to stockholders

[13] "Rights" are also called "privileged subscriptions." This term should not be confused with "privileges" as used heretofore in connection with puts, calls and double options.

as evidence of the right to purchase stock at a price below the prevailing market price.[14]

OPTIONS ON AUTHORIZED BUT UNISSUED STOCK

Sources of Stock Options.—Options on stock may originate in ways and for reasons different from those described in the preceding pages. The most important source of stock options not mentioned thus far is the issuance of options on authorized but unissued stock of corporations. Many corporations have only a portion of their total capital stock outstanding in the hands of investors. The authorized but unissued stock in such cases is available for the purpose of raising cash, paying for goods and services, and in general, for purposes beneficial to the corporation. Frequently directors of a corporation are given authority to issue stock from time to time under such conditions and for such purposes as they deem wise.

Other sources of stock options may be mentioned. For example, options may be granted by corporations on treasury stock; or by parent companies or affiliates, should they wish to dispose of their holdings in other companies; or by banks when they wish to liquidate stock held as security for loans; or by brokerage firms or individuals who own large blocks of stocks and wish to sell them.

Reasons for Issuance of Stock Options by Corporations.—Corporations frequently find it desirable to grant stock options when they wish to raise cash through the sale and distribution of additional stock on the market. In such instances options on authorized but unissued stock are given to investment banking firms or others who underwrite security issues. The option may be a "call" which permits the underwriter to obtain the securities which are being underwritten at a specified price when sales are made to the investing public, or it may be a "put" which permits the underwriter to return any unsold securities at the agreed price.

[14] See Chapter XVII for an explanation of "rights."

Options on authorized but unissued stock are also frequently given to investment bankers and others who underwrite securities as part payment for their services performed in the underwriting of the corporation's security issues. These options, as well as those to be described in the next paragraph, are similar in nature to the stock purchase warrants described above. The option may run for periods of time varying from several months to several years. During the option period the holder of the option will profit should the market price of the security on which he has an option rise above the price at which the option may be exercised.

For the purpose of stimulating their managers and others connected with the corporation to greater efforts, boards of directors have frequently given to these persons options to purchase blocks of stock. The options usually run for periods varying from several months to several years. The purchase price, which is always at a point above the current market price, may remain constant or increase at stated intervals until the expiration of the option. Options of this nature may serve not only to stimulate the managers in increasing the profits of the corporation to a point where their options become valuable, but they may serve also at times in conserving the cash resources of the corporation by being paid out for property or services.

Options on authorized but unissued stock have been used freely in the building of giant enterprises through the means of holding companies. This has been particularly true in the utility field, where two additional uses have been made of options. One is the use of options to assure the parent company control of subsidiaries, and the other is the use of options for the purpose of raising needed capital for subsidiaries from time to time. With respect to control, options may be given by the subsidiary to the parent company under which the latter obtains the right to large blocks of stock at certain prices for a period of, say, ten years. With such an option the parent com-

pany need not fear loss of control, even though it owns less than a majority of the stock. With such an option in its possession it would be a comparatively easy task for the parent company to issue its own securities to obtain the cash needed to exercise the options. Furthermore, a gradual exercising of the parent company's rights to the stock of the subsidiary will take care of the additional capital requirements of the latter for some years to come.

Abuses and Legal Status.—Much criticism has been directed recently toward officials of corporations and security dealers as a result of the sales of certain stocks to members of the public obtained through options or "calls" given secretly to the security dealers by the corporations. Investigation has disclosed that in numerous instances the granting of secret options has led to the manipulation of the market price by the holder thereof for the purpose of getting the public to absorb the stocks at prices which were entirely too high.[15] Many such options have been the basis for pool operations, with all the attendant evils in the form of price manipulation, price stimulation through paid publicity agents, and the improper use of customers' men and brokerage facilities. In many cases officers and directors of corporations which granted the options were participants in the pool operations for personal rather than corporation profit. The provisions in the Securities Exchange Act of 1934, quoted previously in connection with "puts" and "calls," definitely prohibit the use of options of the kind discussed in this section, except when such options are effected according to the rules and regulations prescribed by the Securities and Exchange Commission.

[15] For a summarized account of the abuses of options by corporations, officials, brokers, and others, see *Stock Market Control* by the Twentieth Century Fund, Inc., D. Appleton-Century Company, Inc., N. Y., 1934, pp. 114–124, inc.

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CHAPTER VII

ARBITRAGING

Definition and General Nature.—The practice of "arbitraging" has its origin in the fact that the price of a given security, commodity, or other subject matter, may be lower in one market than it is at the same time in some other market. The term refers to the practice of buying and selling the same subject matter, or two subject matters closely and inherently related to one another as regards price, almost simultaneously in the same or different markets with a view to the clipping of the difference in prices as a profit. Where both markets are within this country, the transaction is called "domestic arbitrage," to distinguish it from "foreign arbitrage," which involves two markets located in different countries. The person who practices arbitraging is called an "arbitrager."

Arbitraging may be of three different types—time, place, and kind. "Time" arbitraging results when it becomes possible to make a profit through the purchase and sale of a commodity, in the same or different markets, with different delivery dates for the two contracts. "Place" arbitraging occurs when the purchase and sale are made in different markets. "Kind" arbitraging exists when the articles or securities involved in the purchase and sale are different in their characteristics, but nevertheless inherently related to one another as regards price. These three types of arbitrage may be combined in different ways. Thus, a time arbitrage includes a place arbitrage, if the purchase and sale are for different delivery periods in different places; or, the kind arbitrage in-

cludes place arbitrage, if the purchase and sale involve different commodities in different places.

Numerous markets afford illustrations of the practice. Thus there may be arbitraging in stocks, bonds, or leading commodities. The marine-insurance business has often afforded a prominent field for international arbitraging,[1] and the same is also true of the foreign-exchange business.[2] Again, interest or dividend bearing securities may be sold and commercial paper purchased. Or, there may be arbitraging in interest rates, money being borrowed at a lower rate than the dividend or interest return obtainable from securities purchased with the borrowed funds.[3] Other leading cases of arbitraging are: between a bond and a stock into which the bond is convertible; [4] between a stock and "privileged subscriptions" giving the holder the right to subscribe to new shares in the same corporation; [5] between a stock or bond and an option warrant which entitles the holder to purchase securities under certain conditions; and between two stocks which have a price relationship to each other owing to a merger or other consolidation. Of these various forms of arbitraging, those pertaining to the stock market, especially to the New York stock exchanges and the London Stock Exchange, have been very important. Arbitraging of this nature, therefore, will be made the basis of this chapter. The nature of international and domestic arbitraging in securities will be explained first, and an explanation of the requirements and services of such arbitraging will be given in the latter portion of the chapter.

[1] See Huebner, S. S., *Marine Insurance,* D. Appleton & Company, N. Y., 1922, p. 167.

[2] See Deutsch, H., *Arbitrage in Bullion, Coins, Bills, Stocks,* etc. Effingham Wilson, London, 1910.

[3] See Chapter XVIII.

[4] See Chapter XVI.

[5] See Chapter XVII.

INTERNATIONAL ARBITRAGING

International arbitraging in securities had its first real development with the laying of the first successful trans-Atlantic cable in 1866. Prior to the Civil War large amounts of American railroad securities were distributed in this country and abroad, and during the remaining portion of the nineteenth century increased popularity of the corporate form of organization led to an increase in the number of American securities quoted both here and on foreign exchanges. By the early nineties international arbitraging in American securities had attained substantial proportions. Since London was the financial center of the world, most of the business took place between this market and New York. Arbitraging transactions were not infrequent, however, between the New York Stock Exchange and the Paris Bourse, the Berlin Bourse, and the Amsterdam Exchange.

New York-London Arbitraging Prior to the World War.—Preceding the War this branch of the business was handled primarily by certain international banking firms, in nearly all cases British, French, and German, which also engaged in the business of foreign exchange. In 1901, we are advised, only about a dozen such firms operated between New York and London. At the commencement of the War, in 1914, the number of firms possessing arbitrage departments had increased to twenty. We are also advised that the volume of arbitrage transactions between New York and London would at times aggregate 100,000 shares per day, involving 5,000 or more cable messages.

Between London and New York there is a difference in time of nearly five hours (4 hours, 55 minutes, and 59 seconds, to be exact), so that when the New York Stock Exchange opened at ten A. M. it was four minutes of three in London. But while the London Stock Exchange officially closed at three P. M., the very time when operations on the New York Stock

Exchange commenced, trading continued on the floor in American stocks until four P. M. After that trading was transferred to the curb market where it could continue until the close of the New York market, or eight P. M. London time.

Owing to the aforementioned difference in time, New York arbitrage houses received quotations from their London correspondents before the New York Stock Exchange opened. In fact, London two P. M. quotations reached New York shortly after nine A. M., and later quotations continued to flow in regularly. These quotations were at once reduced to their New York equivalents, a process to be referred to shortly, and were then conveniently tabulated for immediate use as soon as the first New York quotations made their appearance. Only a few minutes were necessary, following the opening of the New York market, to make important sales of the leading stocks in that market, to collect the quotations, and to have them transmitted to London by experienced operators.

Of fundamental importance to the business was a cable service capable of keeping pace with the fractional differences as they occurred in the two markets. It was only through this means that the arbitrager could hope to remain constantly posted as to the differences in quotations, and to continue to make transactions almost simultaneously in the two markets. In fact, there were instances of so-called "three-cornered foreign arbitrage," involving the same security listed on three international exchanges.

Transmission facilities for arbitraging purposes were organized solely with a view to speed and economy. In New York, describing operations as they existed at the outbreak of the World War when arbitraging had to be suspended, most of the important arbitrage stocks were traded in at "posts" arranged near the railing along the south wall of the Stock Exchange. Here representatives of the arbitrage houses were assigned positions, and pneumatic tubes enabled them to connect promptly with the cable offices located downstairs.

Similarly, in London arbitragers' clerks also had desk accommodations at the cable offices. The speed with which these clerks managed to transmit messages back and forth between the two continents was truly astonishing. To complete an arbitrage transaction it was necessary that the ocean be crossed twice, once by the order to buy or sell, and again by the return message advising that the order had been executed at the given price, and on each of these trips the cablegram, it is stated, had to pass through the hands of at least three operators. All of this was ordinarily accomplished in the remarkably short space of about four minutes, and in some instances only three minutes.[6] Probably no more rapid means of communication can be found in any other type of business. Moreover, to save time and money, all cablegrams were reduced to the smallest proportions. Three or four words served to send all necessary information with respect to orders involving several thousand shares, and a single letter was often made to stand for the name and address of the sender and the exact time of the dispatch.

Suspension During War Period.—Abnormal conditions, caused by the commencement of the World War, brought about a complete cessation of international arbitraging in securities. The conditions referred to were several, namely: (1) Government control of cables and their use for only essential messages; (2) pressure of Government business on banking firms to such an extent as to preclude the continuance of many lines of activity formerly pursued; (3) prohibition of code messages by the British Government; (4) refusal of the markets, owing

[6] See Van Antwerp, W. C., *The Stock Exchange from Within*, New York, 1914, p. 284. In this connection, Van Antwerp makes the following statement: "The celerity and accuracy of the cable service between New York and foreign countries, as perfected in arbitraging, has no parallel elsewhere. Twenty minutes are often required to complete a cable transaction between the London Stock Exchange and the Paris Bourse, and so it frequently happens where speed is required, that messages between those two centers are cabled by way of New York."

to abnormal conditions, to respond promptly to the arbitrager's operations, thus necessitating shipment of securities to a much greater degree than formerly; (5) an enormous increase (some 600 per cent over pre-war rates) in the cost of shipment and insurance combined; (6) the British Government's prohibition of the initiation of arbitrage operations by London houses.

International Security Arbitrage Following the World War.—For several years following the War attempts were made to resume international arbitraging but it was found to be practically impossible under existing conditions of the London market. The cash basis on which business was done on the London Stock Exchange and the absence of short contracts greatly reduced speculative transactions, with the result that the London market was so non-continuous in character that arbitrage transactions could not be undertaken with any degree of confidence. Added to this, was the further uncertainty created by the extraordinary unsettlement in foreign exchange rates. Not until 1923, when the restriction on the export of gold from London was lifted, were these conditions largely removed.

A number of other new conditions faced the arbitrager. When the New York Stock Exchange was closed during the War the railing and other arbitraging facilities were removed. Consequently members who again wished to engage in arbitraging had to make new arrangements for quick communication facilities with London. The arbitragers met this problem by arranging with the cable companies for direct wire service from their own offices. American securities, sold to foreign investors during pre-war years were returned during the War period in settlement of debts created to prosecute the War. For a time this reduced the arbitrager's opportunities for profit. Later, American securities again found their way into foreign markets. The flotation of many foreign loans in the United States and the consequent sale in this country of many foreign securities helped to enlarge the field. After the New

York Curb Exchange entered its present quarters in 1921 it became increasingly important as an arbitrage market. Many foreign securities were listed on the Curb, and in turn many American securities listed on it were bought and sold in foreign centers. The field was further enlarged by the introduction of security trading on the New York Produce Exchange in 1928. Following the War the greatest activity in international arbitraging in securities occurred in 1928 and 1929.

Present Status of International Arbitraging in Securities.—The extent to which international arbitraging in securities is practiced depends greatly upon the activity in the principal world markets. Following the collapse of the stock markets in 1929, arbitraging decreased greatly in amount. London is still the most important foreign market, but trading in American securities there after the market's close at three o'clock takes place only when there is great activity. Since the War, Amsterdam has increased in relative importance as an arbitrage center; Paris and Berlin, however, are not considered good arbitraging markets.

The general methods used in international arbitraging are still essentially the same as those which existed prior to the World War, but in some respects, such as the quotation of securities, there have been technical changes. European markets follow the practice of quoting American securities either in terms of actual prices expressed in their own currencies according to the current exchange rates, or in percentages of par. The second method has been adopted in many European markets since the War. Under this method a quotation of 90 means 90 per cent of the par value of the security in terms of the currency of the country in which the market is located. For the sake of convenience, the par in terms of the foreign currency is assumed to be the round number nearest to the exact equivalent of the American security par. Thus, the mint par of the guilder is 40.195 cents and an American stock with $100 par would have an equivalent par of 248.8 guilders; but

for convenience the par is assumed to be 250. No-par stocks are always quoted in exact amounts of the foreign currency, according to the current rate of exchange.

In London, prior to the War, American securities were quoted on the percentage of par plan. Since the War, American stocks in London have been quoted in dollars, on the arbitrary basis of five dollars to the pound. Bonds, however, are quoted in percentages of par, just as they are in a number of the European markets.[7]

Newspapers in cities where the principal foreign markets are located usually carry the New York quotations of a number of American securities. The *Times* of London carries the New York quotations of approximately 200 securities. The newspapers of the large American cities usually carry quotations of American stocks traded in London and some of them also include quotations of foreign securities traded in the principal foreign markets. The *New York Times* contains each day the quotations of the principal American stocks traded in London as well as the quotations of the most active foreign securities traded in London, Paris, Berlin, Milan and Geneva. At the present time, because of the inactivity of the markets, the list of American stocks traded in London averages about twenty per day. Trading in foreign securities on American markets is still less important than trading in American securities on foreign markets. Regarding this latter point, it should be noted that the use of American shares and American depositary receipts has caused an increase in the trading in foreign securities in American markets.[8]

[7] At present American securities in Paris and Milan are quoted in the currencies of these countries; in Amsterdam and Berlin American securities are quoted in percentages of par.

[8] American shares and depositary receipts are issued by trustees in accordance with a trust agreement under which the trustee holds the foreign securities, receives and disburses dividends, and otherwise protects the holder as specified in the trust agreement. These securities were issued to popularize foreign securities in American markets.

Conversion of London into New York Prices.—Numerous complicated factors claim the arbitrager's attention, and add to the complexity of his work. Thus, in addition to the problem of speedy communication already mentioned, there are stamp taxes and commissions to consider, as well as interest charges, constant fluctuations in money rates both here and abroad, cable tolls, costs of insurance and other shipping expenses, the fortnightly settlement system abroad as contrasted with our practice of daily settlements, rates of foreign exchange, and different methods of quoting prices.

Of these various factors, the last two are very important and deserve a further explanation. Unless reduced to their mathematical parity, a given London quotation is probably considerably different from its New York equivalent. This is due to the fact that quotations in the two markets are not on a par. As previously stated, American securities are quoted in the London market on the arbitrary basis of $5.00 to the pound sterling, whereas, under actual market conditions the rate may be much above or below this figure. The rate has been as high as $7.00 to the pound sterling at the commencement of the War and as low as $3.50 shortly thereafter. At the present time the rate is slightly over $5.00.

To overcome the inaccuracy of this arbitrary method of quoting American stocks in London, it is necessary for arbitragers to reduce London quotations to an exact parity with those of New York. This may be done by multiplying the London price by the New York price of demand sterling, and dividing the product by five; or the London price may first be divided by five and the result multiplied by the price of demand sterling in New York. Compilations of this sort, however, will prove burdensome when we reflect that foreign exchange rates, as well as stock prices in both markets, are constantly changing, and that speed in effecting transactions is essential if any profit is to be realized from the small differences in price prevailing in the two markets. Conversion

tables [9] have therefore been prepared for the special use of arbitragers and for the purpose of avoiding delay as well as errors. These tables contain columns representing the various possible exchange rates, and under each column will be found the London quotations and their New York equivalents.[10]

New York Stock Exchange Rules and Practice.—The rules of the New York Stock Exchange provide that "members who propose to operate in joint-account arbitrage between this Exchange and foreign cities shall file with the Secretary of the Exchange a statement giving the names and addresses of all parties to the joint-account, with a copy of all agreements bearing thereon, which shall include a statement of the proposed division of the profits from said account; and said members shall obtain the approval of the Committee on Quotations and Commissions." Full records of all such arbitrage transactions must be kept, subject to the Committee's inspection. "On securities which are permitted to be dealt in on this Exchange, the joint-account shall be charged the regular commission, both here and abroad." Commissions on unlisted securities must be entered in the account and reported to the Committee; likewise cable, insurance and similar expenses must be included in the account.[11]

Under the above rules members of the Exchange must charge

[9] See Nelson, S. A., *The A, B, C, of Options and Arbitrage,* for a sample of such a table.

[10] If the stock is quoted in English currency, but not on an arbitrary basis of $5.00 to the pound, the conversion is made by multiplying the English quotation by the current rate of demand sterling in New York. Quotations in European markets of American securities, when expressed as a percentage of par of the security, are converted into New York prices by multiplying the foreign price by the nearest round number to the mint par of the security and then multiplying the result by the current New York rate of demand exchange. Thus, a quotation of 12 in Amsterdam for a stock with $100 par would be multiplied by 2½ (250 guilders approximate $100 at mint par) and the result would be multiplied by the current rate of demand exchange for guilders in New York. See p. 114.

[11] See *Rules of the New York Stock Exchange,* Ch. X, Secs. 4 to 11 incl.

regular commissions for all transactions which they execute, whether for arbitraging in joint-account or otherwise. If the member of the joint-account in the foreign center is not a member of the Exchange the commissions charged constitute an important item of expense. Where both members to the joint-account are members of an exchange, one being a member of the New York Stock Exchange, the other a member of a foreign exchange, the expense of commissions, while amounting to a large sum, is not necessarily a big disadvantage. Under such an arrangement each member retains his commissions and at the same time participates equally in the resulting profit. Many Exchange members find that a large profit is not necessary, since the commissions received are sufficient to make the business attractive.

Sometimes brokers do not enter into joint-account arrangements but act as correspondents of an arbitrager in a foreign center. The arbitrager, under these circumstances, initiates all transactions. When a transaction has been made by the arbitrager he advises his New York broker, who is instructed to offset the transaction according to his discretion. Full commissions are charged the arbitrager by the New York correspondent.

Arbitragers, with membership on the New York Stock Exchange, operate usually in a small number of stocks. It is important for the arbitrager to obtain quotations from the floor of the exchange very quickly and to get the best service possible in the execution of orders; hence each arbitrager tends to trade in stocks which are located at posts (or booths) convenient to his telephone connections. At times special arrangements are made with floor brokers in order that good service can be obtained in the execution of orders.

Methods of Closing Transactions.—Having made his purchase and sale in the two markets, the arbitrager will naturally wish to settle these two transactions at the earliest opportunity. Otherwise, through repeated transactions his

account is apt to pile up in each of the two markets to a point that will preclude further arbitraging operations.

Three methods of settlement are available. One of these involves the shipment of securities from the market in which they were bought to that in which they were sold. Except in rare cases, principally when the market refuses for considerable periods of time to respond to the arbitrager's operations, this method is avoided owing to the expense, trouble, and inconvenience involved. The more the arbitrager can reduce his shipments, the greater will be his profit. Such shipment between New York and London not only requires about one week in transit, but the securities must be sent by registered mail adequately insured against fire, theft, and marine perils. In domestic arbitrage, however, a considerable number of firms do not insure securities sent by registered mail, but simply have the certificate numbers certified to by a notary public with a view to obtaining new certificates from the issuing corporations in case of loss.

A second method, and by far the most generally used, consists of balancing the account in the two markets. Whereas the New York market may have been lower than London when the arbitrage transaction was originally made, prices may soon rearrange themselves in such a manner that the London market is lower than New York. When such a situation presents itself, the arbitrager will reverse his transactions, that is, will sell in the market where he is long of stock, at the same time buying in the other market to cover his short sale. If possible, arbitragers will attempt to close their transactions every day. But if the difference in prices between the markets continues in the same direction, they will extend their long and short positions over a week, a month, or even longer. In other words, they will continue to accumulate stock by purchases in the low market, while at the same time selling short repeatedly in the higher market and borrowing the stock to fulfill delivery. This extended position is taken, however, solely in the hope that

the two markets will reverse themselves with respect to prices and that they can then sell their accumulation of securities in the higher market, and buy in the same amount in the lower market in order to liquidate their loans. The more arbitragers there are, it may be added, and the greater the volume of their transactions, the more likely it is that such balancing of accounts can be effected.

Sometimes arbitrage firms also arrange to exchange securities with one another. While one firm may be long a certain stock in New York and short in London, some other firm may be short in New York and long in London with respect to the same security. Here an opportunity presents itself for the two firms to match their opposite accounts. Although easy and simple in its application, this method is seldom resorted to, chiefly for the reason that most arbitrage firms will be in the same market position with respect to any given stock.

DOMESTIC ARBITRAGING

As stated at the beginning of this chapter, all arbitraging transactions executed in markets located within this country are labeled as "domestic." For reasons which will be apparent shortly, it is convenient to consider domestic arbitraging from two standpoints: first, all arbitraging between markets located in different cities; and second, all arbitraging transactions executed in markets located within the same city.

Arbitraging between Markets Located in Different Cities.—Arbitraging between cities in the United States had its first real development with the installation of improved telegraphic communication facilities between American cities. Unrestricted growth, however, did not seem to meet with the approval of the nation's premier Exchange. In 1898 the New York Stock Exchange adopted a resolution preventing such arbitraging by any of its members on the plea that the practice was detrimental to the interest and welfare of the Exchange

because it caused frequent violations of the commission law. The rules at the present time provide that, "arbitrage, or trading between this Exchange and that of any other city in the United States, based on quotations made on the floor of the Exchange, is forbidden," and "the sending, from the floor of the Exchange, of continuous quotations is forbidden. Continuous quotations are successive quotations occurring at intervals of fifteen minutes or less." [12] These rules have no doubt helped to reduce domestic arbitrage between cities. As far as the New York market is concerned, this business must be conducted only by non-members who, being obliged to pay commissions, and lacking the floor facilities so necessary to successful arbitraging, are at a decided disadvantage in practicing this type of business. It is questionable, however, as to the number of inter-city arbitraging opportunities which really occur. Traders on the smaller exchanges always follow New York quotations closely, and it is therefore unlikely that any large number of opportunities ever arise for arbitraging between these markets and New York.

Arbitraging in the Same City.—During the bull market culminating in 1929 there arose an extremely profitable and hence popular form of arbitraging in what are known as "equivalent securities." The term "equivalent securities" is applied to any case where one security can be definitely expressed in terms of another; that is, where a fixed ratio can be established between the two kinds of securities which causes the market price of one to have a definite relationship to that of the other. Some of the more common cases of fixed relationships arise in connection with convertible bonds and stocks, rights, option warrants, stock dividends, split-ups, mergers, and reorganizations. From 1927 to 1930 more than five billion dollars worth

[12] See *Rules of the New York Stock Exchange,* Chap. X, Secs. 1 and 2. In 1911 a resolution was adopted by the Exchange which prohibited joint-accounts in international arbitrage when conducted by a member and a non-member. In 1920 this resolution was rescinded and restrictions similar to those now in force were placed on such trading. See p. 117.

of these kinds of securities were placed on the market.[13] While volume figures are not available there is no doubt but that during 1928 and especially 1929 the amount of arbitraging in equivalent securities reached large proportions. During 1930, it has been stated that excellent profits were still obtainable, and during recent months considerable arbitraging has taken place in the securities of several well-known companies.[14]

Reasons for Growth of Arbitraging in Equivalent Securities.—Arbitraging between equivalent securities has been practiced since the introduction of convertible bonds, rights, and other similar securities, but the business prior to the World War did not compare in importance with international security arbitraging. Several reasons may be offered for the large increase in this type of business during the recent bull market, particularly in the years 1928 and 1929. One important reason has been mentioned, namely, the large amounts of these securities which were issued during these years. The issuance of such a large number of equivalent securities during a period when the markets were active furnished arbitragers with a greater number of opportunities than had ever existed before. Another important reason concerns the markets in New York City. Arbitraging occurred in equivalent securities in all the larger cities of the country, but the existence of three stock exchanges in this one city (the New York Stock Exchange, the New York Curb Exchange, and the New York Produce Exchange) naturally concentrated most of these transactions in the nation's financial center. The rules of the New York Exchange provide that a security listed there cannot be traded in

[13] Weinstein, Meyer H., *Arbitrage in Securities,* Harper and Bros., New York, 1931, p. 67.

[14] The most recent well-known opportunities occurred in National Distillers old stock listed on the New York Stock Exchange and the new stock, listed on the New York Curb Exchange, the latter being issued under a three-for-one split-up arrangement. In the first part of 1933 arbitraging occurred between B. and O. 4½'s due March 1, 1933, and B. & O. Ref. & Gen'l Mortgage 5's, due 1996, the latter being issued as a 50% payment (the other 50% in cash) for the 4½'s which were maturing.

the other two markets, but there is nothing to prevent a corporation from listing one type of security on the New York Stock Exchange and another type on the Curb or Produce Exchange. Thus, the stock of a corporation may be listed on the New York Stock Exchange, and if a split-up is announced, the new stock may be traded on the New York Curb on a "when, as and if issued" basis. It is possible, also, for rights of the same corporation to be traded on the Produce Exchange at the same time. The trading in equivalent securities in this manner on separate markets makes it possible for their prices to vary frequently from their parities, thus giving the arbitrager opportunity for initiating transactions.

A third reason for the growth of arbitraging in equivalent securities is the method of buying and selling on the "when, as and if issued" basis. When, for example, directors of a corporation announce that new stock will be issued for some purpose such as a merger or a split-up of old shares, the new stock will be traded in "when, as and if issued." When the stockholders of the corporation approve the merger or split-up the new securities will be traded on a "when issued" basis. The rules of the New York Stock Exchange permit trading on a "when issued" basis, and the rules of the New York Curb Exchange permit trading on a "when, as and if issued" basis.

Trading Practice.—Space does not permit a discussion of the technic involved in arbitraging in equivalent securities, nor even a presentation of examples of the more common forms of arbitrage transactions which are initiated in connection therewith. The reader is referred to the chapters on convertible securities and rights for illustrations of arbitrage transactions in these securities.[15]

Arbitrage operations in equivalent securities may be conducted in unlisted securities, but more difficulties are encountered in this field than in listed securities. One very important obstacle is the wider spread between the bid and asked prices

[15] See Chapters XVI and XVII.

in most securities. This spread is often so great that it is difficult to estimate closely the difference between the prices of the two securities involved in the arbitrage.

Arbitraging in equivalent securities which are listed may be carried on from two locations: from the office of the arbitrager, or from the floor of the exchange. The conditions concerning listing determine which of these two practices is followed. If the two securities are listed on different exchanges, all transactions are initiated at the firm office of the arbitrager by means of communication facilities with the floors of the exchanges. If the two securities are listed on one exchange, but not at the same trading posts, the arbitraging may be carried on successfully from the firm's office because usually the markets for the two securities will be sufficiently far apart not only to permit prices to get out of line but to enable the arbitrager to act on the arbitraging opportunity from his office. Thus, a convertible bond will usually be traded at a post some distance from the stock into which it is convertible, and this may be true, also, of a convertible preferred stock.

When the two securities are traded at the same post arbitraging is more difficult. If rights are listed on the same exchange with the stock both usually will be assigned to the same post. The specialist operating in the stock will watch the market so carefully that should any arbitraging opportunities arise it would be necessary for the arbitrager to have a broker stationed at the post to take advantage of them. Usually it does not pay to have a broker stationed at a given post for the purpose of arbitraging the opportunities which may arise under such circumstances. Sometimes, however, a firm specializing in rights will operate in a joint-account arrangement with the specialist in the stock. The specialist sells the stock short and the arbitrager buys the rights which may later be exercised to obtain the stock from the corporation for delivery on the specialist's short sales. When mergers and consolidations are announced a joint-account arrangement may be made between

specialists in each of the stocks involved. Under such joint-account arrangements, the arbitragers may agree to continue for a certain period, or until a specified number of shares are arbitraged.

REQUIREMENTS AND SERVICES

Factors Necessary to Successful Arbitraging.—To make arbitraging profitable it is practically necessary that the arbitragers have a membership on both of the exchanges between which operations are conducted. In most instances the margin between prices is so small as to leave no profit whatever if the arbitrager is obliged to pay commissions customarily charged non-members. Since speed is the very essence of success, it is essential that the arbitrager have facilities always at hand for the instantaneous transmission of quotations between the markets in which he is operating. Only by this means can he detect differences in prices immediately upon their appearance, determine whether or not it is profitable to make a transaction, and transmit immediately all messages of actual transactions so that both ends of the line may be kept fully informed. Aside from this equipment, however, there must be a continuous market for the securities in both of the centers used by the arbitragers, and such a market, it has already been explained, requires for its existence the presence of a large speculative class and the practice of short selling on a comprehensive scale. It is for this reason that arbitraging is practically confined to important and very active stocks, such issues being commonly characterized in the daily press as constituting the "arbitrage group." Nor should trading in this continuous market be limited through governmental or other artificial restrictions, such as prevailed after the commencement of the World War.

The short sale is also a prime necessity in the sense that in nearly every arbitrage deal the arbitrager must be a short seller

in one of the markets. Too much emphasis cannot be given to the fact that elimination of short selling would destroy the very basis for profitable arbitraging between markets. The arbitrager must also be given the privilege of borrowing and lending stocks in both markets since he relies upon this practice as the cheapest way of carrying his two transactions until they are closed. In the market where the short sale was made the arbitrager will necessarily want to borrow the stock in order to fulfill delivery in accordance with the rules of the market. On the other hand, in the market where the arbitrager is long of stock he will want to employ it as a lender in the market with a view to raising funds for the conduct of his business.

Benefits Resulting from Arbitraging.—On the surface arbitraging would seem to consist simply of the clipping of small profits. Such profits undoubtedly constitute the motive for most dealers engaging in the practice, but if this factor were the only consideration, the subject would hardly merit a separate chapter. In reality, arbitraging results in several important indirect advantages highly beneficial to the business community, and it is for this reason that the subject should be understood by the general public.[16] Briefly stated these advantages are:

1. *Levels Prices in the Various Markets.*—Buying in the low market will tend to raise the price in that market, while selling in the other market at the same time will tend to lower the price in that market. The result is that any difference in the price of a given security will soon be extinguished. Arbitragers thus prevent the continuance of unnatural differences in prices by supplying a demand in one market with stocks from another. It is largely owing to this factor that prominent international stocks, listed on the world's leading exchanges, are

[16] In this respect the need for special regulation of arbitrage transactions was recognized by the framers of the Securities Exchange Act of 1934. Section 7 (a) provides that the Federal Reserve Board may prescribe "special or different margin requirements" for arbitrage transactions. See also Section 11 (a).

said to "have but one price, a world price." With respect to the "arbitrage group" of securities, arbitraging thus serves to minimize distance and practically to make a world market of the several exchange centers where such securities happen to be listed. The investment and speculative element in the market is thus given advantage of the same price level, irrespective of location. In our leading commodity markets for grain, cotton, coffee, etc., this advantage is even more apparent. Here arbitragers not only bring into proper relationship the several markets as regards transportation and carrying charges, but also the various monthly delivery periods on future contracts, the various grades of the commodity under consideration, and even, as in grain, the various kinds of closely allied crops. Conditions of fairness, considering all time and distance charges, involving transportation, warehousing, interest, and insurance costs, are thus established for all market interests, irrespective of locality and time. As stated on another occasion: [17] "Through the constant watchfulness of arbitragers all leading markets are kept in line with one another. Grain, like water, will seek its level. It is made to move from the center where it is plentiful to places where it is not so plentiful. Instead of chaos we are given a harmonious relationship between different markets, between grades, between the several monthly delivery periods, and even between different kinds of grain."

Arbitraging between domestic markets provides advantages for the holders of equivalent securities by keeping prices at their parity or exact relationship with each other. Thus, the holder of rights, who wishes to sell them in the market, is assured that the market price which he obtains will represent the value of the right at that time. So also, the holder of convertible bonds does not have to convert, but can sell these securities in the market with the assurance that any profit due to the

[17] Huebner, S. S., "Functions of Organized Produce Markets," published in American Produce Exchange Markets, *Annals of the American Academy of Political and Social Science,* September, 1911, p. 23.

conversion privilege will be included in the price of the bonds. Similar benefits accrue to the holders of option warrants and other equivalent securities, such as those involved in mergers and consolidations.

2. *Increases the Continuous Character of the Market.*—By taking advantage of the smallest differences—eighths and quarters and even sixteenths, since the London market permits quotations at such small variations—arbitragers greatly assist in the making of a continuous market in all the securities in which they operate. Before the War, as already stated, arbitraging between New York and London sometimes involved aggregate transactions of over 100,000 shares per day. Through the initiation of these numerous transactions, arbitraging constitutes a powerful indirect factor in bringing about all the numerous benefits to the business community attributable to a continuous market.[18]

3. *Aids in the Distribution of Securities.*—Before the War, when the United States was borrowing capital for internal development, arbitragers, together with investment banking concerns, helped in the distribution of American securities abroad. The arbitragers' activities and their advertisements of American securities in such markets increased the demand for them in other countries. When, following the War, most American securities again found their way into the hands of American investors, the arbitragers did much to create a demand for them in foreign markets and hence aided in a return of many of these American securities abroad. To a considerable extent, also, international arbitraging on a large scale serves as an advertisement of foreign securities in American markets. From the close of the War to 1929 Europeans borrowed much money in the United States through the flotation of securities. After the crash in 1929 many of these securities were sold by American investors, and consequently found their way into foreign hands. It is logical to assume from past experience that

[18] See Chapter II.

as recovery develops the arbitrager will again aid in attracting these securities to our markets.

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PART II

THE ORGANIZATION AND OPERATION OF THE MARKET

CHAPTER VIII

LEGAL STATUS AND ORGANIZATION OF STOCK EXCHANGES

Previous Private Character of American Stock Exchanges.—Unlike commodity exchanges in the United States, which have in nearly all instances been incorporated, American stock exchanges are "private, voluntary, unincorporated associations." As pointed out by Dos Passos in referring to the New York Stock Exchange,[1] a "voluntary association of persons, like the New York Stock Exchange, by which each individual broker is enabled to carry on his separate business under regulations made alike for the protection of himself and his client or principal, has no technical name or place in the law. . . . An institution like the stock exchange is an anomaly of the law. It is amphibious in its nature; for, without being a corporation or a partnership, it possesses some of the characteristics of both." It resembles a corporation in that it may adopt a constitution and by-laws, binding upon the members of the association, and has, unless voluntarily dissolved, a continued existence unaffected by the death, resignation, suspension, or removal of members. It differs from a corporation in that it has no charter and has not been organized in pursuance of any statute or legislative act; has received no special privileges from the state, and therefore owes no special duties to the public; has issued no stock to its members, who have therefore no claim to property rights in the association as stockholders; and, since the privilege of membership is derived

[1] Dos Passos, J. R., *Treatise on the Law of Stock Brokers and Stock Exchanges,* pp. 20, 22.

exclusively from the exchange that grants it, it may confer, refuse, or withdraw such privilege.

Despite the great importance that the New York Stock Exchange has assumed as an integral part of the nation's financial system, it, and the same may be said of other unincorporated stock exchanges of the country, has endeavored to preserve its purely private character. However, there has been an increasing tendency to bring the practices of exchanges under the control of special legislation, and the Securities Exchange Act of 1934 is designed to bring exchanges under the control of the Federal Government in accordance with such rules and regulations as the regulatory body may prescribe "as necessary or appropriate in the public interest or for the protection of investors."

The importance of the essentially private character of American stock exchanges becomes apparent when we compare our practice with that prevailing in continental Europe. In France and Germany, for example, exchanges exist by special legislation. The Paris Bourse is virtually given a monopoly by the French Government in listed securities and its members practically hold government office, being appointed by the President of the Republic and giving to the Government a prescribed bond. The manner of doing business is also carefully regulated by the Government and all prerogatives of the members are prescribed. In Germany, likewise, all exchanges are established with the permission of the Government, which exercises important control over their operation.

Property Rights Possessed by Exchanges.—So long as there is no violation of their rules or of equitable principles of trade, exchanges are not directly concerned with the contracts between members and their principals. They do no business unless the ownership of certain property interests may be so regarded. In this respect they have a property interest in their building sites, and in the income derived from the col-

lection and sale of quotations, the dues paid by the members, and the fees charged for listing securities.

In view of the intimate relationship borne by stock exchanges to the financial and commercial life of the nation, the question as to whether such exchanges are legally quasi-public institutions charged with special public duties has been raised a number of times in the courts. This question has arisen most frequently in connection with the right of a stock exchange to control the publication and distribution of quotations representing the transactions on its floor, and the courts, in their decisions, have invariably referred to the private, voluntary, unincorporated nature of stock exchanges.

Nature of a "Seat" on the Exchange.—A seat on a stock exchange is a species of property that may be defined as giving to the holder the collective privileges of membership under the constitution and by-laws of the exchange which has bestowed such membership. This membership, or seat, can only be obtained by subscribing to the constitution and by-laws of the exchange, and the member is the owner thereof only in a qualified and not an absolute sense. In other words, he obtains the seat under certain restrictions imposed by the exchange. The seat, for instance, is not inheritable property in the absolute sense, although of considerable value.[2] It cannot be sold or transferred to a person whose membership would prove objectionable to the exchange. Admission to the exchange usually takes place by a transfer of membership, but such transfer can only be made if the name of the proposed transferee has been submitted to the Committee on Admission and has

[2] At five year intervals, since 1900, the high and low prices paid for a membership on the New York Stock Exchange were as follows: 1900, $47,500 and $37,500; 1905, $85,000 and $72,000; 1910, $94,000 and $65,000; 1915, $74,000 and $38,000; 1920, $115,000 and $85,000; 1925, $150,000 and $99,000; 1928, $595,000 and $290,000; 1929, $625,000 and $550,000; 1930, $480,000 and $205,000; 1931, $322,000 and $122,000; and 1932, $185,000 and $68,000.

been approved by it. The peculiarity of the property rights attaching to a stock exchange seat is further illustrated by many court decisions which hold that it is not property of such a character as to be included in the category of taxable property.[3] Thus one decision (San Francisco v. Anderson, 103 Cal. 70) holds that:

"What such a seat is chiefly appears in the opinion of this court in Lowenberg *v.* Greenebaum, 99 Cal. 192; in that case we held that a seat in said board, being merely 'a personal privilege of being and remaining a member of a voluntary association with the assent of the associates,' was not property that would pass by a sale under a common writ of execution; and following the views there expressed we hold that it has no such quality as make it assessable and taxable as property. It is a mere right to belong to a certain association with the latter's consent, and to enjoy certain personal privileges and advantages which flow from membership of such association. These privileges and advantages cannot be transferred without the consent of the association, and a forced sale of them would not give to the purchaser the right to occupy said 'seat.' "

It should also be noted that the holders of exchange seats have no proprietary interest in the property of exchanges, and have no right to any proportional part of it upon withdrawing. This principle is based upon the fact that exchanges are not organized for gain, and that they have no interest in the business profits of their members. Their fundamental purpose is to furnish a convenient market place for their members, and the ownership of property by them as an organization is merely incidental. "But, unlike the relation of partners," according to Dos Passos,[4] "a member of the exchange, or his legal represen-

[3] Summary of People *v.* Feitner, 167 *N.Y.* 1 (1901); Matter of Glendinning, 68 *N.Y.* App. Div. 125 (1902); San Francisco *v.* Anderson, 103 *Cal.* 70 (1894).

[4] Dos Passos, J. R., *op. cit.*, p. 33.

tatives, has no right to call for an account of the property or a division of the same. The interest of each member in the property of the association is equal."

The market value of stock exchange seats, usually quoted in the press whenever a transfer by sale is made, depends chiefly upon the limit placed by the exchange upon the number of memberships, and upon the supply of and demand for such memberships. Other things being equal, the price of seats usually fluctuates in accordance with the activity of business on the exchanges. Thus during the extraordinary stock market boom of 1929 a price as high as $625,000 was paid for a membership on the New York Stock Exchange, whereas during the depression year of 1932, only three years later, the price had declined to the year's high of $185,000 and the year's low of $68,000. At present the membership of the New York Stock Exchange is 1,375, while in the case of most of the smaller American exchanges the limit ranges from 150 to 350. In some instances exchanges have undertaken the policy of purchasing seats, if they can be obtained at a favorable price, and retiring them by cancellation. Fluctuations in the price of seats on the leading American stock exchanges are as great as those occurring in a representative list of leading stocks, the price of a New York Stock Exchange membership, for example, having varied within the past twenty years from a minimum of $34,000 in 1914 to a maximum of $625,000 in 1929.

Preference of Exchange Members to the Proceeds of Defaulting Members' Seats.—In view of the large market value often attaching to seats, it is important to note that practically all American stock exchanges, including the New York Stock Exchange, have made provision to the effect that members of the Exchange, if they are creditors of an insolvent member, have a preferred claim, as compared with outside creditors, to the proceeds from the sale of the seat. It is provided that upon the transfer of membership the proceeds thereof

shall be applied to the following purposes and in the following order of priority: [5]

"*First.* The payment of such sums as the Committee on Admissions shall determine are or may become due to the Exchange by the member whose membership is transferred or by the firm registered on the Exchange in which such member is a general or special partner;

"*Second.* The payment of such sums as the Committee on Admissions shall determine are or may become due to the Stock Clearing Corporation by such member or such firm;

"*Third.* The payment to creditors who are members of the Exchange or firms registered thereon of all filed claims as follows:

. . . . . .

(a) Claims arising in the ordinary course of business from Exchange contracts for the purchase, sale, borrowing or loaning of securities entered into on the Floor of the Exchange.

(b) Claims arising from Exchange contracts entered into in the ordinary course of business other than those included in the preceding sub-section;

(c) Claims arising from Exchange contracts other than those included in the two preceding sub-sections, except those made for non-business purposes;

(d) Claims arising from Members' contracts other than Exchange contracts.

"*Fourth.* The surplus, if any, of the proceeds of the transfer of a membership shall be paid to the person whose membership is transferred, or to his legal representatives, upon the execution by him or them of a release or releases satisfactory to the Committee on Admissions, unless the Committee on Admissions shall determine either (a) that the protection of the creditors of the firm registered on the Exchange in which said member is a general or special partner requires the use of said surplus or any part thereof or (b) that said member has expressly agreed that said surplus shall be paid to such partnership, in either of which events said surplus shall be paid over to such firm upon the execution by said member or such firm of a release or releases satisfactory to the Committee on Admissions."

[5] *Constitution of the New York Stock Exchange,* Article XIV, Section 3.

Rules of this character have sometimes been opposed as repugnant to justice. Since the seat, which in New York reaches a high value at times, might be the only valuable asset of the bankrupt, a practice of applying this value toward the payment of creditor members in full, to the exclusion of outside creditors, is sometimes considered indefensible. On the other hand, such rules are defended by exchange members as making possible the acceptance of one another's obligations for large amounts.

Several times the legality of exchange rules providing for the distribution of the proceeds of a seat in the above-mentioned order of priority has been questioned in the courts.[6] According to the facts in Hyde *v.* Woods, 94 U. S. 523, a member of the San Francisco Stock Exchange became a bankrupt and the plaintiff was appointed the assignee. The Constitution of the Exchange contained a provision similar to that stated above. The seat was sold, and the purchaser thereof was duly elected, and the purchase price was paid to the creditors who were members of the Exchange. The plaintiff contended that this distribution of the proceeds of the sale was an unlawful preference within the meaning of the bankrupt law. Mr. Justice Miller in deciding the case said:

"There is no reason why the stock board should not make membership subject to the rule in question unless it be that it is a violation of some statute or of some principle of public policy. It does not violate the provision of the bankrupt law against preference of creditors, for such a preference is only void when made within four months previous to the commencement of the bankrupt proceedings. Neither the bankrupt law nor any principle of morals is violated by this provision so far as we can see. A seat in this board is not a matter of absolute purchase. Though we have said it is property, it is incumbered with conditions when purchased without which it could not be obtained. It never was free from the conditions of Article 14, neither when Fenn bought nor at any time before or since. That rule en-

[6] Hyde *v.* Woods, 94 U.S. 523; Weston *v.* Ives, 97 *N.Y.* 228, 229.

tered into and became an incident of the property when it was created and remains a part of it, into whosesoever hands it may come. As the creators of this right—this property—took nothing from any man's creditors when they created it, no wrong was done to any creditor by the imposition of this condition.

. . . . . .

"It is said that it is against the policy of the bankrupt law—against public policy—to permit a man to make in this or any other manner a standing or perpetual appropriation of his property to the prejudice of his general creditors; and it is to this point that the numerous authorities of counsel are cited. They all, however, relate to cases where a man has done this with property which was his own—property on which he himself imposed the direction or the incumbrance which impeded creditors.

"It is quite different where a man takes property, by purchase or otherwise, which is subject to that direction or disposition when he receives it. It is no act of his which imposes the burden. It was imposed by those who had a right to do it and to make it an accompaniment of any title which they give to it."

The Government of Exchanges.[7]—The internal organization of an American exchange is fixed by its constitution and by-laws. The system of organization is virtually the same, differing only in details, for practically all the stock exchanges of the country. In fact the Constitution of the New York Stock Exchange seems to have been used as a model for the systems of organization prevailing with respect to most other exchanges.

The provisions of the Constitution of the New York Exchange may be divided into two distinct groups, namely, those which outline the government of the Exchange, and those which govern the business conduct of its members. According to the first group of provisions, the whole government of the Exchange is vested in the Governing Committee, consisting of

[7] See *Constitution of the New York Stock Exchange* as revised to October 10, 1933, Articles II to XIII, inclusive.

the president, the treasurer, and forty members, the president and treasurer being elected annually and the forty members being divided into four groups of ten members each, the term of office of one of these groups expiring every year. Directly or by appeal the Governing Committee is vested with all powers necessary for the government of the Exchange, the promotion of the Exchange's welfare and purposes, and the regulation of the business conduct of its members. It also possesses the power to appoint and dissolve all standing and other committees; to define, alter and regulate their jurisdiction; to exercise original supervisory jurisdiction over all matters referred to such committees; to direct and control their actions or proceedings at any stage; and to try all charges against members of the Exchange and punish those who may be guilty.

Most of the details relating to the government of the Exchange are delegated to thirteen standing committees, which are appointed by the Governing Committee from its members, and which, as already stated, are subject to its control and supervision. These committees and their duties are the following: [8]

1. *Committee on Admissions* (consisting of fifteen members), which considers "all applications for membership and all applications of members suspended on account of insolvency for reinstatement to their privileges." An affirmative vote of two-thirds of the Committee is necessary to elect to membership, or to reinstate a suspended member.

2. *Arbitration Committee* (consisting of nine members), which investigates and decides "all claims and matters of difference arising from members' contracts subject to the rules of the Exchange, or at the instance of a non-member between members and non-members." According to the rules this Committee may dismiss any case and refer the parties to their remedies at law, and must so refer them upon joint request of the

[8] These duties have been abstracted from the *Constitution of the New York Stock Exchange* as revised to October 10, 1933.

contestants. Its decision is final in all cases, unless an appeal be taken by a member of the Committee, or in cases involving a sum of $2,500 or over when either party may appeal to the Governing Committee. When a non-member makes a claim, he is required to execute an agreement to abide by the rules of the Exchange, and also a full release of said claim.

3. *Committee of Arrangements* (consisting of nine members), which has general care of the Exchange, which enforces all rules and regulations necessary to the conduct of business, good order and the comfort of the members, and which controls and regulates the quotation service and all telegraph, telephone, wireless or messenger connection with the Exchange.

4. *Committee on Bonds* (consisting of five members), which is given "general supervision over dealings, whether upon the Exchange or otherwise, in bonds, notes and other obligations and in certificates of deposit therefor." This committee is also assigned "all the powers and duties of the Committee of Arrangements in so far as the same affect dealings in bonds, notes or other obligations or in certificates of deposit therefor."

5. *Committee on Business Conduct* (consisting of six members), whose duty it is to consider "matters relating to the business conduct and financial condition of members and their customers' accounts," and to keep in touch with the course of security prices on the Exchange with a view to determining when improper transactions are being resorted to. It is empowered to examine into the dealings of any members and to report its findings to the Governing Committee.

6. *Committee on Constitution* (consisting of five members), to which are referred all additions, alterations, or amendments to the Constitution, and which is instructed to report them back to the Governing Committee after due consideration.

7. *Finance Committee* (consisting of seven members) which examines all accounts and vouchers and acts as a board of audit, reporting the result of its examination to the Governing Committee.

8. *Law Committee* (consisting of five members), to which are referred all questions of law affecting the interests of the Exchange. It acts in an advisory capacity to the executive officers of the Exchange and is empowered, wherever it deems it necessary, to examine into the dealings of any member of the Exchange.

9. *Committee on Odd Lots and Specialists* (consisting of five members), which has "general supervision over dealing in lots of stock of less than one hundred shares and the methods of specialists." It is also instructed to "formulate and submit to the Governing Committee for its adoption rules and regulations with respect to said matters and shall require the observance thereof, when adopted."

10. *Committee on Publicity* (consisting of five members), charged with the duty "under the direction of the President, to keep the public correctly informed concerning matters of public interest having to do with the Exchange."

11. *Committee on Quotations and Commissions* (consisting of nine members), which has charge of all matters relating to commissions, partnerships, offices of members, foreign joint-account arbitrage, and the collection, dissemination and use of quotations, and which is entrusted with the duty of approving or disapproving any applicant for quotations.

12. *Committee on Securities* (consisting of five members), which makes the rules defining the requirements for regularity in delivery of securities dealt in on the Exchange and decides all questions relating to the settlement of contracts subject to the rules of the Exchange, of due bills, of irregularities in securities, or in deliveries thereof, and all questions relating to reclamations therefor. It has also jurisdiction with respect to the making of regulations governing the marketing of rights.

13. *Committee on Stock List* (consisting of six members), which receives and considers all applications for the listing of securities on the Exchange, and which reports its findings and

recommendations thereon, together with full information to the Governing Committee.

In addition to the aforementioned thirteen standing committees, there is also a *Conference Committee,* consisting of the President, Vice-President, Treasurer, and the Chairmen of the Committees on Admissions, Arrangements, Business Conduct, Odd Lots and Specialists, Publicity, Quotations and Commissions, and Stock List, which "hears reports from the various committees and from others, advises with them concerning questions affecting the welfare of the Exchange, and recommends to the Governing Committee such action as in its opinion will prove beneficial to the Exchange."

Suspension and Expulsion of Members.—The power of suspending or expelling members constitutes one of the most important functions of an exchange in the maintenance of a high standard of business conduct for the mutual protection of the members of the exchange as well as the public. What the countries of continental Europe seek to effect by statute in the discipline of brokers, American exchanges, as unincorporated associations, aim to accomplish by their own rules. As pointed out by Dos Passos,[9] the member of an unincorporated exchange "has no rights of a higher dignity than those springing out of a voluntary contract between himself and his fellow members. Such contracts are upheld when they are not unreasonable or contrary to law or public policy, and the member may thereby voluntarily subject himself to summary expulsion for causes and in modes which would not be justified in the case of a chartered corporation."

Numerous specific acts punished by the exchange by fine, suspension, or expulsion were stated in Chapter V on the "Regulation of Brokerage Transactions and the Conduct of Brokers." Not only do American exchanges possess the right to suspend or expel members for violation of their express rules and for fraudulent acts or misstatement of material facts in

[9] Dos Passos, J. R., *op. cit.*, p. 73.

the application for membership, but also for certain acts that may not be specifically defined by, or even mentioned in, their by-laws. Thus, acts not specifically punishable by suspension or expulsion under the Rules of the New York Stock Exchange may be included under three general rules that deserve special mention, namely, Article XVII, Section 7, providing for the suspension or expulsion of a member who is adjudged guilty of "conduct or proceeding inconsistent with just and equitable principles of trade"; Article XVII, Section 8, authorizing the Governing Committee to suspend any member from the Exchange for a period not exceeding five years "who may be adjudged guilty of any act which may be determined by said Committee to be detrimental to the interest or welfare of the Exchange"; and Article XVII, Section 2, authorizing expulsion for any member "guilty of fraud or of fraudulent acts." It should also be noted, that "reckless and unbusinesslike dealing" has been declared by the Exchange to come under the description of being "inconsistent with just and equitable principles of trade." From time to time these general rules are given definite interpretation by the adoption of resolutions that definitely prescribe certain acts as "being inconsistent with just and equitable principles of trade," or as being "detrimental to the interest or welfare of the Exchange," or as "constituting fraud or fraudulent acts."

Requirements of the Securities Exchange Act of 1934.—Under the provisions of this Act every exchange within the jurisdiction of the United States must be registered as a national securities exchange, or it "shall be unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange . . . to effect any transaction in a security, or to report any such transaction." (Sec. 5). The term "exchange," it should be noted, comprises "any organization, association, or group of persons, *whether incorporated or unincorporated,* which con-

stitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood." (Sec. 3 [a] [1]).

Section 6 outlines in detail acts which constitute a violation of the registration statement by the issuer as well as the information and documents which must be submitted to the Commission for registration purposes. If approved by the Commission, the exchange is then registered as a national securities exchange. Provision is further made (1) that nothing in the Act is to be construed as "preventing any exchange from adopting and enforcing any rule not inconsistent with this Act and the rules and regulations thereunder and the applicable laws of the State in which it is located," and (2) that "an exchange may, upon appropriate application in accordance with the rules and regulations of the Commission, and upon such terms as the Commission may deem necessary for the protection of investors, withdraw its registration."

Other sections of the Act give the Commission almost unlimited control over all registered national securities exchanges. Section 19 empowers the Commission to suspend the registration of a national securities exchange for not to exceed twelve months, or to withdraw registration altogether, if after a hearing it appears that the exchange has violated the Act. The same power is also given to the Commission with respect (1) to any registered security if the issuer has not complied with the Act, and (2) to any member or officer of a national securities exchange who has violated the Act or "has effected any transaction for any other person, who he has reason to believe is violating in respect of such transaction any provision of this title or the rules and regulations thereunder."

Trading in any registered security may be suspended by the Commission for a period not exceeding 10 days, while trading as a whole upon any registered exchange, may be suspended,

with the approval of the President, for a period not exceeding 90 days. Furthermore, the Commission is empowered to order the exchange to alter its rules along practically all lines, such as classification of members, elections, disciplining of members, listing of securities, etc. Other sections of the Act authorize the Commission (1) to make investigation of alleged violations, to publish the information obtained, and to bring necessary court actions (Sec. 21), and (2) to make in conjunction with the Federal Reserve Board the rules and regulations necessary to carry out their duties in connection with the Act (Sec. 23). Section 30, it is important to note, makes it "unlawful for any broker or dealer, directly or indirectly, to make use of the mails or of any means or instrumentality of interstate commerce for the purpose of effecting on an exchange not within or subject to the jurisdiction of the United States, any transaction in any security the issuer of which is a resident of, or is organized under the laws of, or has its principal place of business in, a place within or subject to the jurisdiction of the United States, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors or to prevent the evasion of this Act."

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CHAPTER IX

LISTING OF SECURITIES

Definition and Importance of Listing.—Before the stocks or bonds of any corporation can be dealt in on the floor of an exchange they must be "listed," which means that they must meet, to the satisfaction of proper exchange authorities, certain prescribed standards of legality, security and workmanship. Listing constitutes one of the foundations of an organized security market. Experience has shown the necessity of having stock exchanges compel corporations, when desiring to obtain for their securities the advantages of the continuous market which an exchange affords, to meet reasonable requirements of publicity and to issue securities in proper form. Stock exchanges stand between the corporations and the public, and one of their primary purposes should be to see that the interest of the public is properly safeguarded in the issuance and marketing of securities.

All stock exchanges have listing requirements which, however, differ somewhat in their details. The requirements of the New York Stock Exchange are equal in their comprehensiveness to those of any other American market and will be used, therefore, as the basis of this discussion. While ultimate control, as regards this Exchange, is vested in the Governing Committee, there is appointed annually from its membership of forty a Committee on Stock List, composed of six members, empowered: [1]

"(a) To make rules prescribing the requirements for listing and

[1] *Constitution of the New York Stock Exchange,* Article X, Section 1, Division 13.

such other rules and regulations in relation to the listing of securities as may be deemed expedient or necessary;

"(b) To receive and consider all applications for placing securities on the list of the Exchange, and to make report and recommendation thereon to the Governing Committee. In its discretion to permit dealings on a "when issued" basis

(1) in certificates of deposit or interim receipts for securities,

(2) in securities of a corporation, the securities of which are already listed on the Exchange or

(3) in securities growing out of securities already listed;

but in every such case a full report shall be made to the Governing Committee at its next meeting;

"(c) To place upon the List without report and recommendation to the Governing Committee obligations of the Government of the United States, or of any State, County or City thereof, and the external dollar bonds of a foreign government;

"(d) On receipt of assurances satisfactory to the Committee that application conforming to the requirements will be made for the listing of the definitive securities, to place upon the List certificates of deposit or interim receipts for securities, or temporary securities of a corporation, securities of which are listed on the Exchange, and to direct that any such certificates of deposit, interim receipts or temporary securities be removed from the List and further dealing therein prohibited; report of such actions shall be submitted to the Governing Committee at its next meeting thereafter;

"(e) To direct that any security listed upon the Exchange be removed from the List and further dealing therein prohibited upon maturity of such security, or when it shall appear that the outstanding amount thereof has become so reduced as to make inadvisable further dealing therein upon the Exchange;

"(f) To direct that any stock listed upon the Exchange be removed from the list and further dealing therein prohibited when it shall appear to the satisfaction of the Committee that facilities for transfer and registration in the Borough of Manhattan, City of New York, are no longer available.

"(g) To have charge of the arrangement and revision of the printed list of securities."

Applications to list must be signed by an executive officer of the corporation, must be filed with the Secretary of the Exchange, and on notice additional printed or typewritten copies must be filed on or before a stipulated day prior to the date set for consideration. Every application must be accompanied by a payment to the Exchange of 1.2 cents per share, and for bonds of $120 for each $1,000,000, or portion thereof, of the par value.

Misconceptions Concerning the Purpose of Listing.—Few features connected with the mechanism of American stock exchanges are so generally misinterpreted as regards their underlying purpose as the listing of securities. The popular conception too frequently implies that when the New York or some other stock exchange admits a security to its list it recommends that security for favorable consideration by investors and speculators.

This conception is entirely wrong. In listing a security the exchange in no sense assumes responsibility for future fluctuations in the price or the intrinsic worth of that security. It expressly disclaims any intention either to recommend or condemn any security or to associate with its listing any guarantee of value. Its function is to make available to the world an open and continuous market in such stocks and bonds as meet its prescribed standards of legality and form, and questions of price and value are left entirely to the decision of the individual investor or speculator. The mere fact that a security can be bought and sold on an exchange should never be regarded as a guarantee against the risks inherently associated with the ownership of stocks and bonds, or as a safeguard to protect individuals from the consequences of their mistaken judgment. In fact the authorities of our exchanges have even taken the position that an exchange cannot properly condemn or approve the reports of corporations, since by doing so the exchange would be instrumental in passing judgment upon the value of securities.

A moment's reflection will show that the attitude of the New York Stock Exchange cannot be other than that just stated, and that no system of listing can be devised that will be a substitute for the judgment of the individual. In the first place the Exchange cannot make a special investigation of the intrinsic value of the tangible and intangible property of the hundreds of corporations whose securities are listed, and whose property interests are scattered all over the country. The expense and labor involved preclude the possibility of any exchange sending experts to all parts of the country with a view to examining, for instance, all the plants of the numerous industrial corporations that apply for the listing privilege. Expert opinions might be called for but, since the business of all corporations is speculative in character, it would be difficult to know whose valuation to accept. Even assuming that the tangible property of a large corporation could be fairly estimated, such estimates would only be of temporary value. The stock market is a "market for incomes," and prices and values change as the income of the corporation is affected, differently at different times, by the numerous factors that influence the prosperity of the country. Periodic examinations would be essential, therefore, and the assumption of that duty with reference to the entire list of corporations is clearly a practical impossibility. Nor has the Exchange the power to act as a censor of the numerous corporation managements and to dictate their actions and business policy.

Advantages of Listing.—If the Exchange in no sense recommends or guarantees the intrinsic worth of securities, what then is the function of listing? The answer is that the New York Stock Exchange, for example, rigidly requires every corporation seeking admission to its list to comply with a definite set of rules, calling for several hundred items of information, the strict enforcement of which gives reasonable assurance to the public that the securities are legally issued, are prepared in proper form as regards their text, are surrounded by

all reasonable safeguards against counterfeiting or misuse, and represent, at the time of listing, a legally organized, solvent, and going business concern. While the Exchange does not guarantee any security, or even affirm the truthfulness of the statements filed by the corporation, it does certify that due diligence and caution have been used in examining the securities with reference to the aforementioned features. For this reason "admission to the list," to quote the Report of the Hughes Committee on Speculation in Securities, "establishes a presumption in favor of the soundness of the security so admitted," and "the Committee on Stock List constitutes one of the most important parts of the Exchange's organization, since public confidence depends upon the honesty, impartiality, and thoroughness of its work."

Despite its limitations, listing affords to the public and to the corporations involved various advantages in addition to those just mentioned. The first of these is *publicity,* probably the best safeguard that investors can have. Of the various agencies which in recent years have furthered the progress of publicity on the part of corporations, American stock exchanges are entitled to a leading place. The service in this respect has been rendered through two main channels, namely, (1) by compelling corporations to enter into agreements with the Exchange to furnish to their stockholders periodic reports of their physical and financial condition, to give prompt notice of all actions with respect to dividends, interest, or privileged subscriptions, and to promise not to dispose of their interests in subsidiary corporations, except on direct authorization of the shareholders; and (2) by making public all the facts acquired in the process of listing. As explained by the Exchange: [2]

"The Stock Exchange provides a listing application service whereby banks, investment bankers, non-member brokerage firms and others may secure copies of all applications to list securities on the

[2] *New York Stock Exchange Year Book,* 1931–32, p. 79.

New York Stock Exchange as they are approved, on payment of a nominal fee to cover the printing and mailing costs. A large number of banking institutions and brokerage firms make use of this service. Many member-firms also subscribe to extra sets of these listing statements for the use of their statistical departments and branch offices.

"The formal applications to list securities on the New York Stock Exchange contain a great amount of fundamental data about these securities, and are frequently of great value to those who advise investors. These applications, which are approved at the average rate of several hundred a year, give essential information regarding the applicant corporation, such as the corporate structure, the exact relationship in this structure of the security issue to be listed, the company's assets and liabilities, its earnings and dividend payments and many other important details of its business. The Stock Exchange secures this information not only to enable its officers to pass on the suitability of the issue for listing on the Exchange, but also to make available to the entire investing public of the country adequate knowledge concerning listed issues."

The New York Stock Exchange has proceeded on the theory that all the information obtained in response to the numerous inquiries that corporations must answer as a prerequisite to listing (to be discussed later) should be made public for the benefit of those who cannot have access to the records of the company. In publishing the applications all references to rosy prospectuses are avoided by the Exchange, and only the facts are recited. Consideration by the authorities entrusted with listing is refused in the case of all information that cannot be published to the shareholders, and all facts that the Exchange obtains the public can also receive. An application for listing, however, is considered confidential until approved, but when approved all facts obtained become matters of public information. Any one applying may secure any information possessed by the Exchange concerning the company or its securities. Moreover, the agreement between the corporation and the Exchange, providing for the publication of annual reports of

a complete and detailed character, serves as a distinct benefit to investors in enabling them to determine for themselves the merits of the securities that they may contemplate purchasing.

Listing also gives stocks the benefit of a broad, continuous market where sales can be effected with the least waste of time and the smallest price fluctuations between sales, i.e., listing places stocks on a higher plane of convertibility. Closely associated with the greater convertibility of listed stocks is their greater hypothecary value. Generally speaking, listed stocks are more acceptable as collateral for borrowing purposes than unlisted ones, because they are currently quoted on the tape and in the press; and such quotations, as already explained, reflect under normal conditions the judgment of the entire market and are the expression of the combined opinion, made public by actual purchases and sales, of those best able to analyze present and prospective values. The greater frequency and volume of sales on an exchange, with comparatively small fluctuations between transactions, also serve as a protection to holders of collateral in case of forced liquidation. In fact, the more active a security is, the less necessary is a knowledge of its inherent worth for borrowing purposes. This fact is so commonly recognized that, as Chamberlain states: "the loan clerks of the New York banks that cater to brokerage houses are too likely to make loans with an eye solely to the quotations of the day." Even with reference to bonds Chamberlain concludes that: [3]

"In making loans upon collateral, other conditions enter in, which give listed bonds a decided advantage. A bank has not the time or personal interest to investigate, as a purchaser should, the character of collateral security. From the nature of commercial banking, personal credit is the specialty; collateral credit or credit instruments are secondary. The national bank and the trust company look upon listed securities as authentic; reference is easy to current quotations

[3] Chamberlain, Lawrence, *The Principles of Bond Investment*, p. 65.

as the basis for appraisal and loan. Therefore, listed securities are, in general, more acceptable. In taking them the bank moves along the line of least resistance; the loan clerk has less thinking to do."

To purchasers and sellers of securities listing gives the protection and safeguards that stock exchanges afford in regulating brokerage transactions, in enforcing well defined usages and customs, and in maintaining a high standard of commercial honor among brokers. Moreover, exchange business is transacted at a uniform commission and at a lower rate than is often charged for the sale or purchase of unlisted and uncurrent securities. Holders of listed securities, even though these securities may not be pledged as collateral, also have the benefit of constant quotations from day to day which are representative of the general judgment, and have the assurance that they can, at any time, and at approximately the prevailing price, convert their holdings into cash.

Lastly, to the corporation, listing affords a regular market with daily quotations that are widely circulated through the press and otherwise. Its securities are, therefore, kept prominently before the public and are given a certain degree of advertisement and popularization. All the preceding advantages serve to make their securities more attractive to the public than they otherwise would be. It is for this reason that promoters find listing on an exchange a valuable aid in the distribution of their securities, and that financial houses, interested in the flotation of securities, nearly always state prominently in their advertisements of the issues that application has been or will be made to list the same on certain organized exchanges.

Listing Requirements of the New York Stock Exchange.—The extent to which the New York Stock Exchange has sought to safeguard the admission of securities to its market becomes apparent upon a more detailed analysis of its listing requirements.[4] These requirements include numerous state-

[4] Only the more important requirements are referred to in the text.

ments and promises that may be briefly abstracted and classified under the following seven heads:

1. *Organization of the Corporation, the Nature of Its Securities, and Description of the Property.*—For an original listing of capital stock, the corporation must recite, among other items, the place of incorporation, the date and duration of its charter; the nature of its business and any special rights or privileges under its charter; the extent of liability attaching to shareholders, all important features pertaining to all the classes of capital stock, the voting power of obligations of debt, the purposes of the issue and the applications of the proceeds, the history of the corporation, and of any predecessor company or firms, a tabulated list of constituent, subsidiary, owned or controlled companies, with a detailed explanation of all stock issues, mortgage and indebtedness obligations, as well as all liabilities in the form of guarantees, leases, rentals, traffic agreements, etc.; the description, location, nature, and acreage of property owned, controlled and leased, as well as equipment, buildings, franchises, timber, fuel, mining lands, water rights, etc.; the policy with respect to depreciation; the character of annual output for a five-year period; the dividends paid or declared by the corporation, as well as by its predecessor, constituent, subsidiary, owned or controlled companies; the most detailed financial statement with respect to itself and all subsidiary and controlled companies; the place and date of annual meeting, the location of the principal and other offices; and a classified list of officers, and directors, transfer agents and registrars, with addresses. With respect to mining properties, and oil and gas properties, information is required along nine additional lines. For an original listing of bonds, information must be furnished under nine distinct headings (in addition to all the information required for the listing of stock) designed to cover

For a complete copy of the listing requirements of the New York Stock Exchange, see the appendices of Meeker, *The Work of the Stock Exchange,* pp. 551–84.

all important matters pertaining to legality, the names and addresses of trustees, the conditions of the issue, the purpose of the issue and the application of the proceeds, the mortgage or indenture provisions, the character of the security offered, and any unusual provisions or covenants contained in the mortgage, or deed of trust.

2. *Engraving of Securities.*—In view of the enormous amount of the nation's wealth represented by bonds and stock certificates, and the free and easy manner in which title to these evidences of wealth changes hands, it is of the utmost importance that every possible precaution be taken in the making of such securities to afford the greatest possible security against counterfeiting. It is for this reason that all stocks, bonds, coupons, and certificates of deposit, in order to be eligible for listing, must be engraved in the best manner and in strict accordance with the demands of the Exchange. All such securities "must be engraved and printed in a manner satisfactory to the Committee from at least two steel plates by an engraving company whose work the Committee is authorized by the Governing Committee to pass upon; the name of the engraving company must appear upon the face of all securities and also upon the face of coupons and the title panel of each bond. Securities must bear a vignette upon their face." The nature of the two plates, used for engraving purposes, is carefully defined so that, "the combined effect of the impression from the plates will be as effectual security as possible against counterfeiting." Provision is also made that "the printing of securities must be in distinctive colors, to make classes and denominations readily distinguishable."

3. *The Printed Text of Securities.*—Besides regulating the engraving of securities, the Exchange controls the general outline of the printed text of securities. Thus, in the case of bonds, the Exchange takes the position that the average bondholder rarely consults the mortgage securing the bond, and that, while it is not desirable to make the bond recite all facts in too great

detail, it is essential that there should be an insistence upon sufficient reference being made to all vital features so that holders of the bonds may have due notice of all important facts in the mortgage, thus giving them the opportunity, if they so desire, of consulting the details of the mortgage itself. For this reason the corporation submits to the Committee on Stock List a draft of the bond, together with a copy of the mortgage or indenture, with a view to having the same passed upon by the Committee, and, if necessary, revised. The text of the bond, according to the listing requirements, must recite, among other matters, the "conditions of issuance, tax exemptions, terms of redemption (by sinking fund or otherwise), convertibility, default, and interchangeability into other securities."

The text of stock certificates must "recite ownership, par value, whether shares are full paid and non-assessable, terms of redemption, preference as to dividends, voting power, or other privileges, including distribution of assets in the event of the dissolution of the corporation." Common stock certificates must recite the preferences of the preferred stock, since the holder of common stock should know what rights rank ahead of his stock. As an additional safeguard all certificates must contain the following legend: "This certificate is not valid until countersigned by the transfer agent, and registered by the registrar." The transfer agent, it should be noted, is the agent of the company and serves as a check for the company in the issuance of securities. The registrar, on the other hand, is not the agent of the company but acts under the authority of the Exchange. The registrar, therefore, will not register stock until authorized to do so by the Exchange, thus serving as a check against the wrongful issuance of stock by the company. The irrevocable power of attorney, together with the bill of sale and power of substitution found upon the reverse side of the certificate of stock, is also prescribed in the listing requirements of the Exchange.

4. *Transfer and Registry.*—Besides prescribing the text and

form of securities, the Exchange also supervises their transfer and registry in certain important particulars. Every corporation making application for listing securities must agree "to maintain a transfer office or agency in the Borough of Manhattan, City of New York, where all listed securities shall be directly transferable, and the principal of all listed securities with interest or dividends thereon shall be payable; also a registry office in the Borough of Manhattan, City of New York, other than its transfer office or agency in said City, where all listed securities shall be registered." Both the transfer agent and the registrar must be acceptable to the Committee on Stock List. The registrar is forbidden to register any listed stock unless authorized by the Committee and is required to file with the Secretary of the Exchange an agreement to comply with all requirements pertaining to registration. The Committee must approve any change by a corporation of a transfer agency, a registrar of its stock, or of a trustee of its bonds or other securities; and a trust company or other agency may not at the same time act as transfer agent and registrar. When stock is transferred at the company's own office, the transfer agent, authorized to countersign certificates, must be an individual other than an officer authorized by the company to sign certificates of stock. The following additional requirements are also stipulated: "When a corporation makes transfers of its shares in other cities, certificates shall be identical in color and form, except as to names of transfer agent and registrar; certificates interchangeably transferable must bear a legend reciting the right of transfer in New York and other cities."

5. *Papers to Be Filed with Applications for Listing.*—For the listing of stocks these papers comprise a copy or copies (as may be requested) of the Charter, with amendments to date; the by-laws, with amendments to date; leases, franchises, easements and special agreements; resolutions of stockholders and directors authorizing the issue; resolutions of stockholders or board of directors, authorizing, by name, the official to appear

for the listing of securities; opinion of counsel as to the legality of organization, authorization, issue, and validity of securities; the detailed distribution of securities; the resolution appointing the transfer agent and registrar; the certificate of the registrar as to the amount of securities registered at the date of application; the report of a qualified engineer covering the actual physical condition of the property, at a recent date; a map of the property and contemplated extensions; specimens of all securities to be listed; the questionnaire; a certified copy of income accounts, surplus accounts and balance sheets; copy of agreements; and a certified copy of printed circulars issued by bankers describing the security, if available.

In addition to the foregoing the corporation must file, when listing bonds, copies of the mortgage or indenture, together with an opinion of counsel covering the validity of the issue, and a trustees' certificate covering the acceptance and issuance of the bonds, the securities held, and the cancellation or deposit of underlying securities and prior liens.

6. *Agreements to Be Observed by Corporations Applying to List Securities.*—Various agreements are exacted by the Exchange in the interest of publicity and for the protection of the public against certain forms of gross manipulation formerly practiced. Briefly enumerated these agreements comprise the following, aside from the agreements already referred to in connection with transfers and registry:

(1) Immediate notification to the Exchange of any change in the general character or nature of the corporation's business.

(2) Immediate notification to the Exchange if the corporation, or any subsidiary thereof, disposes of any of its property or its stock interests in other companies.

(3) Periodic publication of statements of earnings, as agreed upon with the Committee.

(4) Publication "at least once in each year and submission to stockholders at least fifteen days in advance of the annual meeting of the corporation, of a balance sheet, an income state-

ment for the last fiscal year and a surplus statement of the applicant company as a separate corporate entity and of each corporation in which it holds directly or indirectly a majority of the voting stock." (Various other agreements are listed with respect to the items required in the annual report.)

(5) Notification to the Exchange of the issuance of rights, and the proper protection of the holders of listed shares with respect to such rights.

(6) Prompt notification to the Exchange in the event of issuance of options and warrants to purchase stock.

(7) Prompt notice to the Exchange of dividend actions.

(8) Furnishing of copies to the Exchange of all notices mailed to stockholders with respect to Charter amendments.

(9) "Not to purchase preferred stock for redemption otherwise than pro rata or by lot; to notify the Exchange immediately and at least fifteen days in advance of any such redemption."

(10) Notice of "change or removal, to a substantial extent, of collateral deposited under any of its mortgage or trust indentures under which listed securities are outstanding."

(11) Maintenance at all times of a sufficient supply of certificates to meet transfer demands.

(12) Furnishing to stockholders, upon request and without charge, a printed copy of the preferences of all classes of stock, should the stock certificates of the corporation not recite such preferences.

(13) Furnishing the Exchange, "on demand, such reasonable information concerning the company as may be required."

7. *Listing of Additional Amounts of Listed Securities.*—The financial page will show almost daily that some corporation, whose security issues are already listed, will have an additional amount of some such bond or stock listed. Every such increase in stocks or bonds must be listed separately, although it is not necessary to observe all the requirements demanded, and to read all the documents called for, in the case of original list-

ings. To avoid the filing of a full additional application, especially when it may be necessary to list securities quickly, as in the case of bond conversions into stock, or the issuance of privileged subscriptions, the company in its application may request authority from the Committee on Stock List to list the new securities and the Committee may then recommend that the Governing Committee grant authority that such securities be listed upon official notice of and issuance in accordance with the terms of the application. Upon such official notice being given by the company the registrar is given authority to register the security. While the requirements for such listing are comparatively few, the Exchange does ask for a statement from the corporation showing, among other facts, the amount of and authority for the issue, including action by the stockholders, directors, and public authorities; the purposes of the issue and the application of the proceeds; the amount, description, and disposition of securities exchanged for new issues; additional property acquired or to be acquired; any changes in the charter, by-laws, or capitalization; details as to property acquired and disposed of since the last application; character and amount of output of the business since the last application; and an income account and balance sheet of recent date. When a corporation proposes to increase its authorized capital stock, thirty days' notice of such proposed increase must be given to the Exchange before the new stock is eligible for listing.

Procedure of Listing.—Having classified the listing requirements, we may next outline the general procedure followed in placing a corporation's securities on the list. Several hundred applications for listing come before the Committee on Stock List annually. Comparatively few of these applications are rejected, because in the course of years corporations have ascertained the listing requirements of the Exchange and know to a reasonable certainty the conditions that will be accepted or declined. In fact, many applicants make inquiry in advance

and if they find that they cannot meet the requirements will not file an application. The result is that applications seldom come before the Committee on Stock List unless they have first passed through the hands of its clerk and fulfill requirements.

A corporation wishing to list its securities applies to the Exchange and is given a number of documents,[5] the most significant of which are the list of requirements, the distribution statement, and the questionnaire to be signed by one of the company's officers. The corporation then prepares its application, basing it on the requirements that were furnished to it. Upon its completion, the application is sent to the members of the Stock List Committee, each member being also furnished a copy of the various papers that corporations must file. After the members of the Committee have familiarized themselves with the facts relating to the proposed listing, notice is given to the parties in interest to appear before the Committee to answer such questions as the members may wish to ask concerning any fact recited in the application or in the papers accompanying it. The parties in interest who usually appear are the treasurer of the company, sometimes its president, the legal representative of the company, and frequently a representative of the banking house interested in the security.

Almost the first questions directed to those who appear before the Committee relate to the distribution of the stocks or bonds sought to be listed. "Give us a list showing, not the names of the stockholders, but the number of your stockholders who hold 50,000 shares or more, 40,000 to 50,000 shares, 30,000 to 40,000, 20,000 to 30,000, 10,000 to 20,000, 5,000 to 10,000, and the number who hold up to 5,000 shares." "How many holders of these various amounts hold their stock absolutely free and clear of any engagement not to sell it so that the stock shall not be tied up in a pool?" "Is there any syndicate inter-

[5] In 1932 the New York Stock Exchange reported 207 applications for listing during 1931, 524 in 1930, 759 in 1929, 571 in 1928, 449 in 1927, 390 in 1926, and 426 in 1925.

ested in any of the stock, and if so, how much stock is tied up by a syndicate agreement?" These are some of the questions that the representatives of the company must answer to the satisfaction of the Committee. It must always be remembered that American exchanges, unlike the London Stock Exchange, for example, do not propose to make an initial market for securities. Instead, the New York Stock Exchange insists that the market must be made prior to the listing of the securities. In other words, assuming a company wishes to list $20,000,000 of stock, at least a sufficient amount to insure a fair market must have been sold to the public and be free of control by syndicate agreement, i.e., the securities must be free for market purposes and a few persons are not allowed to control the market by virtue of their holdings or because by agreement others are restrained from selling. The importance of this matter is apparent since it is customary in the issuance of securities by corporations to form syndicates to underwrite the securities, and sometimes following the dissolution of a syndicate, there may still exist a gentleman's agreement by which the parties to the syndicate bind themselves to retain their securities until a stipulated price can be realized.

If the Committee is of the opinion that a sufficient amount of the security, to warrant a fair market, is in the hands of the public, it next considers the application as it stands with a view to revising and amending it to meet the demands of clearness and completeness. Any points not clearly stated are restated, and any unusual powers of the directors, or other peculiar conditions, are inserted. The representatives appearing before the Committee are also closely questioned as to the balance sheet in order to ascertain the absolute solvency of the company.

If all questions have been satisfactorily answered, and if the application is satisfactory, the Committee on Stock List recommends the listing of the securities to the Governing Committee. The revised and amended application, frequently com-

prising over 5,000 words, is printed and a printer's proof, embodying all the changes, is signed by the company's representative. A copy is given to each of the members of the Governing Committee sufficiently in advance of its meeting. At the next regular meeting of this Committee the Chairman of the Committee on Stock List presents the applications that have been approved and moves that the securities be listed. Any member of the Governing Committee may object to any proposed listing because of personal knowledge or because of information obtained with respect to the application. But such objections rarely occur, owing to the care previously exercised. On the affirmative vote of the majority of the Committee the security is listed, the company is at once notified, the registrar, if the securities are stock, is authorized to register the amount of securities recited in the application, and trading therein can begin the next morning. The printed statements on which the listing is based are furnished to all the members of the Exchange, who keep them on file for the information of themselves and such customers as may desire the facts. They are also freely given to any person requesting them, and are furnished in New York to the daily and financial papers which frequently quote copious extracts.

Removal or Suspension of Securities from the List.— Whenever the outstanding amount of any listed security appears to have become so limited as to make further dealings therein dangerous, the Committee on Stock List may direct that the security be stricken from the list. The rules of the Exchange also empower the Governing Committee to suspend dealings in the securities of any corporation previously admitted to the Exchange, or summarily to remove any security from the list.

The exercise of this power by the Exchange has at times been the subject of adverse criticism, chiefly on the ground that innocent purchasers of the stock while on the list may later be deprived of the advantages attaching to listing. Removing

a security from the list is manifestly a serious question, and has always been so regarded by the Governing Committee of the Exchange. Yet, in the absence of Government requirement in the matter, the exercise of this power must be regarded as necessary to enforce the rigid observance by corporations of the agreements already referred to. The practice, however, is particularly justified by the Exchange on the plea that too small an outstanding amount of any listed security is a source of danger to customers and brokers, as well as to the public, and that removal of the stock from the list is necessary to eliminate this danger.

The danger referred to may arise from two causes. If very limited in amount, the stock may easily be subjected to the grossest kind of manipulation. A few individuals, by obtaining control of most of the shares, might be in position to fix an artificial price by occasional transactions on the Exchange and succeed in inducing unsuspecting buyers to purchase the shares at greatly inflated prices. Such manipulation is particularly easy if there is no short interest in the stock seeking to depress its price. On the other hand, if a short interest should exist in the stock, another danger is apt to arise, namely, a corner. Past experience has clearly shown that corners not only affect the parties directly involved, but, by demoralizing the entire security market, indirectly injure holders of other securities. In view of the foregoing reasons the New York Stock Exchange refuses to list a security when owned chiefly by a single interest. The same reasons, it is argued, also require that a security should be removed from the list, or dealing therein suspended, when only a very limited amount remains in the hands of the public.

Progressive Development of Listing Requirements and Suggested Changes.—Whatever may be our conclusions as to the adequacy of the detailed listing requirements of the New York Stock Exchange, it is certain that these requirements have been progressively strengthened in the in-

terests of greater publicity.[6] As indicating progressive development there might be mentioned the fact that the publication of annual reports by corporations, for years merely a recommendation, was made an absolute requirement some fifteen years ago. On April 1, 1910, the Exchange also abolished the so-called Unlisted Department, which had existed since 1885, and which was created at a time of great dullness on the Exchange with a view to enlarging the opportunities for brokerage transactions. Under this system a considerable number of industrial and mining corporations were allowed to obtain a market on the Exchange without furnishing many of the facts now required. The creation of this department has been generally recognized as a great mistake, and as a step "wholly at variance with the duty of the Exchange to protect the investor." In abolishing this practice, as William C. Van Antwerp writes,[7] "The Listing Committee accomplished a twofold blessing in setting the Exchange right with the public by ridding their institution of anything approaching the blind pools of early days, and at the same time forcing certain wealthy corporations to abandon their policy of concealment or lose the privilege of the floor."

Requirements of the Securities Exchange Act of 1934.—As previously explained, exchanges are powerless to dictate unduly the business policy of corporation managers or to serve as a censor of the acts of corporation officials. Section 12 of the Securities Exchange Act, dealing with the "registration requirements for securities," requires information from the issuer of securities along much the same line already discussed in connection with the requirements of the New York Stock Exchange. But certain additional requirements are called for, the most important of which are:

[6] It is stated that the London Stock Exchange will, upon receipt of the published applications, and without further examination, list any security that is listed on the New York Stock Exchange.

[7] Van Antwerp, William C., *The Stock Exchange from Within*, p. 167.

(1) A statement of the remuneration received by the directors, officers, principal security holders, and underwriters from the issuer, as well as the interest of such parties in the securities and material contracts with the issuer and affiliates.

(2) A statement of the remuneration of others—not officers and directors—exceeding $20,000 annually. There must also be a full statement concerning bonus and profit-sharing arrangements, management and service contracts, options in respect to securities existing or to be created, material contracts not made in the ordinary course of business, and material patents.

(3) A statement from every person "who is beneficial owner of more than 10% of any class of any equity security (other than an exempted security) which is registered on a national security exchange, or who is a director or officer of the issuer of such security," reporting the amount owned and any change in ownership within ten days after the close of each calendar month. "Any profit realized by such beneficial owner, director, or officer from any purchase and sale or any sale and purchase, of any equity security of such issuer within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months." The Act also makes it unlawful for any beneficial owner, director, or officer, "directly or indirectly, to sell any equity security of such issuer, if the person selling the security or his principal (1) does not own the security sold or (2) if owning the security, does not deliver it against such sale within twenty days thereafter, or does not within five days after such sale deposit it in the mails or other usual channels of transportation; but no person shall be deemed to have violated this subsection if he proves that notwithstanding the exercise of good faith he was unable to make such delivery or deposit

within such time, or that to do so would cause undue inconvenience or expense."

According to the Act, securities are registered upon application by the issuer, by filing with the exchange and with the Commission all of the information and undertakings called for. If the exchange authorities certify to the Commission that the security has been approved by the exchange for listing and registration, the registration becomes effective within thirty days if the Commission may so determine. The Commission, however, is empowered to permit securities listed on any exchange at the time of registration of such exchange "to be registered provisionally, for a period ending not later than April 1, 1935, without complying with the provisions of this section."

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CHAPTER X

TYPES OF DEALERS AND BROKERS AND THEIR WORK

The membership of an exchange by no means consists entirely of commission-earning brokers. The membership on the New York Stock Exchange includes at present about 187 inactive members (out of a total membership of 1,375), composed of two principal groups, namely, (1) wealthy individuals and representatives of financial institutions who own seats for the purpose of securing reduced commissions on their numerous transactions, and (2) commission firms with out-of-town offices. These individuals or firms employ brokers on the Exchange to transact their business and never execute orders personally. Their membership, however, gives them many valuable business connections, as well as the benefit of a lower rate of commission than that charged the general public. Because the volume of their business is usually large, this reduction in commissions is apt to meet in large part, and sometimes even to exceed, the annual dues incident to membership and the loss of interest on the market price of their seats. This is particularly true in the case of so-called "operators" whose speculative commitments at times reach enormous proportions.

Types of Traders.—Turning to a consideration of those members of an exchange who operate on its floor, we find that they are either "traders" or "brokers." Traders, as distinguished from brokers, may be divided into four classes, namely, "floor traders," "odd-lot dealers," "specialists," and "arbitragers." Each class has its own functions to perform and presents its own peculiar characteristics. Various European exchanges regulate the extent to which their members may exercise the

two functions of "trading" and "serving as brokers." Thus the London Stock Exchange divides its membership into "brokers" and "jobbers" or dealers, and requires that each of its members confine himself strictly to one of these two classes. The Paris Bourse goes even further by forbidding any of its members to act as dealers. On the New York Stock Exchange, however, members are not bound at present [1] to belong to any one of the aforementioned classes, so long as they do not undertake to act as both broker and dealer in the same transaction. In practice the members nearly always specialize in one of the two classes—dealing or brokerage—being compelled to that course in the interest of adequacy of service and profitableness of business return. But if they wish they may, with the exception of certain Exchange restrictions pertaining to odd-lot dealers and specialists, extend their business operation to include the entire range of stock exchange activities.

"Floor" or "Room" Traders.—At present some 86 members of the New York Stock Exchange operate on the floor as "floor" or "room" traders, for their own speculative account. They trade in any stock that shows signs of activity, and are generally "scalpers" of small amounts. A floor trader often changes his position quickly and may be a "bull" one minute and a "bear" the next. If his speculative venture is wrong, he is quick to limit his loss, and if right he is usually satisfied with a small profit. In the long run he hopes by this method to make his profitable days average better than the unprofitable ones. Room traders naturally are inclined to adhere strictly to such principles of trading as in their opinion will best tend to bring about an average profit. Small and sure profits they generally feel should be taken in preference to large and uncertain ones. After remaining long or short of a stock for a whole day or

[1] According to Sec. 11 of the Securities Exchange Act of 1934 the Securities and Exchange Commission is given complete power, if it is deemed necessary, to segregate or limit the functions of members, brokers and dealers.

more they frequently use "stop-loss" orders, that is, orders that become "at-the-market" orders to sell or to buy the stock if the quotation drops or rises to a designated point. Some of them also practice the "evening up" of trades before the close of the day so that they may "go home with nothing to disturb their equanimity."

Floor traders may be described as professional speculators, acting for themselves and not as agents for others. They depend entirely upon profits derived from trading for their own account, and do not receive commissions. Being members of the Exchange, they pay no commissions in connection with their transactions, and usually have the further advantage that they are not obliged to maintain an elaborate office equipment. Often they maintain only desk room in some commission broker's office, and enter their transactions, for clearing purposes, on the clearing sheet of that commission broker, paying him a stated fee per 100 shares for the labor and responsibility associated with the work of clearing. Although having no other purpose in mind than the clipping of small profits, the activity of floor traders proves beneficial to the public in that it helps (1) to maintain a more continuous market, and (2) to create closer prices for stocks. In both of these respects the floor trader serves to enhance the marketability of stock issues listed upon the Exchange.

Recent changes have proved severely detrimental to floor traders, and their number on the New York Stock Exchange has been greatly reduced from that prevailing prior to the World War. State and Federal transfer taxes have been especially severe upon a business dependent upon the capturing of small profits only. Many floor traders have left the Exchange altogether, or have been driven from their true function into long-pull speculation or into some other activity of the Exchange which offers more lucrative profits. Whether the floor trader's opportunities will be at all improved by the Securities Exchange Act of 1934 is problematical. The Commission

is given full charge of the matter, Section 11 of the Act providing: "The Commission shall prescribe such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors, (1) to regulate or prevent floor trading by members of national securities exchanges, directly or indirectly, for their own account or for discretionary accounts, and (2) to prevent such excessive trading on the exchange but off the floor by members, directly or indirectly for their own account, as the Commission may deem detrimental to the maintenance of a fair and orderly market. It shall be unlawful for a member to effect any transaction in a security in contravention of such rules and regulations, but such rules and regulations may make such exemption for arbitrage transactions, for transactions in exempted securities, and, within the limitations of subsection (b) of this section, for transactions by odd-lot dealers and specialists, as the Commission may deem necessary or appropriate in the public interest or for the protection of investors."

Odd-Lot Dealers.[2]—Such dealers devote themselves entirely to the making of a market in lots of less than 100 shares, and have developed as a group in response to the growing demand for a free, continuous market for small investors whose purchases and sales are necessarily smaller than the regular unit of trading (100 shares) prevailing on the large exchanges of the country.[3] This unit of trading is the minimum amount of

[2] According to Sec. 11 (b) of the Securities Exchange Act of 1934: "When not in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, the rules of a national securities exchange may permit (1) a member to be registered as an odd-lot dealer and as such to buy and sell for his own account so far as may be reasonably necessary to carry on such odd-lot transactions, etc."

[3] The New York Stock Exchange enacted rules, effective Nov. 15, 1933, which have been indefinitely postponed, to the effect that no member or firm "dealing in listed securities in amounts of less than the unit of trading shall act as a broker in the listed securities in which he or his firm so deals." Such member is also forbidden to "execute on the floor of the Exchange for his own account or for any other account any order for the pur-

stock for which a broker, according to the Exchange rules, must accept a bid or offer, and the market quotations are based on sales of that unit or multiples thereof. Quotations on odd lots, of say five or ten shares, would be apt, owing to their negligible size and limited quantity, to be misleading to the public. Brokers would have no inducement to buy or sell very small lots in the open market, of say two or three shares, because the minimum commission would not adequately compensate for the labor and time involved. Brokers would also find it impossible in an active market to execute large orders of, say, 500 shares or more if contracts had to be made with all who offered to buy or sell lots of five or ten shares; and bankers would find it extremely inconvenient to lend money on collateral containing numerous certificates for odd amounts.

These difficulties are largely eliminated by the existence of odd-lot dealers who stand ready at all times to buy or sell any odd lot of stock at a slight concession from the market price for full lots. As a result small investors have the opportunity to buy or sell one share or ninety-nine shares, "all equally well within the average of less than one-eighth of one per cent of the wholesale price." [4] As commission brokers come to the odd-lot dealer with their customers' orders to buy these small lots, the latter sells them the stock at a price an eighth or a quarter, or some other small fraction, above the next quotation for 100 shares, and when his sales of such lots reach 100 shares he buys them in the 100-share market in order to fulfill delivery on his contracts. Similarly, if small lots are offered to him, he buys them at a price an eighth or a quarter below the quotation of the next

chase or sale in the unit of trading of any such listed securities." Both of the aforementioned prohibitions are also extended by the Exchange to "any member associated with any such member or firm as their representative on the floor of the Exchange in odd lots in specific securities." (P. 107 of Constitution of New York Stock Exchange, Revised to October 10, 1933.)

[4] Testimony of Henry G. S. Noble, *Hearings before the Senate Committee on Banking and Currency on S. 3895,* 1914, p. 165.

transaction for 100 shares, and when such purchases in any stock amount to 100 shares, he promptly sells them in the 100-share market. His profit consists solely of the difference between the price at which he originally bought and subsequently sold, or originally sold and subsequently bought.

When selling odd lots to small investors, the odd-lot dealer goes short of the market since he sells the odd lots first and then buys the 100 shares in the 100-share market. He cannot without great risk buy the 100 shares in advance of his sales of the fractional lots, because he does not know how many orders for such lots in any given stock will come to him, their volume changing greatly from hour to hour. Moreover, odd-lot buying increases greatly during severe declines when bargain hunters are attracted. To buy the stock first, have the market go down, and then furnish the bargain hunters with the stock at current prices is a procedure that one cannot expect the dealer to follow. His only protection consists in selling first as the market declines and then promptly buying the 100 shares when he knows the amount he has sold. Another service of short selling is thus apparent, since without it the odd-lot dealer would find it impossible to operate, and without him small investors would be deprived of the continuous market at good quotations which such dealers make for them.

The importance of odd-lot dealers is indicated by Henry G. S. Noble's estimate that in an active market about 20 per cent of the business on the New York Stock Exchange is in small lots.[5] Approximately 128 odd-lot dealers are reported as operating on the floor of this Exchange at present, about one-fourth of the number consisting of odd-lot members, and about three-fourths of "associates." Two firms handling this type of business, it is reported, have seven members each, while one has as many as ten members.

Specialists.—This group, comprising about one-fourth of the

[5] *Testimony on S. 3895 before the Senate Committee on Banking and Currency,* 1914, p. 167.

total New York Stock Exchange membership, consists of dealers and/or brokers who make a specialty of one or a limited number of securities. The specialist may execute orders for his own account or as an agent for other brokers, and derives his name from the fact that he "specializes" in stocks located at some post on the floor of the Exchange. According to reports, the majority of specialists serve as dealers for small and quick profits, and like "floor traders" help to make the market more continuous and more stable than would otherwise be the case. However, when acting as a dealer, the specialist may not pretend to serve as a broker and may not charge a commission. As a dealer, he renders with respect to 100-share lots much the same service derived from odd-lot dealers with respect to odd lots. In fact, specialists formerly did a considerable amount of odd-lot business. But to-day only a few specialists still execute odd-lot transactions, the change being attributable to the enormous increase in the volume of 100-share transactions and the consequent tendency toward specialists in each of the two fields, namely, odd lots and 100-share lots.

The existence of specialists is especially important to commission brokers because they are always ready to make a market for them in the securities they represent. Their economic usefulness consists chiefly in their willingness to take chances as speculators in the securities in which they specialize. In being ready to trade under all market conditions they render easier and more certain the commission broker's business of serving the public. Through their speculation they help to create a continuous market. Without them fluctuations between sales of certain stocks would be much greater, and many stocks would likely at times have little or no market whatever.

Like the odd-lot dealer, the specialist must meet the demand either to buy or sell. A commission broker having an order to execute hastens to the post where the security is dealt in and inquires as to the market. The specialist, anxious to be the first bidder, offers to pay 100¼ or to sell at 100½, or at wider

differences if he chooses. If the broker buys 100 shares at 100½, the specialist, generally having sold the stock short, promptly endeavors to buy the shares. Or he may already have purchased the stock in the belief that buyers will appear. If, under the first circumstance he fails to buy the shares at 100½, he will endeavor promptly to limit his loss to an eighth or a quarter, if possible. The same tactics are pursued if the broker should sell to him at 100¼.

Much of the specialist's business, however, consists in serving as a broker in the particular stocks in which he happens to be specializing. Here he may be serving much the same purpose as that rendered by the "floor" or "two dollar" broker, as will be explained later. But in ever so many instances brokers will turn over to the specialist, as broker, the execution of orders which are difficult to execute, owing to the inactivity or the intense activity of the market in the particular security, or because the customer's price limit is so far from the prevailing price as to make it inconvenient for the commission broker to watch the market over considerable periods of time, or, again, because the commission broker may be called away from the post in question just as the market price is nearing his customer's figure. When serving as broker, the specialist is therefore of great assistance to commission brokers and their customers in the interest of speedy and adequate execution of orders. In fact it is doubtful if the practice of using "stop-loss" orders would be possible if it were not for a large group of specialists.

But under all circumstances where the specialist serves as broker, he must be careful not to violate his professional status as such. According to the rules of the New York Stock Exchange (Chap. XI. Sec. 1), "No member, while acting as a broker, whether as a specialist or otherwise, shall buy or sell directly or indirectly for his own account or that of a partner, or for any account in which either he or a partner has a direct or indirect interest, securities the order for the sale or purchase

of which has been accepted by him or his firm or a partner for execution." Only two exceptions are permitted to this rule. First, "a member who, by reason of his neglect to execute an order, is compelled to take or supply on his own account the securities named in the order, is not acting as a broker, and shall not charge a commission." Here, however, the member may not take the securities named in the order, unless "he shall have offered the same in the open market, if bonds at ⅛ of one per cent, and if stocks at ⅛ of one dollar, higher than his bid, and provided the price is justified by the condition of the market, and that the member who gave the order shall directly, or through a broker authorized to act for him, after prompt notification, accept the trade and report it." The same rule also applies where the member supplies the securities named in the order, except that he shall bid for the bonds or stocks in the open market, at the same prescribed figures, but "lower than his offer." Secondly, "a member, acting as a broker, is permitted to report to his principal a transaction as made with himself when he has orders from two principals to buy and to sell and not to give up, such orders being executed in accordance with Sec. 13 of Chapter I," which provides that he must first offer such security at an eighth "higher than his bid before making a transaction with himself."

As a further protection of the public specialists are also forbidden to be interested in any pool involving the shares in which they are dealing. To quote the rule: "No member acting as a specialist and no partner of such a member and no firm in which a member is a general or special partner shall, directly or indirectly, be interested in a pool dealing or trading in the stock in which such a member is a specialist, nor shall any such member, partner or firm, directly or indirectly, acquire or grant, in connection with a pool operation, an option to buy or sell or to receive or deliver shares of the stock in which such a member is a specialist." (Chap. XIV. Sec. 11.)

The problem of properly segregating the specialist's two

functions of trader and broker has always been a difficult one. Moreover, for years there has been criticism and suspicion that certain specialists might not be exercising their dual functions in the public interest. Accordingly this matter was given special treatment in the original draft of the Securities Exchange Act of 1934. As finally passed, however, the whole matter is left to the discretion of the Securities and Exchange Commission. Section 11 (b) provides that:

"When not in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, the rules of a national securities exchange may permit . . . (2) a member to be registered as a specialist. If under the rules and regulations of the Commission a specialist is permitted to act as a dealer, or is limited to acting as a dealer, such rules and regulations shall restrict his dealings so far as practicable to those reasonably necessary to permit him to maintain a fair and orderly market, and/or to permit him to act as an odd-lot dealer if the rules of the exchange permit him to act as an odd-lot dealer. It shall be unlawful for a specialist or an official of the exchange to disclose information in regard to orders placed with such specialist which is not available to all members of the exchange, or to any person other than an official of the exchange, a representative of the Commission, or a specialist who may be acting for such specialist; but the Commission shall have power to require disclosure to all members of the exchange of all orders placed with specialists, under such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. It shall also be unlawful for a specialist acting as a broker to effect on the exchange any transaction except upon a market or limited price order."

"Bond Dealers" and "Brokers."—This group, comprising about 60 members, and commonly called the "bond crowd," consists of dealers or brokers, or both, specializing in bonds. Their service is much the same as that explained for specialists in the stock market. As dealers they buy and sell for their

own account, and as brokers they execute orders on commission for their principals. Owing to the more limited character of the bond market, as regards volume, most of the bond dealers also serve as brokers, and vice versa. Like specialists in the stock market this group, when acting as dealers, serves to render the bond market more continuous and stable. Likewise, when acting as brokers, the commission broker and his customer are served in the interest of quick service and at the best obtainable price.

Arbitragers.—The business of arbitragers, as explained in the chapter on arbitraging, is to buy in one market and sell at a higher price in another, with a view to the making of the difference. Most of the arbitraging has taken place between the New York and London markets, although a considerable amount also occurs between the markets afforded by some of the minor exchanges of the country. Our previous explanation of the arbitrager's functions and methods renders a repetition unnecessary. Chapters XVI and XVII also explain the usefulness of arbitraging in connection with the marketing of "rights" and the conversion of bonds into stock.

Types of Brokers.—Turning now to a consideration of brokers, using this term in the strict sense, we find that they may be divided into two classes. It is difficult, again, always to draw a hard and fast line between these classes, because on American exchanges brokers are not restricted to any one class, and some, therefore, at times act in one capacity and at other times in another. The two classes referred to comprise commission brokers, and "floor" brokers. The function of each of these classes will now be considered.

Commission Brokers.—Commission brokers are partners of a commission house and devote themselves to the execution of orders for their firm's customers, the firm receiving a commission of not less than 3 cents per share on stocks selling between 50 cents and $1, 7½ cents per share when selling at $1, and above, but under $10, 12½ cents when selling at $10 and under

$25, 15 cents at $25 and under $50, 17½ cents at $50 and under $75, 20 cents at $75 and under $100, 25 cents at $100 but under $200, 30 cents at $200 but under $250, and 5 cents additional for each additional $50 in price. (Art. XIX, Sec. 2.) [6] The commission on shares selling under 50 cents is "as mutually agreed." Moreover, on all transactions involving an amount of $15 or more, a minimum commission of not less than $1 is provided for by the rules.

Of the New York Stock Exchange membership, 273 are reported as commission firm members. Their function is to serve as agents for others, and to execute customers' orders with the least delay, at the best possible price, and in strict accordance with the terms thereof. Prompt execution of orders means pleased customers, and satisfaction among customers means larger business. If the commission firm is a large one, it may have two or even more floor representatives. Commission firms, it should be stated, also differ considerably with respect to the clientele they serve and the type of business they emphasize. Some have only a comparatively small group of wealthy customers. Others have branch offices and out-of-town correspondents, and number their customers into the thousands, spread among average investors throughout the nation. Some firms specialize largely in certain groups of shares, such as railroads, industrials, or oil shares, and acquire a reputation in those special fields, while others emphasize the market as a whole.

"Floor" Brokers.—Commission brokers, or other members of the Exchange for that matter, often find it highly desirable, when obliged to execute orders simultaneously in many stocks, to have so-called floor brokers assist them in the execution of orders in any part of the Exchange. In other words, these brokers, numbering some 289 on the New York Stock Exchange, are brokers for other brokers. At one time they received for their services $2 per 100 shares, as contrasted with the com-

[6] For a detailed statement of commission charges see Art. XIX, reproduced as Appendix VII.

mission broker's regular charge of $12.50 to the public, and were thus commonly known as "two-dollar brokers." To-day, however, their compensation is somewhat higher,[7] although it remains very much less than the commission charged the outside public. As a rule they receive orders from many different firms, and are expected to give to all the closest attention. They cannot delegate their orders to some one else without sacrificing their limited commission. To be of greatest value to their employers they must not only be skillful in the execution of orders but must keep in constant touch with floor gossip and news. Their meager wage, however, is compensated for in part by the absence of office responsibilities and the risks and unpleasantness frequently associated with the commission broker's relations to his customers. Their service, as Meeker points out "imparts a flexibility and a reserve power to the machinery of the Exchange which it would not otherwise have, and enables the fluctuating number of sales made from day to day to be

[7] On the New York Exchange commissions on business for members of the Exchange, when a principal is given up, shall not be less than the following:

Price	Rate per Share
Selling under 50 cents	As Mutually Agreed
Selling at 50 cents and above, but under $1	½ cent
Selling at $1 and above, but under $10	1¼ cents
Selling at $10 and above, but under $125	2½ cents
Selling at $125 and above	3 cents

Commission on business for members of the Exchange when a principal is not given up shall not be less than the following:

Price	Rate per Share
Selling under 50 cents	As Mutually Agreed
Selling at 50 cents and above, but under $1	¾ cent
Selling at $1 and above, but under $10	1¾ cents
Selling at $10 and above, but under $125	3¾ cents
Selling at $125 and above	5 cents

For a detailed statement of commissions see Appendix VII.

handled smoothly and efficiently, whether they were many or few." [8]

American and London Systems Compared.—Unlike American exchanges with their several classes of dealers and brokers to which members may belong, the London Stock Exchange's membership consists of but two classes—jobbers and brokers—and members can belong to only one or the other. The broker, under the London system, can act merely as a middleman between the public and the jobber. The jobber, on the other hand, cannot deal with the public directly, and is obliged to make his trades on the floor of the Exchange with brokers and fellow jobbers. Brokers, in other words, are commission brokers, receiving their compensation in the form of commissions, while jobbers are merchants of securities and depend on the profits resulting from their deals.

A broker in London having received an order from a customer must go to a jobber who specializes in that security. Without being told by the broker whether he wishes to buy or sell, the jobber is asked to name his price limits, and will quote, let us say, 50 and 50⅛, meaning that he is willing to buy the stock at 50 and sell at 50⅛. The broker will try to drive as hard a bargain as possible for his customer and may intimate, therefore, that the quotations are too wide. Thereupon, the jobber may "split" the difference, thus making the quotation 50 1/16. At this price the broker buys the security, and thereupon advises the customer of the particulars of the transaction, including the name of the jobber. In conducting his business, it should be added, the jobber nearly always sells short and relies upon a continuous market to enable him to buy immediately the stock that he sold to the broker; likewise in case the broker sold to him there is reliance upon a continuous market to dispose of the stock immediately.

The jobber combines in himself the functions of specialist, speculator, and trader. Whether his presence is more advan-

[8] Meeker, J. Edward, *The Work of the Stock Exchange*, p. 82.

tageous to the public than the American plan is a disputed subject with opinions much at variance. There are those who state that the large number of jobbers on the London Exchange—their number greatly exceeding that of the brokers—assures closer quotations, especially in a panicky market, for the great mass of inactive securities. Others feel that the New York Stock Exchange method, by not restricting the operations of brokers and by throwing the field open to all members, offers the greatest advantages, or at least that "the same result is obtained in the New York Stock Exchange far more openly and above board by the presence in all active securities of a host of such jobbers—brokers, traders, specialists, and speculators—each actively bidding and offering by voice and gesture, and without collusion, and each thereby contributing to the making of the freest possible market and the closest possible price." [9]

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CHAPTER XI

CUSTOMERS' ORDERS AND BIDS AND OFFERS

The customer, in buying and selling stocks, may use any one of a number of different kinds of orders, each of which has its advantages and its disadvantages. When a customer orders his broker to buy or to sell, the order, when it reaches the floor of the exchange, becomes a bid or offer for the stock involved.[1] The constitution and by-laws of each stock exchange contain provisions specifying types of bids and offers and regulating their use on its floor. It is the purpose of this chapter to discuss the different kinds of orders which the customer may use and to point out the most important exchange rules pertaining to these orders and to bids and offers. Because they are typical in this respect, the rules of the New York Stock Exchange will be used.

Classification of Customers' Orders.—Customers' orders may be classified in a number of ways. Probably the most important classification to the average investor is that based upon price. Customers' orders may be divided into various groups according to the instructions given to the broker regarding the price at which the order is to be executed. Orders to buy and to sell, however, may be classified on the basis of other important characteristics. Thus, they may be classified according to the length of time the order is to remain in force, or according to the length of time which may elapse before delivery must be made. These three classifications will be discussed in the order mentioned.

Customers' Orders Classified According to Price.—

[1] This statement does not apply to odd lots. See Chapter X.

Based upon the instructions given to the broker relating to the price at which they are to be executed, most customers' orders may be divided into the following kinds: (1) at-the-market orders; (2) fixed price orders; (3) immediate or cancel orders; (4) stop-loss orders; and (5) discretionary orders. The most common of these are at-the-market and fixed price orders. Stop-loss orders are also frequently used.

1. *At-the-Market Orders.*—At-the-market orders, often called "market" orders, specify no price and they must be executed *immediately* at the *best price obtainable at the time.* "Immediately" means as soon as the order can be transmitted to the floor of the exchange, and "at the best price" means the price then quoted at the post where the security is traded. Thus, if a customer instructs his broker to "buy 100 U. S. Steel common, at the market," the broker on the floor, upon receipt of the order, will proceed to the post where Steel common is bought and sold. There he may find that the last recorded sale was at 62, and that the stock is now quoted at 62 bid, and 62¼ asked. The broker must attempt to buy the stock at the best possible price and hence he will bid 62⅛. If he cannot obtain it for this price he must then bid 62¼. No discretion can be exercised by the broker, no matter how good his intention, in deferring the execution of such orders. On the other hand, the broker, as long as he acts carefully and in good faith, is fully protected by law against any consequences that may grow out of the fact that he finds it possible to execute the order only at a price far removed from the quotation that ruled when the order was given.[2]

[2] Sometimes a broker will not execute an at-the-market order pending further instructions from the customer. For example, if in an inactive stock, the broker finds that he can execute the order only at a price far removed from the last sale price, he may defer execution until he can call his office to inform them of the situation. If the customer can be located immediately the floor member receives fresh instructions. If the customer cannot be located the floor member is advised to execute the order to the best of his ability. Efforts to furnish good brokerage service prompts the floor broker to use such discretion; but it involves the ex-

At-the-market orders are frequently given by all classes of customers. Creditors, when closing out collateral, use this type of order for the express purpose of having an immediate execution to forestall any possible adverse movement of the price. It is obvious that in the case of semi-active and inactive securities at-the-market orders may be the cause of considerable price fluctuations. It is in the execution of such orders that odd-lot dealers, specialists, and floor traders serve a very useful purpose in that they are instrumental, through their speculations, in making the market more continuous.

2. *Fixed Price Orders.*—The customer, if he wishes, may stipulate that his order is to be executed at a fixed price. Orders to buy at a fixed price can be executed only at or below the price designated; and orders to sell at a fixed price can be executed only at or above the price indicated. For example, in the illustration used above, the customer, fearing the possibility of having to pay a high price if he uses an at-the-market order, can order his broker to "buy 100 U. S. Steel common, at 62¼." In this case the buying order must be executed by the broker in the open market, as soon as possible, and at the stipulated price of 62¼, or at a better price if the stock is offered at a lower price when the order reaches the floor. When the broker finds that Steel is quoted at 62 bid, and 62¼ asked, he must attempt to purchase at 62⅛. If he cannot secure the stock at this price he must bid 62¼, but he cannot pay more.

3. *Immediate or Cancel Orders.*—An immediate or cancel order is often used in place of an order at a fixed price. An example of such an order would be, "buy 100 U. S. Steel at 62¼, immediate." The word "cancel" may be used instead of immediate. This order would either be executed at once, at the best possible price, or, if it cannot be executed at once because the offer prices on the floor are too high, the broker will cancel the order and make a report of the condition of the market to

ercise of care and good judgment upon his part, as well as the risk that the customer will not be satisfied with the way the order is handled.

the customer. The customer then may enter the same order, or if he wishes, he may revise it. The immediate order should not be confused with the at-the-market order, which is executed at once, at the best price obtainable.

Immediate orders are often used by those who buy and sell inactive stocks in which the difference between sales prices frequently amounts to a number of points. Immediate orders are also used when the market as a whole is so active that it is difficult to ascertain the exact condition of the market in the stock involved. During such times, for example, if an immediate order to buy is not executed at once, the customer receives a report on the market condition of his stock. This report would be difficult to obtain through the regular quotation reporting channels. An order at a fixed price, under such conditions, may never be executed and while the customer is endeavoring to learn the bid and ask prices for his stock, the price may rise sharply causing the customer to miss the market.

4. *Stop-Loss Orders.*—The rules of the New York Stock Exchange state that "a stop order to buy stock becomes a market order when the stock sells at or above the stop price"; and, "a stop order to sell stock becomes a market order when the stock sells at or below the stop price." [3] Stop orders always contain a definite price, set either above the prevailing market price, if it is a buy order, or below the market price, if it is a sell order. A stop-loss order to buy, for example, reads, "buy 100 U. S. Steel common, at 64, stop." Upon receipt of this order the broker will not take any action since the market price will be lower, say at 62. Just as soon, however, as a sale of Steel occurs at 64 or higher, the broker must buy 100 shares of the stock for the best price obtainable at the time.

Stop-loss orders are used chiefly as a means of protection against uncertain price fluctuations. The customer on the long side of the market may use a stop-loss order to limit any loss which he will suffer if the price of his stock declines. For ex-

[3] *Rules of the New York Stock Exchange,* Chapter XVII, Section 1.

ample, if Jones buys 100 American Can at 110 he can place an order with his broker to "sell 100 American Can at 105, stop." If the price of the stock declines to 100, Jones, in all probability, will be sold out at or near 105. If, after Jones buys his stock the price does not fall but instead rises to 120, the stop-loss order can be changed to sell at 115, stop, in order to protect a portion of the profits. A short seller may use the stop-loss order in a similar manner. At times buying stop-loss orders are used by those who wish to purchase a given stock in the event of a price rise. For example, a trader places a buying stop order because he believes a stock is likely to have a considerable price rise. If the rise materializes the trader will get his stock at a price only a few points above the current market price. On the other hand, if the rise does not occur the stock will not be purchased. Bankers and other lenders of money, may also use such orders to protect themselves against borrowers who allow their collateral to depreciate in price beyond the agreed limit.

Since the stop order becomes a market order when the price of the security reaches the price stipulated in the order, it follows that the broker may not be able, especially in a rapidly declining or advancing market, to sell or to buy the stock at the stipulated price. Nevertheless, the broker must act at once when the stipulated price is reached, although the next bid or offer may be considerably below the previous sale. The customer must stand the loss, if any, and the broker would be legally liable for failure to act promptly, if in case of an order to sell, for example, he had an opportunity to execute the order at a price lower than the stop price but neglected to do so in the sincere expectation of a rise. Evidently this legal position of the broker was not understood by many members of the public at the time of the panic associated with the so-called "peace note leak" of 1916. On that memorable day the market apparently became non-continuous for a brief period of time. Certain securities, otherwise very active, declined ten points or more

in a few minutes with the result that numerous stop orders had to be executed at prices much below the limits set in the order, although immediately afterwards many of the prices rebounded to almost the figures prevailing before the decline commenced. The chagrin of many whose stop orders had been executed might well be imagined, and complaints were exceedingly numerous. Probably to prevent similar complaints in the future, the New York Stock Exchange saw fit, under date of December 27, 1916, to embody the legal meaning of a stop order in a special resolution.[4]

Two disadvantages connected with the use of the stop-loss order are thus apparent. One is the possibility that, after the stop order is made operative by a sale in the market, the order will be executed at a price far from the stop price. This disadvantage results because it becomes an at-the-market order. There is also the possibility that, after the stop order has been executed, the price trend may change so that the customer would have had a profit, if his stop-loss order had not been executed. For example, suppose stock is bought at 60 and a stop-loss order is entered at 58. If the price of the stock drops to 58, or lower, and then rises again to 60, or above, the owner probably would have been sold out at or near 58.

Another possible disadvantage of stop-loss orders may be mentioned. If numerous stop orders are found to exist in a given security, they may be "uncovered" by manipulators. Let us assume that with a stock selling at 78, numerous stop orders have been placed by holders of such stock at 77, 76, and 75. Knowing that these orders become at-the-market orders as soon as the stock in question sells at the above prices, manipulators, if they learn of the existence of such orders, may suddenly sell the stock heavily with a view to depressing it from 78 to 77. As soon as the stock reaches 77, all stop orders to sell at that price come automatically on the market and may

[4] The resolution contained the definition of stop orders which was given at the beginning of this section.

serve to depress the price to 76, when the next lot of stop orders would have to be executed, thus possibly further depressing the price to 75 when more orders would have to be executed. In the meantime, those who originally started the selling movement would accumulate the stock represented by the stop orders; and concluding that such orders had been fairly well uncovered they might easily bid the stock up to approximately its former price. Because stop-loss orders may be used by those who manipulate the market, section 10 (a) of the Securities Exchange Act of 1934 provides that such orders may not be used in connection with the purchase or sale "of any security registered on a National securities exchange, in contravention of such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

With respect to these disadvantages stop orders do not furnish the same certainty of limiting a loss or protecting a profit as do privileges in the form of "puts" and "calls." It will be recalled that "puts" and "calls" definitely insure the holder of them against any loss in price beyond the commission and the price of the privilege. Since privileges extend over a period of time, they also allow the holder to wait until the end of the stipulated period to decide whether it is more profitable to exercise the privilege or to purchase or sell the security in the market. Although the market price of the security may at one time show a large loss, against which the holder of the privilege is protected, that price, before the expiration of the "put" or "call" period, may have changed so materially as to show a profit. In other words, "puts" and "calls" are a means of insurance during the entire period for which they are issued. Stop orders, on the other hand, terminate when executed, and do not, as in the case of privileges, give the user thereof the benefit of future favorable price movements.

Variations in the use of the stop order are possible, but in practice such cases are rare. Thus, if a customer desires to stop

a loss, and at the same time does not want to sell the stock at less than the stop price, he can give a "stop and limit order" to the following effect: "Sell 100 U. S. Steel common at 78, stop and limit." Or, this limit may be varied as follows: "Sell 100 U. S. Steel common at 78 stop, limit 77." In the first case the broker cannot sell for less than 78, and in the latter case he must sell at 78, if possible, and at not less than 77. As in the previous illustration, the broker must regard the stop order as becoming operative when the stop-order price is reached in the market.

5. *Discretionary Orders.*—The rules of the New York Stock Exchange do not prohibit brokers from accepting discretionary orders, but many brokers do not care to assume such responsibility.[5] Most discretionary orders are placed with customers' men, and hence the orders which reach the floor of the exchange are generally of the usual types.[6] Arrangements are sometimes made, however, whereby the broker on the floor is to use a certain amount of discretion in executing a customer's order. For example, a customer may desire to accumulate a large block of a certain stock. In order to purchase the stock at the best possible price and with the least disturbance to the market, the broker may be authorized to buy and to sell over a period of time, according to his best judgment, with the pur-

[5] Section 11 (b) of the Securities Exchange Act of 1934 provides that it shall be unlawful "for a specialist acting as a broker to effect on the exchange any transaction except upon a market or limited price order."

[6] The rules of the New York Stock Exchange provide that discretionary accounts for customers must be handled by partners of member firms, or by customers' men, if authority is delegated by the partner to the customer's man, and if the customer gives his written consent. See *Rule 6 of Supplementary Rules Governing Customers' Men* adopted May 7, 1930, by the Committee on Quotations and Commissions.

A discretionary account is one where the customer authorizes his broker to use discretion in making purchases and sales on his behalf. Such purchases and sales are made without specific instructions from the customer and the broker determines the specific securities that are to be bought and sold. See Meyer, Charles H., *The Law of Stock Brokers and Stock Exchanges,* Baker, Voorhis & Co., N. Y. 1931, p. 306.

pose of accumulating the desired line of stock. Other types of orders which involve discretion, but not necessarily as to price, may be mentioned here. A customer, in an inactive stock, may give an order to buy or to sell at a fixed price, with a range of half-point or a point on either side. Again, the broker may be authorized to buy or to sell, if he thinks it advisable, at a certain time, say eleven o'clock; or, he may be instructed to buy or to sell during the last half-hour of trading. Special orders of the kind just mentioned are not desired by the broker, since it is usually difficult, in an active market, to carry them out to the customer's satisfaction.

Orders Classified According to the Length of Time They Remain in Force.—Orders to buy and to sell differ as to the time they are to remain in force. "Market" orders and "immediate" orders, as we have seen, remain in force for only a few seconds after they reach the floor of the exchange. Orders at a fixed price, stop-loss orders, and some discretionary orders may, if not executed, remain good for any period of time agreeable to both broker and customer. Orders at a fixed price and stop-loss orders should specify the time of expiration. If an order should be received specifying no time limit, the broker will either keep the order in force for the day only, or keep it in force until the customer revokes it, depending upon whichever practice his firm follows in such cases. Thus, if an order is given to "Buy 100 U. S. Steel, common, at 62," and no reference is made to the time limit, the broker may cancel the order at the end of the day if the price does not decline sufficiently to permit the order to be executed, or he may continue it in force until he receives further instructions from the customer, or until it is executed. Because the broker desires to prevent any misunderstanding regarding the time limit, he will invariably ask the customer to state his intentions in this respect. The customer may specify that it is to be an "open" order, which means one without any time limit. Or, he may designate some definite period during which the order is to

remain good. The usual methods of designating orders in this respect are: (1) "G.T.W." orders, which means "good this week," and void at the close of trading the next Saturday; (2) "G.T.M." orders, which means "good this month"; and, (3) "G.T.C." orders, or those which are to remain "good till countermanded."

Most brokerage houses confirm all orders by mail. Thereafter, at regular intervals, the customer is asked to instruct his broker regarding the disposition of any orders which he may have on the broker's books.[7] If a stock sells ex-dividend, all customers who have buying orders at fixed prices therefor, and stop orders to sell, are notified usually that the designated price will be lowered by the amount of the dividend, unless instructions to the contrary are received. Orders to sell at a fixed price and stop orders to buy are not reduced, unless the customer, upon notification, so orders. Some firms will cancel open orders for a stock when it sells ex-rights, and ask for further instructions. Others continue such orders in force and notify the customer.

Special arrangements, as previously mentioned, may be made between broker and customer regarding the time the order is to remain in force. Thus, the customer may request his broker to buy or sell at a designated hour, or on a specified day. The broker may be instructed to sell a certain stock at a certain time, or when it reaches a certain price, and invest the proceeds in other securities at a particular time or at a specified price.

Orders Classified with Reference to Time of Delivery.—The discussion of the types of orders thus far has been mainly from the viewpoint of the customer. In this section we are concerned with the delivery provisions which may be in the customer's order, not only from the customer's view-

[7] Some brokerage houses make this check-up at the end of each month. Others prefer the 15th of each month because statements are sent out at the end of the month and they feel more attention will be paid to the notice if it is sent at some other time.

point, but from the broker's viewpoint as well. While the customer determines the type of contract he wishes to make with respect to delivery of the securities, there is much that is of interest to the broker in the provisions regarding delivery and the receipt of payment therefor. Another reason for emphasizing the broker's interest at this point is that bids and offers on the floor of the Exchange must specify how soon delivery must be made. It should be noted, also, that bids and offers on the floor of the Exchange may arise from members trading for themselves, as well as from orders from customers.

Contracts to buy and to sell securities made upon the floor of the Exchange, fall into four main classes according to the period of time during which delivery of the securities involved must be made. Bids and offers for each of these types of delivery are considered to be essentially different propositions, and when made simultaneously, may be accepted without precedence of one over another.[8]

With respect to time of delivery, bids and offers for active stocks may be made only as follows:

1. "Cash," that is, for delivery of the securities by the seller upon the same day that the contract is made.

2. "Regular way," that is, for delivery of the securities by the seller upon the second full business day following the day of the contract.

3. "Seller's option," for not less than three days nor more than sixty days. These contracts call for delivery, at the option of the seller, within the time specified in the contract. The most common forms of such contracts are those which provide for delivery during seven days, fifteen days, and thirty days.

Under a seller's option, the seller may, upon one day's written notice make delivery upon any full business day. If not made prior to the last day of the option period, delivery must be made on the day of expiration. The seller is required to give notice to the buyer before 4:00 P. M. on a full business day, and

[8] *Rules of the New York Stock Exchange,* Chapter I, Section 7.

before 1:00 P. M. on a half-holiday. Notice may not be given until the second full business day following the day the contract is made. It is because the seller must always make delivery on these options that members are permitted to make such contracts on the floor of the Exchange. Seller's options should not be confused with "puts," which are frequently referred to as stock options. Delivery may or may not be made on a "put," depending upon the price movements of the stock involved.[9]

Seller's options are used when delivery of the securities cannot be made under a regular way contract. A seller may have the securities in a foreign country, or in some other place not accessible at the time. If the sale is to be made in New York, the New York broker must sell regular way and borrow for delivery, or sell under an option permitting him to deliver within some period longer than two days. On all seller's options written contracts must be exchanged not later than the day following the transaction. With respect to bids and offers for seller's option, the rules of the New York Stock Exchange provide that "on offers to buy 'seller's option,' the longest option shall have precedence; on offers to sell 'seller's option,' the shortest option shall have precedence." [10]

4. "When issued," that is, for delivery when issued as determined by the Committee on Securities.[11]

The following regulations of the New York Stock Exchange

[9] See Chapter VI, "Options and Their Functions."

[10] *Rules of the New York Stock Exchange,* Chapter I, Section 6.

[11] Section 12 (d) of the Securities Exchange Act of 1934 contains the following provision relating to unissued securities: "An unissued security may be registered only in accordance with such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. Such rules and regulations shall limit the registration of an unissued security to cases where such security is a right or the subject of a right to subscribe or otherwise acquire such security granted to holders of a previously registered security and where the primary purpose of such registration is to distribute such unissued security to such holders."

concerning the time of delivery on contracts should also be noted. Bids and offers without stated conditions are considered as "regular way," and the great mass of business on the Exchange belongs to this class. All deliveries of securities falling due on full business days must be made before 2:15 P. M. of the day when delivery is called for under the contract. Contracts falling due on holidays or half-holidays observed by the Exchange are settled on the succeeding full business day unless otherwise specified. On half-holidays securities sold specifically for "cash" must be delivered at or before 11:30 A. M.

Regulation of Bids and Offers.—In addition to the foregoing rules attention should be called to certain rules regulating bids and offers adopted by the New York Stock Exchange on March 30, 1910, and amended thereafter. Prior to the adoption of these rules, a broker could offer to buy or to sell a large block of securities and refuse to accept any number of shares less than the total amount. This practice led to abuses through manipulation of prices. Dealers could by this means establish quotations for a certain security below or above its previous price, by simply offering to give or to take so large an amount of the security that no one would be in a position to receive or to offer the amount. The rules at the present time provide that "the recognized quotations shall be public bids and offers on lots of one trading unit of stocks or bonds, or multiples of either, as the case may be," and that "all bids or offers for more than one trading unit of stocks or bonds shall be considered to be for the amount thereof or any less number of units." [12] This means that the broker offering to buy 1,000 shares of a particular stock at a price above the current quotation is compelled to accept all offers of 100 shares or multiples thereof until the entire order of 1,000 shares has been filled. In addition to this rule regulating bids and offers, further provision has been made to the effect that "if a bid is made for a larger lot above the price at which smaller

[12] *Rules of the New York Stock Exchange*, Chapter I, Sec. 8 (a) and (b).

lots are offered, or if a transaction is made in a larger lot above the price at which smaller lots are offered, the bidder for the larger lot or the buyer of such lot shall be compelled to buy any or all of the smaller lots which were publicly offered at the time, at the lower price, up to the amount of the larger lot. If the bid for the larger lot is accepted, and the buyer is unwilling to buy more, the seller of the larger lot must give up to the members who were publicly offering to sell at the lower price, such amounts as they were publicly offering to sell at the lower price, if the claim is made immediately." [13] A similar rule applies in case an offer is made to sell a larger lot of stock below the price that is bid for smaller lots. It is expressly provided, however, that the foregoing provisions shall not apply to lots of less than 100 shares, nor to active openings when bids and offers are simultaneous.

The foregoing rules are supplemented by additional rules that provide that "a member may sell on offer the largest amount bid for without regard to priority of bids. Should the offer be of an amount larger than the largest bid, the balance shall go to the next largest bidder in sequence, bids for equal amounts being on a parity. A similar principle shall apply to buying on bids." [14] Bids and offers must be made with the publicity and frequency necessary to make them generally known at the time or they will not be recognized. "Disputes arising on bids or offers, if not settled by agreement between the members interested, shall be settled, if practicable, by vote of the members knowing of the transaction in question; if not so settled, it shall be settled by any member of the Committee on Arrangements." [15]

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[14] *Ibid.*, Sec. 8 (e).
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CHAPTER XII

THE SHORT SALE [1]

The short seller in the stock market has been aptly defined as "a dealer who, becoming convinced that a given security is selling at a price not likely to be maintained, makes a contract to deliver that security with the expectation of obtaining it later at a difference in price which will constitute a profit to himself." [2] Short selling, as already explained, is by no means confined to the stock market but is an operation occurring in many branches of business. It represents one of the great forces that prevent the speculative market from becoming one-sided, and constitutes one of the most effective means of restraining unwarranted marking up and down of prices.

Principles Governing the Short Sale in the Stock Market.—The short sale is inherently a speculative transaction, since the seller sells a security that he *does not yet own* in the hope that that security will subsequently decline so that he may purchase for delivery on his contract at a lower price than that received from the person to whom he originally sold it, and net the difference. In most respects the principles outlined in other chapters, as regards the execution and legal interpretation of the order and the respective rights of the customer and broker, are also applicable to the short sale. But in certain important particulars short selling differs radically from a speculative account on the "long" or "bull" side

[1] For a discussion of the economic services of short selling see Chapter IV.

[2] Henry G. S. Noble's *Testimony before the Senate Committee on Banking and Currency on S. Bill 3895*, 1914, p. 160.

of the market. It is the purpose of this chapter to explain these features.

Nature of the Order to Sell Short.—No prescribed type of order is demanded by brokers from customers desiring to sell a security short. Customarily the order will read as follows: "Sell for my account and risk 100 U. S. Steel common at 78, and borrow for delivery." Sometimes the term "short seller" is used in the contract instead of "and borrow for delivery." Either term is intended to indicate that the seller does not own the security sold, and that the broker must make arrangements to borrow the same in order to make delivery on the contract. Frequently, however, the order contains no such intimation, the customer expecting the broker to be governed in his actions by the terms of previous dealings, or intending to declare his position after the broker has contracted to sell the security and before it must be delivered. When the customer's intention to sell short has been made known to the broker, the order, when fully interpreted, becomes the following: "I order you to contract to sell for regular delivery for me and at my risk on the Stock Exchange of which you are a member, according to its rules and customs, 100 shares of the common stock of the U. S. Steel Corporation at 78 dollars or better for every one hundred dollars' worth of the par value of the shares, and I further order you to borrow 100 shares of the same stock and deliver these according to the rules of your Stock Exchange to the purchaser or purchasers under the contract or contracts of sales." [3]

Nature and Terms of the Loan Transaction.—Since the customer has sold securities that he does not own, and yet must make delivery on a regular way transaction, he can place himself in a position to take advantage of the decline in price he anticipates in only one way, namely, by borrowing the securities from some one else for delivery purposes. This he instructs his broker to do for him. To facilitate such borrowing,

[3] Norton, Eliot, *Short Sales of Securities through a Stock Broker*, p. 17.

exchanges permit their members to borrow securities from one another. For some time, it should be noted, the New York Stock Exchange has required the consent of a customer before his securities, whether pledged or carried for his account, could be lent to others; and the Securities Exchange Act of 1934 contains a similar requirement with respect to all registered national securities. (Sec. 8 [d]). By custom, contracts for the loan of securities are governed in nearly all cases by the following conditions.[4]

1. Although acting as agents for their customers, brokers in borrowing securities from each other regard themselves as principals in the transaction.

2. The loan is a "call" loan, that is, one that can be terminated on demand by either the borrower or lender of the securities.

3. The borrowed stock is assigned in blank by the lender, thus enabling the borrower, as he is authorized to do, to use the securities as he sees fit. In fact, the title to the securities when they are delivered by the borrower to the buyer is usually transferred by the latter on the books of the corporation. In a general way, therefore, a loan of securities assumes the form of a purchase from the standpoint of the borrower, and a sale from the standpoint of the lender. The significance of this similarity will later be shown to have an important bearing on the clearing of securities through the stock-exchange clearing house, since brokers on their clearance sheets record securities they borrow as purchases and securities they lend as sales. In reality, however, the loan transaction is regarded by the parties thereto as a loan in the strict sense of the term, the lender continuing in all respects as the owner of the securities.

4. The loan is secured by the borrower agreeing to keep on deposit with the lender at all times the market value of the

[4] For a very detailed account of the conditions and principles underlying the loan transaction involved in a short sale see *ibid.*, especially pp. 8–13.

borrowed securities as measured by the quotations prevailing on the exchange of which the parties to the loan are members. Sometimes, although this is not the general practice, additional security in the form of a margin over and above the market price may be demanded by the lender. As the price of the security rises or falls, the borrower either pays to the lender or draws upon him for such sums as represent the increase or decrease in the market value.

5. Since the lender continues as the owner of the securities, having merely lent them, the borrower agrees to pay him all dividends, interest, or other accretions on the securities. Having merely given the borrower the use of the securities, it would be unfair to have the lender lose the income thereon between the time they are lent and their return. As will be explained in greater detail later, dividends and other income on securities are treated in the loan account as increases in the market price of the securities. Assessments levied during the continuance of the loan, on the contrary, must be paid by the lender as the owner of the borrowed securities, since the security that will later be returned to the lender will include the amount of the assessment.

6. On all money pledged by the borrower as security for the loan the lender agrees to pay interest, and the rate customarily paid is the one prevailing for call loans at the time. If the security is scarce for borrowing purposes, the lender may demand that the rate of interest be reduced below the prevailing rate for call money, and if it is still scarcer, he may demand that he receive the market price without the payment of any interest at all, in which case the security is said to "loan flat." It may happen, however, that the security is so scarce that, in order to obtain it, the borrower is actually obliged to pay the lender a premium in addition to the purchase price.

The lending of stock at a very low rate of interest on the money given as security, or lending it flat or at a premium, is usually brought about when the market in the security is in

an "over-sold" condition. By this is meant that there has been, in view of the normal supply of and demand for a security, an unusually large amount of short selling. The borrowing demand for the securities, therefore, in view of the limited floating supply, will be so large that a special inducement must be given the lender in the form of a small interest rate, or possibly even the free use of the money representing the market price of the securities. In this respect the loan market for securities has at times been manipulated, that is, securities were purposely made to appear very plentiful for lending purposes in order to encourage short selling, while later the securities were suddenly withdrawn for lending purposes and made to appear very scarce. Again, it may happen that stocks cannot be borrowed at all. In such cases, the market is said to be "cornered." Briefly stated, a corner in a stock exists when a short interest therein finds it impossible to obtain the shares necessary to fulfill delivery on contracts of sale previously made. Such a situation is brought about by an operator or clique of operators obtaining possession of all or nearly all the shares of a given stock that are available for delivery purposes, thus compelling short sellers to settle at a price determined by those operating the corner.

It remains to be noted that where a broker sells securities short for a customer, that customer, just as in the case of a speculative purchase, is the principal in the transaction. From this it follows that although the customer's broker, the borrower, collects the interest that the lender pays on the purchase price of the stock, the customer might be considered as being entitled to the interest so received. A canvass of a considerable number of brokerage firms shows a variance in practice as regards the giving of this interest to the customer. Certain firms state that they credit the customer with some portion, such as one-half, of the interest obtained from the lender of the stock. Others give no portion of this interest, except interest on the margin, which the customer has pledged to protect the

broker. They do this on the plea that the short sale involves extra trouble and responsibility not met with in the case of a speculative purchase. In some instances the firms state that special consideration is given to those who are short sellers on a large scale, the interest factor in such cases being very important.

7. Upon terminating the loan the borrower must return the securities, and the lender must repay the money deposited as security plus interest at the agreed rate. The borrower, however, need not give back the identical securities originally borrowed, and in fact could not do so because they were used to deliver on a sale and the title thereto has probably been transferred to the buyer. One certificate of stock is as valuable as another for the same amount and of the same kind of shares, and the lender is therefore satisfied to receive back securities equivalent in kind and amount to those originally lent.

Rights and Duties of the Broker in Conducting a Short Sale for His Customer.—After having contracted to sell securities short for a customer, the broker must borrow the securities in accordance with the foregoing conditions governing the loan. He is authorized to borrow from one or more brokers, or even from other persons, as he sees fit. Upon receiving the securities from the lender he must deliver them to the buyer in accordance with all the rules and customs of the exchange on which the sale was made. He must also, on delivering the securities to the buyer, receive their purchase price, which sum he must place to the credit of the customer on his books, and then hand it over to the lender as a pledge for the borrowed securities. He also charges the customer with the commission, any transfer taxes that may be imposed, and all legitimate expenses incurred. By custom the broker is allowed to borrow the securities from another customer, with consent, for whom he may be carrying them, he being regarded in this act as the agent of such customer. He cannot, however, legitimately lend his own securities for delivery on a customer's short sale, since to do so would

violate the principle of law that "the agent cannot deal as a principal with his principal."

In maintaining the loan for the customer the broker is governed by the law of agency, and must exercise due care and at all times act in good faith. But the loan need not be maintained indefinitely; it can be terminated after a reasonable time upon proper notice to the customer. One lender may also be substituted for another by the broker at any time, and full authority is given to him to pay any premium that may be necessary to effect a continuation of the loan.

The Customer's Liability to Protect the Broker.—In the making and maintenance of a loan of securities brokers, as already stated, treat each other as principals, and the borrower not only agrees to return the securities but to pay the lender all dividends and interest that may become payable thereon during the period of the loan, and at all times to keep on deposit with him their market price. Manifestly, the assumption of these obligations justifies the borrowing broker in demanding as security a margin from the customer on whose behalf the obligations were assumed.[5] Out of this margin the broker is authorized to take his commission and to pay all legitimate disbursements that he is obliged to make on behalf of the customer. If the price of the securities rises above that at which they were originally sold, the margin is considered as being reduced by the amount of the rise. Whenever, owing to any of the aforementioned reasons, the margin is reduced the customer is bound, when called upon by the broker to do so, to restore it to the agreed percentage. Should the customer fail

[5] The Securities Exchange Act of 1934 makes the following brief reference to short selling. Section 10 (a) declares that "it shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange (a) to effect a short sale, or to use or employ any stop loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

to respond to such margin calls, the broker can purchase the securities in the open market, return them to the lender, and terminate the transaction. In case, however, the price of the securities falls below that at which they were originally sold, the customer is entitled to reduce his margin by the amount of the decline.

Termination of the Transaction by the Customer.—Although borrowing the stock in his own name, the broker in reality acts as agent for the customer. It follows, therefore, that the customer may at any time order the broker to purchase the securities and terminate the loan. The relation between customer and broker in this respect is fully stated by Norton in the following words: [6]

"At any time after the loan has been made the customer has the right to have the loan closed and the transaction brought to an end. It is to enable him to exercise this right that the loan is required to be made so that it can be ended at any time. Though the loan is made in the stock broker's name, yet it is made for the customer, and consequently this right is the right of one of the principals in a call loan to bring it to an end whenever he likes. . . .

"To exercise this right all the customer has to do is to provide the stock broker with the securities requisite to satisfy the loan and direct him to close the loan with them. Since the stock broker is the customer's agent to close the loan, he must obey this direction and must act with due care and good faith. . . . The way the customer usually gets and intends from the beginning of the transaction to get the securities needed to close the loan is to buy them. And since it is obviously more convenient to do so through the stock broker who originally sold them, the customer almost invariably does so."

Operation of the Short Sale Illustrated.—Having in mind the preceding discussion of the principles governing short selling, the manner of conducting a short sale may now be illustrated. For this purpose let us assume the following transaction:

[6] Norton, Eliot, *op. cit.*, p. 41.

On October 1, a customer orders his broker "X" to sell short for him on the New York Stock Exchange, regular way, 100 shares of a given stock at 75 (par value of shares $100). The order is executed at this price, the shares being sold to broker "Y." The customer agrees to protect the broker with a margin of 20 points, and further agrees to keep this margin good.

Broker "X" borrows the shares from another broker "A", but on October 8, "A" asks to have the loan discontinued. During the week of October 1 to October 8 call money in New York rules at three and one-half per cent and the stock rises gradually to 86.

On October 8 "X" borrows the stock from "B". On October 9 call money rises to five per cent, and on October 10 to six per cent, but on October 11 reacts to four per cent. On October 11 the stock sells "ex-dividend" $1 a share. The stock in the meantime has declined to 80.

On October 14 "B" asks for the return of the securities and "X" enters into a loan transaction with broker "C". Call money is still ruling at four per cent. On October 15 an assessment of $10 a share becomes due (the stock not being full paid).

By October 21 the stock has declined to 78, and on that date the broker closes the transaction at this price, the customer having given an order to this effect.

According to the terms of the sale, the transaction being "regular way," "X" must deliver the 100 shares to the purchaser "Y" before 2:15 P. M. on October 3, that is, on the second full business day following the day of the contract. To obtain the shares "X", contracting in his own name, borrows the stock from "A" on the best terms then obtainable, the shares being assigned by "A" in blank so that "X" may use them as he pleases. Upon receiving the shares "X" gives "A" a check for $7,500, the market price of the stock. Although "A" may insist upon "X" giving him further security for the loan of the stock, such a course is not generally followed among brokers. The $7,500 given to "A" by "X" amounts to nothing

more than a call loan secured by the 100 shares as a pledge and can be terminated by either party. For this reason, although "A" (the lender) continues to remain the owner of the 100 shares, "X" as the pledgee, having had the stock assigned by "A", has the right to use the pledged shares in fulfillment of the short sale. Since "X's" customer is short of the stock and can be called upon to deliver it, "X" is justified in turning the borrowed stock over to the purchasing broker "Y", who may have it transferred if desired. "X", therefore, delivers the borrowed shares to "Y" in fulfillment of the sale, and receives from him the purchase price of $7,500. The sale and delivery having been completed, "X" charges his customer with the customary commission together with the State and Federal transfer taxes, and credits him with the amount ($7,500) of the purchase money received, the margin of $2,000 deposited, and interest on that margin. It is thus seen that the money received is treated by "X" exactly as though the customer owned the securities that were sold.

When on October 8 the stock has risen to 86, "A" is entitled to another $1,100 from "X", since it is a condition of the loan transaction that the borrower must keep with the lender the market price of the securities borrowed. This additional sum "X" obtains by calling on his customer for additional margin to the same amount, and the latter having agreed to maintain a 20-point margin is obliged to comply with the demand.

"A", having the privilege of terminating the loan at any time, called upon "X" on October 8 to deliver back the stock. To do so "X" exercises his right to shift the loan transaction to some one else, and borrows the stock from "B," to whom he gives his check for $8,600, the then market price of the stock. "X" now terminates his loan with "A" by handing over to him the 100 shares received from "B", and in turn receives back from "A" the $8,600 plus interest at three and one-half per

cent upon the different amounts held by "A" between October 1 and October 8.

Since call money ruled at three and one-half per cent when "X" borrowed the stock from "B" on October 8, "B" pays this rate to "X" on the $8,600 deposited. But this loan of money is, as already explained, a demand loan, and it follows that as the interest rate for call money changed, the rate paid by "B" to "X" correspondingly went up or down each day, as the case might be, rising to five per cent on October 9, six per cent on the 10th, and dropping to four per cent on the 11th. But, in the absence of an agreement to the contrary, "X" does not credit the interest thus received from "B" to his customer's account on the ground that its retention by himself is justified because of the additional trouble involved in conducting this type of transaction.

When the stock declines from 86 to 80, "X", being only obliged to keep with the lender the market value of the stock, calls upon "B" to return $600, thus reducing the money loan to $8,000. The customer, likewise, can draw upon "X" for $600, thus reducing his margin to 20 points as had been agreed.

When the dividend of $1 a share is paid on October 11, it is credited by "X" to "B's" account, since "B" is still the owner of the shares, having merely lent them. Since the amount of the dividend is deducted from the market price of the stock as soon as it sells "ex-dividend," "X" on October 11, could technically demand $100 from "B" to offset the drop in price, returning this money to "B" on the day that the dividend is payable. In general practice, however, such minor fluctuations are ignored. "X" must also debit his customer with this $100 dividend, while "B", instead of receiving it from "X", merely deducts that amount from the loan. The shares originally borrowed by "X" from "A", but now owed to "B", it will be recalled, were sold and delivered to "Y", who, having transferred it on the books of the corporation, is entitled to the

dividend. "B", however, as owner of the shares he lent, is also entitled to his dividend, although his name no longer stands on the books of the corporation. It follows, therefore, since "B's" shares have been used for "X's" customer to fulfill delivery on an actual sale of the stock and all future dividends thereon to "Y", that the customer is responsible to "B", through his broker, for all dividends that become payable on the stock during the continuance of the loan.

On October 14 "B" exercises his right to terminate the loan and "X", in order to return the 100 shares, borrows that number from "C", giving him the then market price of $7,900, the price now being 79 because of the payment of the $1 dividend. The stock is handed to "B" who returns to "X" the loan of $7,900 plus interest on $8,600 at three and one-half per cent for one day, at five per cent for one day, at six per cent on $8,000 for one day, and at four per cent on $7,900 for three days.

On October 15 an assessment of $10 per share becomes due, and an adjustment becomes necessary which is just the reverse of that prevailing in the case of dividends. "C", as the owner of the stock, is liable for the payment of this assessment of $1,000. Moreover, since $10 has been paid on each share, the price of the stock rises from 79 to 89. Instead of "C" paying "X" the $1,000 assessment, however, and calling for that sum from "X" to cover the rise in the price of the stock, he simply marks up his loan by that amount, namely, to $8,900. "X", on the other hand, credits his customer with a like amount.

During the interval between October 15 and October 21 the stock, according to our illustration, declined from 89 to 78. As the decline proceeded, "X" was entitled to call on "C" for a return of such amounts of money as would keep the loan equal to the market value of the stock. By the time the stock had declined to 78, "C" had been called upon by "X" to return $1,100, thus reducing the loan from $8,900 to $7,800.

On October 21, with the stock at 78, broker "X" is ordered

by his customer to close the transaction at that price. This "X" does by buying the stock in the open market. Upon receipt of the shares from the seller, "X" pays therefor $7,800. The shares thus received are then handed to "C" who returns to "X" the loan of $7,800, plus interest at the rates that have prevailed during the interval. While the stock was declining "X's" customer could also have asked for a corresponding reduction in his margin deposit, but we will assume that such a reduction was not requested.

The transaction having been terminated, "X" will render a statement to the customer crediting him with (1) his original margin of $2,000; (2) additional calls for margin of $1,100 to which he responded; (3) the assessment of $1,000; (4) interest on the assessment and the cash deposited as margin; and (5) the price received for the stock when originally sold, namely, $7,500 less commission and transfer taxes; and debiting him with (1) the dividend of $100, (2) a withdrawal of $600 of margin, and (3) the purchase price of the stock, namely, $7,800, plus the customary commission. As previously stated, brokers sometimes credit their customers with a portion of the interest received on the money loaned on the borrowed stock, but no such assumption was made in our illustration. It should also be stated that, as between brokers themselves and between brokers and customers, it is not customary in every-day practice to insist upon an adjustment in margins to meet all the small and immaterial fluctuations that may occur.

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CHAPTER XIII

THE QUOTATION SERVICE AND SOURCES OF MARKET INFORMATION

The successful speculator or investor must depend upon quick, accurate, and comprehensive news concerning an almost infinite variety of topics. This information may be discussed conveniently under two heads, the first pertaining to the quotation of current market prices, and the second including all other sources. The ticker furnishes price quotations, and many different agencies, including the ticker, make available other news of importance in security dealings. The prompt and wide-spread dissemination of such information has materially broadened the market and facilitated trading in the remote parts of the country.

Before summarizing the various sources of information it is desirable to stress the importance in the financial world of the part played by the telegraph, telephone, cable, and radio. The latter is the least important of these agencies of communication, but it is useful insofar as it facilitates the prompt dissemination of important news items. Toward the end of 1929, the Stock Exchange approved the establishment of branch offices on trans-Atlantic liners, and in such cases, of course, the radio was essential.

The telegraph, telephone, and cable are indispensable to our organized markets, both stock and commodity, and their use is universal. As a means of transmitting out-of-town orders and of sending market information very long distances, the telegraph exceeds in usefulness all other agencies. It is customary

for brokerage houses located in the stock-exchange centers to connect their out-of-town branch offices by private wire, and in some instances important houses maintain a considerable number of such private wires. By this means it is possible to have an order originating in San Francisco executed with practically as much speed as if it had come from Wall Street itself.

The telephone serves the same general purpose as the telegraph, except in a more local sense. To effect greater speed and convenience all active firms possess private telephone booths on the Exchange, where practically all orders are received from members' offices. Not only does this facilitate the prompt transmission of orders, but it serves to keep these offices constantly advised of all the details relating to their transactions, such as price, name of the other party, etc., immediately upon the execution of the orders to buy or sell. The office is thus placed in a position immediately to notify the customer and to proceed with the completion of its office records. As already explained, members' private telephone wires to the floor number about 2,000 and require the services of some 1,600 telephone clerks. At times nearly 2,000,000 calls are transmitted in a five-hour day.[1]

Just as the telegraph has been instrumental in annihilating distance in this country and in thus bringing all sections within the immediate reach of our large central markets, so the cable has been instrumental in annihilating distance between nations and in bringing practically all sections of the world within easy reach of any of the great international exchanges. The rapidity with which arbitraging between New York and London is conducted has already been explained, and the practice is manifestly dependent upon a highly organized system of cabling orders between these markets. To facilitate the practice elaborate codes have been prepared, so that one or a few words will suffice to convey the fullest instructions. In the interest of

[1] *Year Book*, New York Stock Exchange (1931–32) p. 81.

secrecy and economy, it may be added, many concerns use their own private codes.

QUOTATION SERVICE

Importance of Speed in Transmitting Quotations.— In probably no other business does promptness play so important a rôle as in the stock market. Arbitraging in all its phases, for example, is dependent upon the making of transactions in at least two different markets, often widely separated, at approximately the same time. Investors residing in all sections of the nation desire to have at least a daily record of the market value of the stocks and bonds they own. Traders in securities demand even more, since it is their desire usually to place their buying and selling orders with reference to the prevailing price, and a few minutes' difference in time may represent a material change in this respect. Bankers, brokers, and other creditors, holding numerous classes of securities as collateral for loans, likewise find it imperative to know at all times the market value of the securities thus held. As has been aptly said by Pratt: [2] "Most of the tools of Wall Street are time savers," and "the very life of the Street seems to depend upon accurate, immediate, and continuous quotations from the Stock Exchange." While reference was made by Pratt to the New York Stock Exchange, owing to the many important issues listed there, the thought is equally applicable to the numerous minor exchanges of the country. Even with respect to unlisted securities, the immediate quotation service of our organized exchanges is highly desirable, since price tendencies in these markets are nearly always reflected promptly in the unlisted group.

It need hardly be pointed out that speed is essential also in supplying information other than quotations. In the final analysis quotations merely represent the translation into prices

[2] Pratt, Sereno S., *The Work of Wall Street,* Appleton & Co., N. Y. (1912) p. 182.

of the varied opinions that result from the dissemination of news pertaining to *all* of the factors that influence prices.[3]

The Ticker Service.—Continuous quotations are furnished by means of an electrical device known as the "stock indicator" or "ticker." The exact nature of this instrument need not be elaborated upon, owing to its presence for inspection in practically every brokerage house, bond house, bank, or trust company of any importance, as well as in prominent hotels and other public places. Suffice it to say that by means of this instrument stock and bond transactions made on the floor of the Exchange are printed, by means of a system of symbols and abbreviations, upon a narrow ribbon of paper, known as the "tape."

Prior to the introduction of the ticker in 1867, it was customary to spread quotations by means of messengers. Since that time many improvements have been made both in the ticker itself and in the collection and transmission of the information.[4] The gradually increasing number of stocks and bonds listed and traded in has necessitated research and improvement in this direction. The following figures indicate the seriousness of the problem that confronted the Exchange in the recent bull market. The first 1,000,000 share day occurred in 1886; prior to 1928 there had been only eleven days on which the volume of trading exceeded 3,000,000 shares, and on none of these did it reach 4,000,000 shares.[5] Yet during 1929 "the average trading on Saturdays was 2,032,535 shares, and on other days (including short sessions) 4,201,341 shares."[6] The largest volume of trading on a single day was 16,410,030 shares on October 29, 1929.[7]

[3] *Infra*, p. 330.

[4] For the details of this development see, Meeker, J. E., *The Work of the Stock Exchange*, Ronald Press Company, N. Y., Rev. Ed. (1930) pp. 596–600.

[5] *Year Book*, New York Stock Exchange (1931–32) p. 86.

[6] *Report of the President*, New York Stock Exchange (1929–30) p. 37.

[7] The volume of shares actually changing ownership was probably con-

The Ticker System.—Quotations are furnished by the New York Quotation Company, a corporate subsidiary of the New York Stock Exchange, and by The Western Union Telegraph Company.[8] The former supplies quotations to members of the Exchange located on Manhattan Island below Chambers Street. The latter transmits the information received over one of these tickers to all non-members and to members located outside of the above-mentioned district. Stock ticker service was extended to the Pacific Coast in 1926 and quotations are delivered in Los Angeles and San Francisco at an average delay of not more than one minute from the time they appear on the tape in New York.[9] Subsequently the service was further extended to include, among other cities, Vancouver, B. C., and Havana, Cuba.[10]

Method of Reporting Quotations.—Each issue dealt in on the Exchange is assigned a position at one of the trading posts. As transactions occur they are reported by the selling members to employees of the Exchange, called "reporters." Each reporter is stationed at a particular location and when a sale is made, he writes the abbreviated name of the stock, the price and the amount upon a slip of paper which he sends by pneumatic tube to the ticker sending platform, located above and to one side of the main trading floor. Here it is copied on a keyboard by a ticker transmitting operator. The main ticker system, which operates at a printing speed of 500 characters per minute, is fed by four such keyboards, each handling slips from a portion of the floor and each connected in rotation

siderably larger because of the practice of not reporting "odd lots" and "stopped stock." Meeker, *op. cit.*, p. 617.

[8] The Gold and Stock Telegraph Company, which formerly transmitted quotations, was leased to The Western Union Telegraph Company on January 1, 1882, for a period of 99 years, and the ticker business of the former is being conducted in the name of the latter.

[9] Report of the President, *op. cit.* (1925–26) pp. 33–4.

[10] *Ibid.*, (1927–28) p. 61; (1930–31) p. 83. The service to Havana in the winter of 1930–31 was "the first instance of ticker service outside of continental North America."

to the main system. Obviously, when a number of transactions occur simultaneously at various posts on the floor, it is impossible to print them on the tape at one time. Some transactions must be printed later than others even when the market is not particularly active. In a normal market the report of a sale appears on the ticker from one to two minutes after it has been made, but when trading activity increases the interval is lengthened and the tape is said to be late. Before the introduction of the new high-speed tickers in September, 1930, and particularly on those days during which the trading volume was abnormally large, the ticker frequently lagged an hour or more behind the market.

Strange to say, the record for lateness was not established on October 29, 1929, when the largest single day's trading occurred. Although the ticker operated for two hours and thirty-two minutes after the market closed on that day, a few days earlier, on October 24, it had continued to run until 7:08½ P. M. As a matter of fact even the new high-speed ticker fell more than thirty minutes behind in the last hour of trading and did not print final quotations until 3:50 P. M. on July 21, 1933, when trading reached 9,573,000 shares. Suggestions have been made to establish an express ticker system or to introduce two systems, one for industrials and the other for rails and utilities. Despite its defects, however, it is generally admitted by electrical engineers that from the standpoint of speed and freedom from error, the ticker system stands at the head of all such services.

Various palliatives have been resorted to from time to time in an effort to provide prompt quotations. In 1919, a separate ticker system for bond quotations was installed. In 1927, a method of reporting prices was inaugurated whereby certain figures were eliminated. Subsequently, on days when the tape was late, volume under 5,000 shares was also omitted. During the feverish days of 1929 the ticker system broke down completely and to furnish some basis for judgment, quotations of

the leading stocks were sent over the bond ticker at ten minute intervals. News tickers also carried the leading quotations. Some indication of the drift of prices on the New York market was also obtainable from quotations transmitted over the ticker systems of the smaller exchanges. These have relatively few transactions to report and are therefore more nearly on time.

During 1928 the Exchange inaugurated a new system of furnishing bid and asked prices to members' offices. Clerks stationed at each trading post telephone the latest prices to a central quotation room located on an upper floor of the Exchange building. This room is connected by direct wire to the various members' offices and bids and offers may thus be immediately obtained. Needless to say this service was of outstanding value during the days when the ticker did not carry quotations in harmony with actual sales on the floor.

In addition to quotations, the ticker prints miscellaneous news items of importance to the Street. At fourteen minutes after two o'clock, the words "Delivery Time" are printed on the tape and, shortly after, the lever of the instrument gives fifteen distinct beats. The last beat signifies 2:15 P. M., the close of the recognized settlement time for transactions on the Exchange. The tape also prints the words "Market Closed," and after completing the quotations furnishes the closing bid and asked prices, the high and low prices for the day, and settlement prices from the Stock Clearing Corporation.

The Stock Board.—From the standpoint of a customer interested in the price of a specific security, the ticker tape has a serious defect. Unless the specific security has just been traded in, or the customer has been following the quotations for some time he cannot conveniently obtain the desired information. This defect is remedied by the stock board on which the essential facts pertaining to the most active stocks are summarized. Each stock issue has its own column in which is stated the dividend rate, the high and low prices for the current

and perhaps the preceding year, and the opening, high, low and last prices available at the time. Originally, changes on the board were made by erasing the old quotations and writing in the new ones with chalk. Later a special board with prepared slots for the insertion of cards was used. Several years ago the automatic stock board made its appearance in the larger houses. This board is operated electrically from a central station control board and price changes are recorded simultaneously on all boards on the circuit. Increased speed and accuracy are thus obtained. A small board which may be placed upon a desk is available for private offices. By merely dialing, the subscriber may have flashed on this board the opening, high, low and last quotation of the specific stock desired.

A second defect of the ticker is that only a limited number may comfortably read the tape. For the convenience of their clients, many brokers have installed the Trans-Lux or movie ticker. This is usually so placed that a view both of the stock board and of the moving tape, magnified and projected upon a screen, may be obtained at the same time by those interested.

Use of Abbreviations.—A system of symbols and abbreviations is the only practical one for reporting transactions. Were the tape to record the full name of all the corporations, as well as to print full words to express the particular security, the number of shares sold, the price, etc., the ticker would soon fall so far behind the market as to be outdistanced by even the daily press. Instead, every effort is made to use abbreviations to the greatest degree possible, consistent with clearness and accuracy. To the novice these abbreviations are meaningless, but to those actively connected with the business each impression on the tape has a definite significance. In fact, many of the abbreviations for corporate names become so generally known to the Street as to result in the application of nicknames to the corporations in question. Mr. Meeker

has written the following concerning the difficulties of financial abbreviations: [11]

"Some symbols are obvious enough—even the amateur might suspect that 'PA' indicated the Pennsylvania Railroad. But most stock symbols are more difficult to identify than this, and before they all become at once recognizable constant reference must be had to the explanatory list of symbols hung near the stock ticker. The amateur's difficulty is only increased by the hasty and unintelligible explanations given him by experts. If he asked to what stock 'MN' may refer, he will probably be told 'Mexican Pete,' which is not the sobriquet of some southwestern desperado but an abbreviated way of saying 'Mexican Petroleum.' But in time he too will learn to refer to the Atchison, Topeka & Santa Fe Railway (A) inelegantly but concisely as 'Atch,' or the Missouri, Kansas & Texas Railroad (KT) as 'Katy.' This queer and sometimes fantastic slang used in brokerage circles undoubtedly saves valuable time, and is convenient, practical, and simple enough—once it is understood."

For a detailed description of abbreviations and the general arrangements used to denote sales, bids and offers on the New York Stock Exchange the reader is referred to Appendix VIII of this volume. Over 1,100 stock and bond *symbols,* with their meanings, are arranged alphabetically in the reference pamphlet. Another section presents an alphabetical arrangement of the *names* of the stocks and bonds, with their symbols. Again, some 53 abbreviations are used to indicate the reporting of bids, offers, inactive stocks, odd lots, and quotations outside of their proper places, as well as to designate certain much-used words and phrases, such as adjustment, collateral trust, convertible, delayed delivery, flat, non-voting, rights, when issued, with warrants, ex-dividend, etc. In May, 1934, the New York Stock Exchange started a program for the standardization of bond contractions and abbreviations. At that time

[11] Meeker, *op. cit.*, pp. 411, 412. For additional examples the reader is referred to Schabacker, R. W., *Stock Market Theory and Practice,* Forbes Pub. Co., N. Y. (1930) pp. 49, 50.

the Committee on Bonds planned to issue a list of abbreviations each week until the entire new list had been covered, after which it proposed to issue a separate bond abbreviation

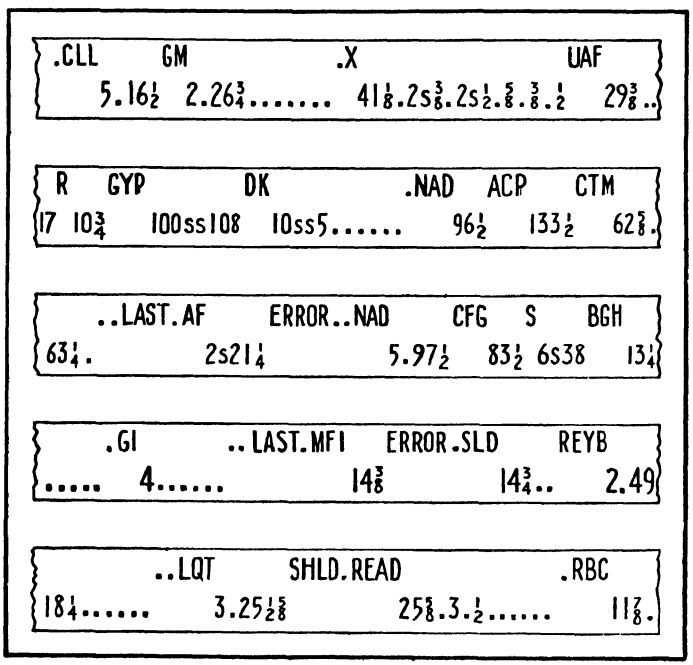

FIGURE 1

book. The printing speed of the New York tape is 500 characters per minute and since 1890 the number of impressions per year on the tape has ranged from 5,400,000 in 1914 to 27,600,000 in 1929.[12]

Sample sections of the stock tape are reproduced in Figure 1.

[12] To put the figures on a comparable basis, there must be added 12,000,000 to the 1929 figures, representing bond quotations. Prior to 1920 both stock and bond prices came over one ticker. *Year Book*, New York Stock Exchange (1931–32) pp. 84, 85.

Interpreting the abbreviations used, the quotations on the several sections read as follows:

First row reports sales of 500 shares of Continental Oil Company (Delaware) at 16½; 200 shares of General Motors Company at 26¾; 100 shares of United States Steel Corporation at 41⅛, 200 shares at 41⅜, 200 shares at 41½, 100 shares at 41⅝, 100 shares at 41⅜, and 100 shares at 41½; 100 shares of United Aircraft and Transport Corporation at 29⅜.

The second row reports sales of 100 shares of Baldwin Locomotive Works at 10¾; 100 shares of General Cigar Company preferred (an inactive stock) at 108; 10 shares of New York Dock Company (an inactive stock) at 5; 100 shares of National Distillers Products Corporation at 96½; 100 shares of American Can Company preferred at 133½; 100 shares of J. I. Case Company at 62⅝.

The third row, disregarding the incomplete quotation, reports that the last record of 200 shares of American Car and Foundry Company at 21¼ was an error; 500 shares of National Distillers Products Corporation at 97½; 100 shares of Corn Products Refining Company at 83½; 600 shares of Sears Roebuck Company at 38; 100 shares of Burroughs Adding Machine Company at 13¼.

The fourth row reports sales of 100 shares of Gimbel Brothers, Inc., at 4; that the last 100-share lot of Marshall Field and Company at 14⅜ was out of place and in error, the correct price being 14¾; 200 shares of the Class B stock of the R. J. Reynolds Tobacco Company at 49.

The fifth row, again disregarding the incomplete quotation, reports that the last quotation of 300 shares of the Liquid Carbonic Corporation at 25$^{15}/_{28}$ should read 100 shares at 25⅝ and 300 at 25½; 100 shares of Republic Steel Corporation at 11⅞.

Stock Exchange Regulation of Quotations.—In supplying quotations to their members and to the public, stock exchanges have always shown a determined policy of guarding

the quotations against misuse and of forestalling their employment by bucket shops or competing institutions. In fact, nearly all instances of litigation with respect to the matter show that the complainant had been denied a ticker service by the exchange on the ground that he was bucketing orders or otherwise disobeying exchange regulations.

Control of the quotation service, using the New York Stock Exchange as an illustration, rests with a special standing committee of nine members, known as the Committee on Quotations and Commissions. This Committee has the following powers: [13]

"It shall have charge of all matters relating to the collection, dissemination and use of quotations; it shall have power to approve or disapprove any application for quotation service to a non-member, or for telephonic or telegraphic wire or wireless connection between the office of a member or a member's firm and the office of any corporation, firm, or individual not a member of the Exchange, transacting a banking or brokerage business, and it shall have power at any time to disapprove the furnishing of any such quotation service or any such wire or wireless connection, and to require the discontinuance thereof. It may inquire into wire or wireless connections of every kind whatsoever between the office of a member and any member or non-member, and may require the discontinuance of any such connection."

The Committee has determined that application for ticker service by a non-member "shall be accompanied by supporting statements in the form of letters sponsoring such application from at least two members of this Exchange." If one or both sponsors withdraw their sponsorship or cease to be members of the Exchange, additional letters must be procured so that there shall be at all times at least two such statements on file

[13] *Constitution of the New York Stock Exchange,* revised to October 10, 1933. Art. X, Sec. 1, Tenth. See also *Rules of the Exchange,* Chapter XIII.

with the Committee.[14] In all instances quotations are distributed by the Western Union Telegraph Company under the terms of a contract, which among other things, provides that delivery of quotations must be strictly limited to subscribers approved by the Exchange and that the contract may be terminated at the will of the Exchange. Other exchanges have similar regulations.

To what extent exchanges will continue to have absolute power over the reporting of transactions is difficult to foretell. According to section 19, subsection (b), of the Securities Exchange Act of 1934, if an exchange fails to make suggested changes in its rules and practices, the Securities and Exchange Commission is authorized to alter or supplement the rules of an exchange in respect of such matters, among others, as "(8) the reporting of transactions on the exchange and upon tickers maintained by or with the consent of the exchange, including the method of reporting short sales, stopped sales, sales of securities of issuers in default, bankruptcy or receivership, and sales involving other special circumstances."

Non-official Character of Quotations.—While every effort is made by the various exchanges to furnish their quotations to the public promptly and accurately, it is important to remember that the quotations thus furnished are not guaranteed. To assume responsibility for their correctness would involve any exchange, despite every possible effort in the interest of accuracy, in constant explanation and litigation.

For many years no official statistics regarding stock or bond sales on the New York Stock Exchange were kept or published. For this information the Exchange had to rely upon compilations made by the leading metropolitan journals from the reports of sales printed upon the tape. Because it was frequently necessary to omit the volume of individual sales from the tape in the interest of speed subsequent to November, 1928,

[14] *Rules of the Committee on Quotations and Commissions.*

the Exchange since that time has compiled the volume of open market trading in each issue dealt in, as well as the grand volume of open market trading. This is tabulated from slips made out from reports on the floor, and is supplied through the Publicity Department so that the papers can continue to compile tables of stock quotations.

Legal Control of Quotations by Stock Exchanges.—Attention already has been called to the facts that American stock exchanges possess the right to control the publication and distribution of their quotations, and that such quotations constitute one of the important property rights of the exchanges. The principle is well established that the exchange may select one telegraph company "and give to it all the privileges of collecting news on its floor, and exclude all others." [15]

In a relatively early New York case the court thus summarized the reason for such right: [16]

"The claim that the Stock Exchange has no right to exclude the Commercial Telegram Company from its floor upon the ground of public policy evidently proceeds upon an entirely erroneous theory. The Exchange is a private association; it has the right to admit to its floor whom it pleases; it obtained nothing from the State except that protection which the law affords to every citizen; it has sought no special privilege and obtained no special powers. It is, therefore, just as much the master of its own business and of the method of conducting the same as any private individual within the State. It may make public the transactions which occur within its walls or it may refuse all information in respect thereto.

. . . . . .

"The New York Stock Exchange has asked nothing from the people of the State, except that which is granted to every citizen, it

[15] Wilson *v.* Commercial Telegram Co. (1888) 3 *N.Y. Supp.* 633, 635.

[16] Commercial Telegram Co. *v.* Smith (1888) 47 Hun (*N.Y.*) 494, 505, 507. In this case, however, the Exchange was bound by a contract which granted the same privileges to one company as were enjoyed by another.

has no special privileges under the law, it has no special rights, and the people therefore have no right to interfere in the transaction of its business to any greater extent than they have in that of any individual."

Whether or not exchanges have the right arbitrarily to furnish quotations to some persons and to refuse them to others is a question on which the decisions differ. In 1889, the Supreme Court of Illinois [17] held that although the Board of Trade could withhold its quotations entirely, nevertheless if it furnished them to some it could not refuse them to others who were willing to pay for them and be governed by reasonable rules and regulations. The reasoning of the court may thus be summarized. The Board of Trade had for so long a time permitted the use of its quotations that business had conformed to such a system. The market reports and quotations, even though the private property of the Board, had therefore become affected with a public interest and were subject to regulation by the legislature and the courts to prevent injury to such public interest. Private property, whether of individuals or of corporations, devoted by its owner to a public use, ceases to be *juris privati* only, and is subject to public regulation. A right to withhold quotations arbitrarily would enable the Board to create monopolies and to "dictate who shall deal in the agricultural products of the country, and at will impoverish or enrich merchants, shippers and producers." [18]

[17] New York and Chicago Grain and Stock Exchange *v.* Chicago Board of Trade (1889) 127 *Ill.* 153. The court applied the controlling principle of Munn *v.* Illinois (1876) 94 *U.S.* 113. "Property does become clothed with a public interest when used in a manner to make it of public consequence and affect the community at large. When, therefore, one devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good, to the extent of the interest he has thus created."

[18] New York and Chicago Grain and Stock Exchange *v.* Chicago Board of Trade (1889) 127 *Ill.* 153, 165.

Although this decision was followed in some other states,[19] it was repudiated both by the Federal and New York courts.[20] The United States Supreme Court considered, but was not forced to decide the question of arbitrary discrimination in the leading case of Board of Trade *v.* Christie Grain and Stock Company,[21] in which it held that the collection of quotations was entitled to the protection of the law. In 1926, however, the same court definitely decided that neither the exchange nor the telegraph company transmitting its quotations was compelled to serve all merely because it served some. To quote Mr. Justice Sutherland: [22]

"In furnishing the quotations to one and refusing to furnish them to another, the exchange is but exercising the ordinary rights of a private vendor of news or other property. As a common carrier of messages for hire, the telegraph company, of course, is bound to carry for all alike. But it cannot be required—indeed, it is not permitted—to deliver messages to others than those designated by the sender."

In an earlier decision the Supreme Court held that the transmission of quotations constituted interstate commerce, and that a state public service commission was therefore without power to enforce a decree requiring telegraph companies to cease discriminating against a would-be subscriber whom the exchange disapproved.[23] For this reason any exchange located

[19] Western Union Telegraph Co. *v.* State (1905) 165 *Ind.* 492; Western Union Telegraph Co. *v.* Foster (1916) 224 *Mass.* 365, reversed in (1918) 247 *U.S.* 105.

[20] Board of Trade *v.* Christie Grain and Stock Co. (1902) 116 F. 944, affirmed (1905) 198 *U.S.* 236; Matter of Renville (1899) 46 App. Div. (*N.Y.*) 37.

[21] (1905) 198 *U.S.* 236. The defendant had neither paid for the quotations nor submitted to reasonable regulations.

[22] Moore *v.* N. Y. Cotton Exchange (1926) 270 *U.S.* 593, 605. The contention that the contract between the exchange and the telegraph company created a monopoly and restrained interstate commerce was not upheld by the court.

[23] Western Union Telegraph Co. *v.* Foster (1918) 247 *U.S.* 105.

in a state permitting arbitrary discrimination has that right in all the states, even in those which prohibit such discrimination. While there is this conflict in the decisions relating to discrimination, nevertheless when the attempt is made to compel either the exchange or the telegraph company to deliver quotations to a bucket shop, to which continuous quotations are indispensable, the courts are unanimous in holding that they will not protect such business either by mandamus or by injunction. Where it is impossible to prove that an office is operating as a bucket shop, the exchanges must rely upon their right of arbitrary discrimination.

OTHER SOURCES OF INFORMATION

Numerous other agencies supplement the ticker service in distributing stock and bond quotations far and wide. In their combined effect all these agencies represent so comprehensive a quotation and news service as to enable even the remotest sections of the country to remain constantly acquainted with the daily happenings in our leading financial centers. Not only do some of these agencies gather and publish news, but they also interpret and evaluate the effect of such news upon individual securities and upon the market as a whole.

News Tickers.—News tickers are operated on the same principle as the stock ticker. The machines are rented to subscribers and as the news is received in the main office of the news bureau it is transmitted by wire and appears throughout the day on a broad band of paper, much as if written by an automatic typewriter. Current market information, such as stock and bond prices, money rates, dividend declarations, important legislation and political developments, etc., is thus available practically as soon as the information is obtained at the central office. Whereas the stock ticker furnishes quotations promptly, the news ticker serves to acquaint the Street with special occurrences that may vitally influence individual

securities or the market as a whole. Most of our large cities possess such a service, and its use as an accurate and rapid news distributor is generally regarded as indispensable.[24]

News Bureaus Operating a Bulletin Service.—Such bulletins, or news slips, are issued at fifteen-minute intervals by certain well known news bureaus, and are designed to supply detailed market information in advance of the various editions of the daily papers. In fact, many of the financial items published in newspapers seem to be reproductions of the information as originally furnished by these news bulletins. As soon as printed, the slips are distributed by messengers to the subscribers of the service. Every conceivable kind of news, deemed important from a market standpoint, such as market tendencies, crop reports, corporation earnings, insolvencies, dividend actions, etc., are fully set forth. When received, the slips are usually kept on pads by brokers and others for the perusal of their clients, who thus at all times during business hours have available a full record of current financial events. It may be added that this service furnishes more detailed information than is sent over the news ticker, thus supplementing the latter which is essentially for news flashes.

Newspapers.—Although slower in their operation than the preceding agencies, our daily newspapers constitute the chief reliance of the general public for market news. As a matter of fact two leading financial newspapers are published by the news ticker agencies. These are the *Wall Street Journal* and the *Journal of Commerce*. The latter, in addition to publishing financial news, covers in detail information dealing with business, commodities, insurance, and kindred items. There is hardly a daily newspaper in the country that does not publish at least a list of quotations, such as opening, high, low, and closing prices, sufficiently large to enable the reader to ascertain the price tendency of the market. In most of our larger cities

[24] The New York News Bureau and Dow, Jones and Company are the two well-known agencies operating in the Wall Street district.

practically every daily paper devotes one or two full pages to the security and commodity markets, while the leading New York publications, in addition to supplying complete and accurate news of local security and commodity, as well as out-of-town and foreign markets, "give an accurate description of the forces contributing to changes, carry articles on all special developments of importance in Wall Street, publish the earning and dividend statements of virtually every company in the country which has a wide distribution of securities, carry special articles by economists; in short, they supply their readers daily with fifty-five to sixty columns of financial news and tables, sufficient to fill an ordinary volume. It is not unusual to have one-fifth of a modern newspaper devoted to finance." [25] In the larger cities nearly all newspapers issue various editions, giving the latest quotations obtainable at the time of printing.

Financial Periodicals.—While many articles pertaining to business and finance appear in popular periodicals, certain publications specialize in this field. Some, such as *Barron's*, the *Financial World* and the *Magazine of Wall Street* stress the security markets; others, such as the *Annalist* and the *Commercial and Financial Chronicle*, cover more of the financial field; while *Commerce and Finance*, *Forbes*, and the *Magazine of Business* emphasize general business, but include specialized departments relating to securities.

Statistical Bureaus.—Certain interests in the market, such as bankers, brokers, operators, and investors necessarily desire the benefit of expert analysis with respect to market conditions and the financial standing of individual corporations. Such special service is rendered by statistical bureaus such as *Moody's*, *Poor's*, and *Standard Statistics*, one or more of which are subscribed to by practically every brokerage house and investment institution. Here are presented the salient facts

[25] *The Business Section of a Newspaper*, New York Herald Tribune, Introduction.

concerning the history, physical plant, capitalization, earnings, dividends, price records, and other essential information pertaining to virtually all corporations, whether their securities are listed or unlisted. The information furnished by these sources represents the analytical work of experts, and is intended to free the business man from the necessity of consulting an innumerable number of sources. In the absence of such a service, it is clear that many firms and individuals would labor under the difficulty of acquiring a large reference library, as well as the expense of employing a group of experts. These services differ from the news gathering agencies in that "they check, codify, index and present in compact and convenient form all of the news they have been able to find, and generally group such items together in a general description and tabulated report on each individual security or corporation to which the news may have reference." [26]

Market Letters.—As supplementing all of the preceding agencies for the distribution of market news, mention should be made of the immense amount of literature issued by brokerage houses, bond houses, banks, market letter writers, vendors of various trading systems and forecasters, etc., in the form of circular letters and booklets. Many brokerage houses issue a daily market letter, covering a typewritten page, in which they review the market for the day and forecast its action on the following day. In addition they sometimes publish a weekly review, and at times, special letters, analyzing a specific security. Investment houses, too, have statistical departments for the preparation of such material, and at regular intervals send a market letter to all their clients. Moreover, when floating bond or stock issues practically all syndicate members interested in the flotation circularize their prospective clientele with printed circulars containing a detailed statement of the financial condition of the corporation whose stock or bond issue they are advertising.

[26] Schabacker, *op. cit.*, pp. 429, 430.

Market Advisory Services.—As may be imagined, when the average individual is confronted with such an enormous supply of information from so many sources, he is lost in the maze of figures, facts, and opinions. Because of a lack either of time or of ability and training he finds it impossible to form any decision upon which he is willing to rely. To meet this problem various market advisory services have been inaugurated. Their main purpose is to give advice and to make specific recommendations concerning the securities to be purchased and sold and the time when such purchases and sales should be made. Although by no means infallible,[27] the soundest of these services give to their subscribers the benefit of the findings of their expert statistical and analytical organizations. In addition to these, it may be added, many of the other organizations furnishing market information, as well as some general periodicals, have separate departments whose function it is to furnish readers or clients with an opinion regarding the advisability of buying or selling specific securities.

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[27] For an evaluation of some of the more prominent services the reader is referred to Cox, G. V., *An Appraisal of American Business Forecasts,* Univ. of Chicago Press, Chicago, Rev. Ed. (1930).

CHAPTER XIV

STOCK EXCHANGE CLEARING HOUSES

Origin of Stock Exchange Clearing Houses.—Stock exchange clearing systems had their origin some twenty years before the New York Stock Exchange saw fit to establish its system in 1892. The first establishment of such a system occurred in Frankfort, 1867, and the Berlin, Hamburg, Vienna, and London Stock Exchanges adopted the system in 1869, 1870, 1873, and 1876, respectively. In 1886 the Consolidated Stock and Petroleum Exchange of New York introduced its system, which is said to have been "the first system to clear both stocks and money for a board of brokers," [1] although the Philadelphia Stock Exchange had previously taken some steps along this line.[2]

Until 1892 all attempts to establish a clearing house in connection with America's leading exchange failed, largely because of the fear that a clearing system would reveal to the clerks operating it the business secrets of brokers. In that year, however, the banking interests of New York, having become alarmed at the enormous amount of temporary credit given to brokers through the certification of their checks, threatened to curtail such required certification unless the Exchange adopted some means to reduce its volume. This action on the part of the banks forced the Exchange to adopt a clearing system, and the establishment of its clearing house dates from May 17, 1892, just one hundred years after the first brokers'

[1] Noyes, A. D., "Stock Exchange Clearing Houses," *Political Science Quarterly,* vol. viii, p. 257.

[2] *Ibid.,* p. 259.

agreement from which the Exchange developed. At the start only four stocks were cleared; the next year twenty-one were included; and at the present time, although the number varies, it is estimated that 90 per cent of the total volume of transactions are cleared.

The Theory of Clearing.—Probably the best way to arrive at an understanding of the principle of security clearance and to realize the advantages of such a system is to trace the procedure followed in completing a transaction involving the purchase of a security at a time when no clearing system existed. Suppose that Brown, a customer, ordered White, his broker, to buy 100 shares of Pennsylvania at 38. Without attempting to follow the execution of the order in detail, it may be assumed that the transaction was made on the floor of the Exchange with Jenks, another broker. It now becomes the duty of Jenks to compare the details of the transaction with White, at the latter's office, to insure that the essential details of the contract are correctly understood by each of the parties. To complete the transaction Jenks would have to deliver the 100 shares of Pennsylvania, which he obtained from his customer, to White's office on the day of delivery as specified in the rules of the Exchange. Upon receipt of the stock, White would give a check to Jenks for the necessary amount and would deliver the certificate to his customer, Brown. If this were the only transaction made, it is obvious that the introduction of a clearing system would not result in any advantage.

Suppose, however, that White had another customer who wanted to sell 100 shares of Pennsylvania, and that Jenks had a second customer who wanted to buy the same number. In other words each broker has two customers, the one desiring to buy and the other desiring to sell. This would require two transactions on the floor of the Exchange. These would require Jenks to deliver 100 shares to White's office and obtain a check, and at the same time White would have to deliver 100 shares

to Jenks' office and obtain a check. A clearing system could now be used to advantage. Since each broker owes the other 100 shares of Pennsylvania there would be no need for delivery of stock by either one. Each broker could satisfy the demands of his buying customer by delivering to him the certificate obtained from his selling customer. Further, if both transactions had been executed at the same price of 38, each broker would owe the other $3,800, which would obviate the necessity of an exchange of checks. Thus, with a clearing system neither broker would have to deliver securities nor make any payment to the other.

Unfortunately, brokerage transactions are not so beautifully simple. In actual practice it is not probable (1) that each broker's customers would have desired to buy and sell the same number of shares of the same stock, (2) that each transaction would have been executed at the same price, and (3) that both transactions would have been made with the same broker, i.e., it is not likely that White would have bought from Jenks in executing his client's buying order, and sold to him in executing his client's selling order. For these reasons the clearing system in actual practice does not obviate all deliveries of securities or all payments of money. In any event, however, some economies are possible and these economies become more pronounced as the number of transactions increases. To illustrate, suppose that one of White's customers had bought 100 shares of Pennsylvania at 38 and another had sold 200 shares at 39. Instead of receiving 100 shares and delivering 200 shares, a clearing system would enable White to fulfill his obligations by the delivery of only 100 shares. Further, instead of paying $3,800 and receiving $7,800, he would receive a net payment of $4,000. And the clearing system would permit each of these savings even though the purchase was made from one member and the sale to another. It should be apparent that stock exchange clearance involves clearing both of securities and of payments. The first of these is known as

clearing and the second as settlement, although both are in fact clearances. Clearing is made possible through set-off of purchases and sales wherever possible, and through the substitution of parties where set-off is not possible.

A system of clearance therefore involves (1) a comparison, (2) a clearance of securities, (3) a delivery of security balances that cannot be cleared, (4) a clearance of the money value of security deliveries, and (5) a money settlement.

The theory of security clearance may be viewed from another angle. Suppose that "A", "B", "C", and "D", members of the Exchange, have made the following transactions in Pennsylvania Railroad stock. "A" sells 100 shares to "B" at 38; "B" sells 100 shares to "C" at 38; "C" sells 100 shares to "D" at 38. By off-set and the substitution of parties through a clearing house, the three transactions could be settled by directing "A" to deliver 100 shares to "D" and by requiring "D" to pay $3,800 to "A". Here again the illustration is too perfect. It is unlikely that the same number of shares will be bought and sold by all parties at the same price. But if "A" had sold 100 to "B", "B" had sold 100 to "C", and "C" had sold 300 to "D", some economy would be effected by directing "A" to deliver 100, and "C" to deliver 200 to "D". But when the prices differ at which the various purchases and sales are made, some money adjustment is necessary and for purposes of uniformity an arbitrary settlement price is introduced. If, for example, "A" sells 100 shares to "B" at 38, "B" sells 100 shares to "C" at 39, and "C" sells 300 shares to "D" at 40, it is necessary to fix an arbitrary price, usually the nearest even price to the closing bid price on the Exchange, in order that all deliveries will be made at a uniform price by all members. Assume that the settlement price is 40 and that "A" is directed to deliver 100 to "D", and that "C" is directed to deliver 200 to "D". The accounts in Figure 2 will then represent the clearing sheets of each of the members. This is the extent of the first clearing system adopted by the Exchange, and at present constitutes

the work of the Night Branch. The work of the Day Branch will be explained in succeeding pages.

Purchases		A	Sales	
		To "B" 100 at 38		3,800
Balance to Deliver 100 at 40	4,000		check	200
	4,000			4,000

Purchases		B	Sales	
From "A" 100 at 38	3,800	To "C" 100 at 39		3,900
Draft	100			
	3,900			3,900

Purchases		C	Sales	
From "B" 100 at 39	3,900	To "D" 300 at 40		12,000
Balance to Deliver 200 at 40	8,000			
Draft	100			
	12,000			12,000

Purchases		D	Sales	
From "C" 300 at 40	12,000			
		Balance to Receive 300 at 40		12,000
	12,000			12,000

FIGURE 2

While it is impossible to determine the extent of the profit or loss of the various members as a result of the day's transactions, nevertheless it is possible to show by analyzing the above accounts that the clearing system *per se* does not result in any inequity. "A" has a balance of 100 to deliver at 40, despite the fact that he contracted to sell at 38. He must return this

$200 excess to the clearing house, which leaves him in the same position as if he had actually received the contract price of 38 from "B". The latter purchased 100 at 38 and sold the same number at 39. He is required neither to deliver nor to receive any securities and he is entitled to a profit of $100 which he obtains by a draft drawn on the clearing house. "C" bought 100 from "B" and sold them, together with an additional 200 to "D" at 40. "C" therefore is entitled to a profit of $100 which he obtains by a draft. In his case no adjustment need be made for a difference in sale and delivery prices since they are the same. "D" purchases 300 from "C" at 40 and since he receives them through the clearing house at the price specified no adjustment is required. Each member is in the same position as he would have been had no system of clearing been employed. The settlement price is immaterial. Furthermore, the clearing house has received $200 which exactly represents the total of drafts drawn upon it. It may be added that each member's check or draft embodies in it (1) the difference between the purchase and sale prices of the securities that are cleared, and (2) the difference between the actual contract prices and the prices at which deliveries are made of those securities that are not cleared.

The Development of the New York Stock Exchange Clearing System.—Before the inauguration of a clearing system by the New York Stock Exchange in 1892, various attempts had been made to establish some method of clearing, but they were not very successful and were used only to a limited extent. To be successful a clearing system should be applicable to the entire membership of the Exchange and should clear transactions as regards both securities and money. The clearing-house system of the New York Stock Exchange meets both of these requirements. It has been so arranged as to enable all brokers to clear all their clearing-house transactions on their own clearing sheet. In case the broker's purchases and sales of all the different kinds of securities in which

he traded during the day are equal, he finds it unnecessary to receive or deliver any stock, and instead of paying a separate check for each lot of securities bought and receiving separate checks in payment for each lot of securities sold, all his transactions for the day are settled by a single check or draft representing the difference between the total value of the purchases and sales. If the difference shows a debit balance, it is paid by check to the clearing house, and if a credit balance, it is obtained by drawing a draft on the clearing house. In case, however, the broker's total purchases and sales for the day do not balance, only those amounts of the various securities appearing on both sides of the clearing sheet can be cleared. The balances of securities that may appear on one side or the other of the sheet must actually be received or delivered at a fixed "delivery" or "settlement" price, published by the clearing house in advance of the making up of the clearing sheet. The totals of these fixed delivery items are taken care of by a system of debits and credits in the clearing house. As has been explained, no injustice results from this practice, because the brokerage firm in making up the statement automatically credits or debits itself on the clearing sheet for any loss or profit (for which, of course, it is not responsible), that may arise because the arbitrary settlement price happens to be higher or lower than the contract price. All such debits and credits by all brokerage houses concerned in the transactions will necessarily offset one another so that the sum total of all checks sent to the clearing house will just equal all drafts upon it.

Legality of Clearing Houses.—Notwithstanding their manifest advantages, the establishment of clearing houses was opposed on the ground that the cancellation of deliveries on contracts appearing on both sides of the clearing sheet is a mere settlement of differences and is contrary to the state law requiring in all contracts "an intent to deliver." Numerous decisions, however, relating to both stock and commodity ex-

changes, uphold the legality of clearing systems in all cases where actual delivery on contracts is *enforcible*. Such enforcement exists under the rules of the exchanges, and all contracts made thereon are entered upon with "intent to deliver" since the seller must consider himself, at the time of contracting, as bound to make delivery if the buyer so requests. As has been stated: [3]

"The clearing house is the agent of both of the parties, and where a selling broker sends to it his account of sold shares, the clearing house in such a case is authorized by the buying broker to accept such shares, and if such an account were to contain nothing but sold shares, the clearing house, as the agent of a buying broker, would simply direct the selling broker to deliver the shares to his (the clearing house's) principal; but where the account contains bought as well as sold shares, the clearing house then, acting as the agent of both the brokers, sets off one transaction as against the other. This the principals themselves might legally do, and consequently it is obvious that their agents may do the same. In fact, the sheets sent to the clearing house by the different brokers are substantially nothing but bills of sales made to them, and sent to their common agent, the clearing house."

The Supreme Court of the United States, in the case of Clews *v.* Jamieson, 182 U. S. 461, (1901), also declared the clearing-house rules of the Chicago Stock Exchange to be legal in their application to all contracts where there is no evidence of an intention merely to settle differences. "To say that such rules afford wrong ground would infer an understanding between the parties doing business subject to them—that their contract was not one of actual sale but merely one to speculate upon 'differences'—is, in our opinion," to quote the Clews *v.* Jamieson case, "to presume an illegal contract against its plain terms, and without any sound basis for the presumption."

[3] Biddle, Arthur and George, *A Treatise on the Law of Stock Brokers* (1882) p. 61.

Clearing houses, however, cannot be used as a cover for fictitious transactions and their records; in fact, quite to the contrary, to quote Dos Passos,[4] "they can (in the absence of proof by the brokers' books, showing the names of parties from whom they bought or to whom they sold stock, that the transactions were real) be used in evidence for the purpose of showing that, as the majority of the alleged transactions were never cleared, they never in fact occurred." Even the practice of "ringing out," prevailing chiefly on commodity exchanges and by which brokers who have acted for buyers and sellers in the making of contracts for future delivery cancel their contracts and adjust the differences in price, has been considered legal so long as it is not used to promote a gambling contract.[5]

Management and Organization of the New York Stock Exchange Clearing House.—For many years the New York Stock Exchange Clearing House was run by the Exchange itself. A committee of five, appointed by the Board of Governors supervised its operation. As time went on, however, it became more and more evident that the system would have to be extended. As at first constituted it aided materially in decreasing the amount of credit needed to finance security transactions, but with the normal growth in the volume of business the problem became acute. A system of direct delivery required a great deal of credit because all deliveries were paid by certified checks. This presented a problem since a broker could not get his securities until he paid for them and he could not pay for them until he received the securities to deposit as collateral. The solution generally used was either the over-certification of broker's checks or the making of morning loans with the agreement that collateral would be deposited as soon as received. These methods were not popular

[4] Dos Passos, J. R., *Treatise on the Law of Stock Brokers and Stock Exchanges*, Vol. 1, p. 408.

[5] See legal citations *ibid.*, p. 409.

with the banks, and subsequent to the beginning of the World War with the increase in financing the need for additional clearing became more acute. The old system eliminated the demand for a great deal of credit since it cleared securities. Thus, if a broker had bought 600 shares and sold 500 shares of the same stock, he would have to finance the delivery of only 100 shares. But if he purchased 600 shares of one stock and sold 500 shares of another he would have to finance a delivery of 600 shares. It was to solve this problem that the Exchange amended its Constitution on December 26, 1918, to provide for the organization of the Stock Clearing Corporation.

The Stock Clearing Corporation is a corporation, chartered during the year 1919, with a capital of $500,000 divided into 5,000 shares, all of which are controlled by the New York Stock Exchange. The Board of Directors numbers twelve, four of whom are elected yearly for a term of three years. Members or firms desiring to become clearing members must contribute to the clearing fund an amount as fixed by the corporation at the time of the member's application for membership. This contribution may thereafter from time to time be increased or diminished by the Stock Clearing Corporation, but the minimum amount is fixed at $10,000. Provision is also made for the creation out of earnings of a surplus fund of $500,000. In addition, each member is liable for an additional 100 per cent of his contribution in case of losses by the corporation that cannot be made good out of surplus.

The Stock Clearing Corporation began its operations on April 23, 1920. It greatly increased the services rendered the broker by providing for a means of clearing money balances on securities received and delivered, and also by making provision for the clearing of collateral call loans. The old Clearing House was left intact with the exception of a few modifications and was designated the "Night Clearing Branch." For the purpose of clearing the money balances and the collateral call

loans a new section was established, known as the "Day Clearing Branch," and from this point on it will be indicated at which branch the various operations take place.

All transactions in securities designated by the Clearing Corporation must be made through the Clearing House unless otherwise specially stipulated in the bid or offer, or otherwise agreed upon. Members of the Exchange are admitted to clear in their own names if they have an office near the Exchange with a proper clerical force; but members without such facilities may, on the written engagement of a fellow member with proper facilities, have him handle their transactions through the Clearing Corporation. The number of clearing members varies from time to time with business conditions. At present they number approximately 350.

According to its by-laws, the Clearing Corporation "shall maintain a list of the stocks, bonds, notes, rights to subscribe and other securities, rights or interests which may be the subject of contracts cleared through the Stock Clearing Corporation." This list is changed from time to time and includes only the active securities. The rules provide that unless otherwise determined no transaction shall be cleared unless the security involves "a lot of 100 shares of stock or a multiple thereof or $1,000 par value of bonds or a multiple thereof." The expenses of operation are provided for (1) by a charge of five cents "for every 100 shares of stock on the night clearing sheet delivered and for every 100 shares of stock on the night clearing sheet received and for every 100 shares of the balances to be received and delivered as shown on the night clearing sheet"; (2) by the following charges "for every $1,000 charged or credited to a clearing member by the Day Branch of Stock Clearing Corporation in connection with the settlement of (a) transactions in United States Government issues, two cents; (b) transactions in bonds other than United States Government issues, three and one-half cents; and (c) transactions in all securities other than bonds, three cents"; (3) by interest received on

money deposited in various banks; and (4) by fines imposed for delays and errors.

However, according to Section 19, subsection (b) of the Securities Exchange Act of 1934, final control over the time and method of making settlements, payments, and deliveries and of closing accounts is vested in the Securities and Exchange Commission.

The Method of Clearing Securities Explained.—In illustrating the operation of the New York Stock Clearing Corporation let us assume that on a given day a brokerage firm "X" makes the following transactions.

Purchases

From	No. Shares	Security	Price
"A"	500	U. S. Steel com.	54½
"B"	700	Pennsylvania	33
"C"	400	A. T. & T.	120

Sales

To	No. Shares	Security	Price
"K"	600	U. S. Steel com.	55½
"L"	600	Pennsylvania	34
"M"	400	A. T. & T	119

In the illustration only a few transactions were assumed in order that the reader might more easily obtain an understanding of the principles of the clearing system. No attempt will be made to discuss the system in detail since it is quite complicated and involves the use of a large variety of forms.

Comparison of Transactions.—Prior to the sending of the clearing sheet to the Clearing House it is essential that "X" should make sure that there is no misunderstanding between itself and any of the buyers and sellers with whom it made contracts as regards the price and number of shares involved in any of the six transactions. Such misunderstandings might easily arise, owing to the usual excitement on the Exchange and the limited memoranda that brokers find it possible to make.

Their occurrence, unless promptly discovered in advance of clearing the transactions, will cause much delay to the Clearing House, and will subject the firm at fault to heavy fines.

To avoid all such misunderstanding and to furnish a clear record of the day's business, the rules of the Clearing Corporation, which are held binding by the Stock Exchange rules, provide that as regards all Clearing House transactions "clearance" or "exchange tickets" must be exchanged between the buyers and sellers. In addition to establishing the accuracy of the details of each transaction, these tickets authorize the Clearing House to act on the member's behalf in the deliveries and receipts of cleared securities. Prior to 1916 these tickets were exchanged by messenger service to individual offices, but in that year there was established a central "Distributing Department" in what is now the Night Branch. At frequent intervals during the day exchange tickets are deposited with the Distributing Department, which maintains a small box for each member, very similar to the ordinary mail box in a post office. These tickets, after being deposited, are assorted by the Distributing Department and placed in the boxes of the various members who call for them at intervals throughout the day. The buyer's ticket is placed in the box of the seller, and in the same manner the seller's ticket is placed in the buyer's box, the two tickets serving to confirm the transaction.

Applying this method to the transactions recorded on page 247, it follows that "X" sends to the Distributing Department a clearing-house ticket signed by itself authorizing the Clearing House to deliver to "K" 600 shares of U. S. Steel common at 55½, and will receive *via* the Distributing Department in exchange a corresponding ticket, signed by "K" authorizing the Clearing House to receive the stock from "X". Similarly, "X" will send tickets to "L" and "M", and will receive from them corresponding tickets in exchange. On the other hand, "X" will receive from "A" a ticket authorizing the Clearing House to deliver to it 500 shares of U. S. Steel common at 54½, and

in return will send to "A" a ticket authorizing the Clearing House to receive from "A" that number of shares at the stipulated price. "X" will also receive clearing-house tickets from firms "B" and "C".

The Clearing Sheet.—When all the clearing-house tickets have been exchanged—that is, all the transactions have been verified—"X" is in a position to enter its six purchases and sales on the so-called "clearing sheet." Although not a facsimile of the clearing sheet in actual use by the Night Branch, the form shown in Figure 3 will illustrate the principles involved.[6] The clearing sheet must be delivered before 1:00 P. M. on each business day except Saturdays by all members having transactions to be cleared on the next settlement day. Saturday is not a settlement or a clearing day. The clearing sheet presented to the Night Clearing Branch on Monday for the next settlement day includes Saturday's transactions and those of the preceding business day.

The sheet contains a statement of all the broker's transactions for the given day, all securities to be received, either because they have been purchased or borrowed, appearing on the left-hand side, and all securities to be delivered, either because they have been sold or lent, appearing on the right-hand side. The numbers on the lines of the clearing sheet correspond with the line numbers appearing on the exchange tickets for the various transactions and serve to index each item, thereby proving a great help in looking up such items or in checking the tickets with the sheet. These numbers are also valuable for purposes of reference to the transactions in the broker's books of account.

A glance at the clearing sheet (Figure 3) reveals that "X" has bought 1,600 shares and sold 1,600 shares. In all 3,200 shares

[6] As a matter of fact, stock balances to receive and deliver are no longer entered on the clearing sheet itself, nor is the debit or credit balance settled by a check or draft, a debit or credit memorandum now being used.

FIGURE 3.—ILLUSTRATION OF NIGHT BRANCH CLEARING SHEET OF FIRM "X"

Received From	Shares	Security	Price	Value	Deliver To	Shares	Security	Price	Value
"A"	500	U. S. Steel com.	54½	27,250	"K"	600	U. S. Steel com.	55½	33,300
"B"	700	Pennsylvania	33	23,100	"L"	600	Pennsylvania	34	20,400
"C"	400	A. T. & T.	120	48,000	"M"	400	A. T. & T.	119	47,600
Balance to Deliver					Balance to Receive				
	100	U. S. Steel com.	55	5,500		100	Pennsylvania	34	3,400
	Draft			850					
	1,700			104,700		1,700			104,700

were bought and sold. Where the broker has bought as many shares of the same stock as he has sold, it is obvious that the shares of this particular security may be cleared and insofar as he is concerned no receipt or delivery is necessary. This is illustrated by the purchase and sale of American Telephone and Telegraph stock in the illustration. If these two transactions had been the only ones of the day, the broker could have settled for the difference in prices by sending to the Clearing House a check for $400. Conversely, if the sales price had exceeded the purchase price he could have drawn a draft on the Clearing House for the excess credit. This same situation, i.e., that no securities would have to be received or delivered by him, would exist no matter how large the number of transactions the broker had made, provided he had bought and sold the same number of shares of each of the various issues. In all such cases a draft would only represent the excess of his sales over his purchases, and a check the excess of his purchases over his sales.

It happens only occasionally that a broker's purchases and sales on a given day balance one another. In all probability he will have some balances to receive and some to deliver. In the illustration, "X" sold 100 shares more of U. S. Steel common than he bought. He therefore has a "balance to deliver" of 100 shares and this appears on the left-hand side of the clearing sheet. Similarly, "X" bought 100 shares more of Pennsylvania than he sold. He therefore has a "balance to receive" of 100 shares and this appears on the right-hand side of the clearing sheet. All the balances to deliver are entered on the left-hand side and all the balances to receive on the right-hand side, so that the total shares appearing on each side of the sheet are equal.

The Use of a "Settlement Price" in the Delivery and Receipt of Stock Balances.—As previously explained, it is necessary to use some arbitrary settlement price to facilitate the operation of the clearing system. The actual delivery and re-

ceipt of the stock balances of U. S. Steel common and Pennsylvania cannot be eliminated. The 100 shares of U. S. Steel common, as will be shown later, must actually be delivered by "X" to some one designated by the Clearing House who has a balance of that amount to receive; and the 100 shares of Pennsylvania must be received from some other broker designated by the Clearing House who has a balance of that stock to deliver. Since there are two parties—a buyer and seller—to every stock exchange transaction, and since all brokers belonging to the Clearing House must clear all their business in securities on the Clearing House list, it follows that where one broker has a balance to receive in any given stock there must be some other broker or brokers who have a corresponding balance to deliver, and *vice versa*. These various brokers, having balances of stock to receive and deliver, it is the function of the Clearing House to bring together.

But it will be asked, "How can 'X' be expected to receive balances from or to deliver them to other brokers named by the Clearing House when it has had no business dealings with them and when its contract prices in the stocks under consideration are different from the contract prices of the brokers from whom it is to receive or to whom it is to deliver its balances? How is 'X' to agree with the other firms upon the amount to be paid for these balances?" This difficulty is overcome by the adoption of "settlement" or "delivery" prices that must be used in effecting payments for all balances of stock to be received or delivered. Assuming in the illustration that the settlement price for U. S. Steel common is 55, and for Pennsylvania 34, "X" delivers the balance of 100 shares of U. S. Steel common to some broker designated by the Clearing House and is credited with this stock at the settlement price of 55, although it was actually sold at 55½. In the same way "X" is debited with the settlement price of 34 for the 100 shares of Pennsylvania which he is to receive. The various sums thus to be credited and debited are entered on the clearing sheet.

An examination of the clearing sheet will show that firm "X", in order neither to gain nor lose because of the adoption of arbitrary settlement prices, is entitled to a payment of $850 from the Clearing House, and this sum it obtains by drawing its draft on the Clearing House for that amount. It is to be remembered, however, that it is quite immaterial what settlement prices are used, because whatever a broker unjustly loses or gains through the use of an arbitrary settlement price as compared with the contract price, will be received by him from the Clearing House or returned by him to the Clearing House. In other words, the draft for $850 represents (1) the difference between the purchase and selling price of the different stocks that could be cleared; and also (2) the difference between the contract price and the arbitrary settlement price for those stocks that could not be cleared and that must actually be delivered and settled for on the basis of the arbitrary settlement price.

In the illustration the following stocks were cleared: 500 U. S. Steel common; 600 Pennsylvania; and 400 American Telephone and Telegraph. On U. S. Steel common "X" is entitled to a payment of $500, since it was sold at one point above the purchase price. To this must be added an additional payment of $600, representing the excess of sales price over purchase price on Pennsylvania. However, "X" owes $400 as a result of his American Telephone and Telegraph transactions so that as regards the stocks that were cleared he is entitled to a net amount of $700. On the securities that could not be cleared, "X" has lost $50 on 100 shares of U. S. Steel common as a result of delivery at the settlement price, since he receives only 55 and is entitled to 55½. He has lost an additional $100 on the 100 shares of Pennsylvania since he bought it at 33 but must pay 34 when he receives it. The draft of $850 therefore places "X" in the same financial position that he would have occupied if all deliveries and receipts had actually been made at the contract prices.

Tickets for Delivery or Receipt of Stock Balances.—When the clearing sheet has been prepared and the balances to deliver and receive ascertained, "X" will make out a security balance ticket for each individual balance of stock to be delivered or received. Thus, "X" will make out a delivery balance sheet stating that it will deliver 100 shares of U. S. Steel common at the settlement price of 55, and it will make out a receive balance ticket stating that it will receive 100 shares of Pennsylvania at 34. These statements of balances, together with the clearing sheet, the attached draft for $850, and all Clearing House tickets received from the various brokers from whom "X" purchased or to whom it sold, are then delivered by "X" to the Night Branch of the Clearing House before 1:00 P. M. All the other brokerage firms will also deliver their clearing sheets, tickets, and statements of balances—these including among others the transactions with "X"—so that the Clearing House has a complete record from both parties to all transactions and is fully authorized to clear the business.

Preparation of "Allotment Sheets."—The Clearing House, having received all the records referred to, can now proceed to audit all the items and make up its "allotment sheets." This involves a comparison of the clearing house tickets with the clearing sheet, and the sorting of all the statements of balances to be received or delivered so as to facilitate their use in the making of allotment sheets, one of which is prepared for each stock in which dealings have occurred. The purpose of the allotment sheet is to enable the Clearing House to designate the brokers to whom deliveries must be made and from whom receipts must be accepted. On one side of the sheet are listed all the balances of a particular stock to be received; on the other are listed all the balances to be delivered. The number of shares to be received or delivered is indicated in connection with each clearing member. Since there are two parties to every transaction, the balances on the two sides of the sheet will always equal each other in the total number of shares in-

volved, and it is easy to designate a buying firm or firms to receive the stock balances of each selling firm.

Delivery of Balances.—Between 9:00 A. M. and 9:30 A. M. of the settlement day the "security balance tickets are returned to the clearing member at the Night Clearing Branch with the names filled in of the members to whom deliveries are to be made and from whom securities are to be received, which then become orders for the receipt and delivery of securities." Thus, "X" will now know to whom he must deliver 100 shares of U. S. Steel common and from whom he will receive 100 shares of Pennsylvania. This completes the functions of the Night Clearing Branch and from this point the work is taken up by the Day Clearing Branch.

The Day Branch.—As previously stated, before the extension of the clearing system in 1920, each broker who had a balance of securities to deliver sent it to the office of the broker designated to receive it and he received a check for the amount as determined by the settlement price. Thus, a considerable amount of credit was still required to finance these transactions. To cut down still further this volume of credit the Day Branch was inaugurated. At first the actual deliveries were still made to the various offices, but instead of receiving payment by check the delivering member was credited each day by the Clearing Corporation with the amount he was entitled to receive for securities delivered by him. At the same time, the receiving member was debited for the value of securities that he was obligated to pay for the securities that were delivered to him. A member's credits and debits offset one another in great part and the excess of one over the other was adjusted by a draft on or check to the Clearing Corporation. These debits and credits were contingent upon actual receipts and deliveries and were reported to the Day Branch before 10:00 A. M. on itemized lists made up from the information contained on the security balance tickets that were returned by the Night Branch. Upon the actual receipts and deliveries having been made, the

contingent debits and credits were transformed into actual debits and credits. Thus, in the illustration assumed, "X" will receive from the Clearing Corporation the difference of $2,100. Without the Day Branch, it would have received a check for $5,500 and given a check for $3,400. Obviously, the saving of credit becomes more pronounced when the number of security balances to receive and deliver is greatly increased.

At this point it is desirable to see whether the clearing system as a whole has resulted in any inequity. In the illustration, "X" purchased securities for which he contracted to pay $98,350 and he sold securities for which he was entitled to receive $101,300. As a result of the transactions he should have received the excess of sales over purchases, or $2,950. This exactly equals the amount that he receives from the Clearing Corporation, i.e., a draft of $850 from the Night Branch and a draft of $2,100 from the Day Branch.[7]

Central Delivery.—The disadvantage of making actual deliveries to the various offices was soon recognized and in 1929 the Central Delivery Department was started. This functions much as the Distributing Department of the Night Branch in that it greatly cuts down the number of trips by messengers. All deliveries that are ready to be made are taken care of by one trip to the Central Delivery Department. On his return the messenger brings back all the securities that have been received up to that time for his particular firm. The Clearing Corporation estimates that for one day this system reduced the number of trips by messengers from 12,140 to 1,429, thereby obviating over 88 per cent of the trips otherwise required. At first the system of central delivery applied to only a limited number of securities, but it was extended several times thereafter to include all cleared stocks, cleared bonds, non-cleared

[7] As previously indicated the amount of $850 owing as a result of the Night Branch Clearing is credited to the member's account in the Day Branch, so that the whole transaction would require only one draft for $2,950.

stocks, U. S. Government bonds, and non-cleared bonds, so that at the present time the Central Delivery system applies to all securities listed on the Exchange. This department also handles security deliveries between Stock Exchange houses and non-Exchange member banking institutions.

It should be mentioned that in order to avoid an excess of credit accommodation the Clearing Corporation keeps a record that indicates at any hour of the day just how far each member has proceeded with the delivery of securities.

Clearance of Loans.—The clearing of collateral call loans, previously referred to, is one of the most important of the new functions of the Clearing Corporation. The value of this system will be appreciated better after a brief description of the old method. Whenever a broker desired to make a new loan, he always found it necessary to obtain an intermediate credit from his bank until the collateral could be delivered, or if he desired to transfer an existing loan from one lender to another, credit was necessary for the purpose of redeeming the hypothecated securities before they could be delivered to the new lender. In either case it meant a temporary unsecured loan that resulted in a large amount of over-certification. By means of the new method the over-certification by banks has been obviated by the Clearing Corporation extending the necessary intermediate credit. To make this possible each clearing member has been compelled to contribute at least $10,000 to a guarantee fund, which is used to aid in the financing of the clearing operations. The total of this sum at any time is not permitted to fall below $10,000,000, so it can readily be seen that the Clearing Corporation is financially capable of extending temporary credit of very large amounts.

Negotiations for new loans are usually made at the "money desk" on the floor of the Exchange. Then if the parties wish the Clearing Corporation to act for them, they sign a loan agreement that is subject to the approval or disapproval of the Clearing Corporation. According to the rules the Clearing Cor-

poration may decline to act within a limited time, depending upon the time of day at which the loan agreement is filed. If not rejected within that time, it is automatically accepted and the Corporation will act for the parties. Booths have been provided in the Day Clearing Branch for the various lenders of money and for the Clearing Corporation tellers designated to handle the accounts of the various clearing members. The collateral is sent to the Day Branch where it is checked up and, if satisfactory, it is delivered to a representative of the lending institution by the Corporation upon the presentation to it of a check covering the loan.

Similar arrangements are made for the transfer of a loan from one lender to another, for the paying off of loans when terminated by the borrower or called by the lender, and for the substitution, withdrawal, or addition of collateral. It is important to note that in all these transactions the Clearing Corporation extends the intermediate credit and thus performs a banking function. This is made possible by the clearing fund previously referred to. However, the amount of accommodation that any one member may receive is limited in several ways. The amount of unsecured accommodation is dependent upon the size of the member's contribution to the clearing fund; the Clearing Corporation at all times reserves the right to refuse to act in any loan transaction; and it may demand different or additional collateral while it is extending credit on a loan.

At the end of the day the cash debits and credits that result from the handling of loans are entered on the clearing member's record sheet, which also contains debits and credits arising out of security clearance, and out of receipts and deliveries of securities through the Clearing House. The net difference is taken care of by (1) a check to or (2) a draft on the Clearing Corporation, as the case may be.

Stock Transfer Department.—Ordinarily stocks placed in transfer are not available for credit purposes. In 1923 the

Clearing Corporation inaugurated the practice of issuing through the Stock Transfer Department its assignable receipts for stocks to be placed in transfer. In 1926 it extended this plan to include exchange receipts issued for securities deposited in connection with re-organizations and capital re-adjustments. Both classes of receipts are accepted as collateral by the lending banks and much credit is available that would otherwise be tied up for twenty-four hours or more. "On one day, 797,300 shares of stock with a money value of $96,906,900 have been placed in transfer and receipts issued therefor. Furthermore, at one time, there were outstanding 3,533 receipts, representing 1,649,500 shares with a money value of $181,648,100, and representing 162 firms." [8]

Advantages Derived from Stock Exchange Clearing Houses.—By greatly reducing the volume of checks and deliveries of stock the system of clearing, it is plain, relieves brokers and banking institutions of much risk, confusion, labor, and loss of time. In addition, a great amount of overcertification is avoided since the capital demands of brokers are greatly reduced by the clearing of security balances and call loans. Attention has previously been called to the large reduction in the number of trips by messengers brought about by the introduction of the Central Delivery system. Statistics are also available to indicate the obviation of the use of bank credit and the theoretical obviation of bank checks. Although the funds obviated vary directly with the value of all contracts settled which in turn vary with the volume of trading, nevertheless there is a fairly constant percentage of funds obviated. During 1929, the peak year, the total value of all contracts was $123,312,000,000 of which $100,780,000,000 or 81.7 per cent was obviated. During the period 1925 to 1933 the percentage obviation varied between 85.1 in 1928 and 77.3 in 1933. The saving in percentage is even higher when check ob-

[8] Streit, S. F., *Description of Operation of Stock Clearing Corporation,* March, 1933, pp. 16, 17.

viation is considered. During 1933, the peak year, only 62,876 checks were required to handle 4,756,787 items theoretically requiring checks, a saving of 98.7 per cent. During the period 1925 to 1933 this percentage varied between 97.7 in 1926 and 98.7 in 1933.[9] To give another illustration, "one Stock Exchange firm owed $1,980,000 on stocks to receive and had credit of $1,975,000 on stocks to deliver involving 163 deliveries and about 150 receipts, all of which were settled with a check for $5,000." [10]

Other advantages also result from the operation of the Clearing Corporation. Comparisons of transactions are facilitated so that errors may be promptly adjusted. In case of insolvency the system is instrumental in saving much time and loss in making settlements. The whole business of Stock Exchange firms is standardized and regulated. Daily clearings also serve much better than the European system of fortnightly settlement of transactions as a precautionary restriction upon brokers against over-extension of credit and over-speculation. No doubt in the future further extensions of the clearing system will be made. The Exchange has already experimented with machine clearance, whereby the Stock Clearing Corporation makes out clearing sheets for its members by machine. During 1933 there was some discussion of a stock exchange bank so that physical transfer of securities in Wall Street would no longer be necessary except when actual possession was demanded by traders or investors. Under this plan the securities would remain in the bank and title thereto would be transferred much like title to cash in a bank is transferred by checks. It should be added that the second-day delivery system adopted by the Exchange in September, 1933, has aided materially in preventing congestion in the Night Branch and in reducing the number of fail-to-deliver items.

Methods Adopted to Assure Secrecy.—Much of the op-

[9] New York Stock Exchange Bulletin, Feb., 1934, p. 18.
[10] Streit, *op. cit.*, p. 11.

position to the establishment of the New York Stock Exchange Clearing House was based on the supposition that the clearing sheets would disclose the business secrets of brokers to the clerks operating the system. This fear, however, has proved to be unfounded. Not only does the Clearing House strictly safeguard all transactions cleared, return all sheets and tickets delivered to it, and decline to keep records of its own, but its machinery for clearing is so devised and operates with such speed that no opportunity is afforded for the acquisition of business secrets.

Perhaps the most effective means of concealing the actions of a broker consists of the arrangement whereby all loans of stock are entered on the clearing sheet. Thus, let us assume that our firm "X", in addition to the business referred to on page 247, had borrowed from broker "R" 100 shares of Pennsylvania and loaned to broker "S" 100 shares of U. S. Steel common. On the clearing sheet the 100 Pennsylvania would appear on the debit side with the purchases and would be included in the balance to receive, thereby increasing that amount to 200 shares. As shown in Chapter XII on The Short Sale, borrowing of stock corresponds exactly to a purchase as regards delivery of the shares and the payment therefor. Lending of stock, on the other hand, corresponds in form to a sale, and the 100 shares of U. S. Steel common lent to "S" would therefore appear as a sale on the credit side of the sheet and would increase the balance of U. S. Steel common to 200 shares. Employees of the Clearing House have no way of knowing whether a broker is buying or borrowing, or selling or lending stocks; and stocks that seem to have been purchased may actually be borrowed to fulfill delivery on a short sale. They are unable to tell the position of "X", for although 800 shares of Pennsylvania would be entered on the sheet as purchased, part or all of this amount may have been borrowed. It is equally impossible to tell whether "X" bought or borrowed 500 shares of U. S. Steel common, or sold or loaned 700. Large operators,

also, usually conduct their deals through several and sometimes many brokers, with a view to concealing their position in the market.

Again, each firm is given a number that appears on all the forms sent to the Clearing House, and the procedure of clearing is based largely on the use of these numbers. While the clerks may know many of these numbers, it is impossible to remember all. The work is spread over so many employees that each handles only a small part of the total. Such haste is also required in the process of clearing that little opportunity is given to trace out the position of any one broker's transactions. Furthermore employees of the Stock Clearing Corporation are carefully selected, are under bond, and are thoroughly impressed with the confidential nature of the work of the Stock Clearing Corporation. Since the inception of the Clearing House, there has never been a known leak of any confidential information.

New York Stock Exchange Clearing System Contrasted with Other Systems.—Nowhere in Europe does the American system of clearing brokers' accounts both for securities and for money seem to exist. Instead, the work of European stock clearing houses consists only in the comparison of contracts between brokers who have bought and sold securities, and thus resembles the "ringing out" method prevailing on American commodity exchanges.

Stock exchange accounts in Europe are generally settled on the fortnightly plan, that is, as in London, about every two weeks at the middle and end of each month. The scope of the clearing is therefore very broad, because in the course of two weeks brokers naturally enter into many contracts to buy and sell the same security, and at the settlement time it will be found possible to eliminate a very large proportion of the total deliveries otherwise necessary. As is the case in New York, an arbitrary and uniform settlement price is adopted for the settlement of all accounts, but the clearing of all money exchanges

takes place outside of the clearing house. The following is a brief explanation of the London fortnightly system. Each settlement extends over three days, and at a cetain hour on the first day all old accounts end and business subsequently transacted falls within the new fortnightly account. Three distinct operations comprise each settlement as regards most classes of securities, and a separate day is devoted to each operation.

On the first day—called "Contango day" or "making-up day"—arrangements are made for the carrying over of stocks to the following account by operators who either are not prepared to pay for stock they purchased or to deliver stock that they sold. This day is, therefore, of importance only as far as speculative accounts are concerned.

On the next day—called "ticket-day" or "name-day"—brokers who have bought stock and wish to take it up hand tickets, each of which bears the amount and name of the security, the name and address of the buying broker's client, the price, and the date and name of the member to whom the ticket is issued, to the jobbers from whom they bought the stock. If these jobbers are not in possession of the securities, having bought them during the same account from some other jobber, they pass them on to the seller after endorsing the seller's name. In this way the ticket passes from seller to seller until it reaches the firm that actually has the securities and intends to deliver them. The passing of these tickets, as explained by Duguid, is greatly facilitated by the Settlement Department of the clearing house. He states: [11]

"It is not every member of the Stock Exchange who belongs to the clearing house, nor is it every security that enjoys the benefit of its operations. But in cases where it can be used, this is the process. On Contango day each member prepared a "clearing sheet" for each security in which he has dealt. This sheet may, of course, show many sales and many purchases, each to or from a different member, but all that the member who has prepared the sheet has

[11] Duguid, Charles, *The London Stock Exchange*, Chapter VII.

to concern himself about—in so far as the securities are concerned, and it should be noted that the clearing house only clears securities, not money—is the delivery or receipt of the differences between his sales and his purchases; the clearing house does the rest. If, for instance, a member's sheet shows that he has bought a total of 6,000 of a certain stock, no matter in how many different bargains with different members, and has sold 5,000; then, instead of a separate ticket having to pass through his hands for each separate bargain, the clearing house discovers from the other sheets some member who has sold 1,000 more than he has bought of the particular stock in question. The passing of the stock is then adjusted by bringing these two members together. The way in which all bargains which come within the clearing house are cleared off can be easily grasped when it is recognized that for every bargain there are both a buyer and a seller. But the clearing house has nothing to do with the adjustment of the different prices at which securities are bought and sold. In fact, all bargains dealt with by the clearing house are passed through the accounts at a fixed price, the 'making-up price,' and the securities have to be paid for at that price. The settlement of differences has to be arranged in the accounts between member and member, and this brings us to the business of the last day of the settlement, 'pay-day,' the real day of settlement."

On the third or last day referred to by Duguid—called "pay-day" or "account day"—all differences must be paid, and all securities to be delivered must be handed over and paid for, although extra time is given for the delivery of registered securities. All differences must be paid by check on some bank holding membership in the bankers' clearing house. "By this rule," Duguid explains, "it is secured that every member has both to pay and receive differences at the same time, and the differences which a member receives are directly pledged, as it were, for payment of those he has to give."

Much has been written by way of a comparison of the relative advantages of the European fortnightly settlement with the American daily settlement. Such a comparison is difficult and probably unfair because of the totally different conditions

underlying the organization and nature of the two markets. The American system, by calling for a reckoning each day as contrasted with the postponement of settlement for two weeks under the fortnightly system, serves as a precautionary restriction upon brokers against over-speculation. On the other hand, it is argued that the daily settlement system is not at all adapted to the needs of the London Stock Exchange, with its system of brokers and jobbers, with its enormous international business in securities, and with its members in the habit of doing business on a credit and not a cash basis.

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CHAPTER XV

TRANSFER OF SECURITIES

Responsibility of Corporation in the Transfer of Securities.—Originally the transfer of stock was a simple matter.[1] When a stockholder desired to dispose of his interest the transfer was accomplished by having the stockholder enter, or sign an entry, on the books of the corporation showing the transfer of ownership.

Today the business of transferring stock is much more complicated. The stockholder does not make a personal visit to the corporation for the purpose of transferring his stock. Instead, he signs a written order directing the corporation to make the change. The small corporation, in many instances, employs a clerk or has its secretary supervise transfers, but the large corporation finds it necessary to employ a number of persons in its transfer department. Many corporations turn their transfer work over to banks and trust companies which maintain special departments organized for this work. These professional transfer agents, in addition to transferring stock,

[1] Technically, stock is one thing and certificates another. A stock certificate is evidence that the person named therein is owner of a certain number of shares of the capital stock of a given corporation. In modern business transactions, however, the certificate is usually recognized by most persons as the property itself, and the courts are showing a tendency to support this view. As will be noted shortly, this latter view is taken in the Uniform Stock Transfer Act, which, in effect, provides that the transferable value of the stock lies wholly in the stock certificate.

In this country stock certificates are nearly always in registered form, that is, they are issued in the name of specified persons, and ownership of the stock which they represent is transferable only upon surrender of the old certificate properly endorsed and entry of such change on the corporation's books of record.

perform other services, such as preparation of certified lists of stockholders, payment of dividends, handling of stock subscriptions, conversion of securities, and mailing of notices to stockholders.

The law imposes upon the corporation the duty of keeping the books of record and that of making transfers of stock when requests are received therefor. In making transfers the corporation must be careful to make only those which are duly authorized by the legal owner. If the company makes an unauthorized transfer, it becomes liable to an innocent holder, regardless of the care exercised by the transfer agent. Obviously, when making transfers the transfer agent is anxious to take all possible precautions to protect the corporation. But if the transfer agent refuses to transfer stock when the transfer has been properly authorized, the injured party may hold the corporation responsible for any loss incurred. Furthermore, in making a transfer, the law imposes upon the corporation the duty of protecting the rights, equitable as well as legal, of all parties concerned. Thus, if securities held in trust are to be transferred it is the duty of the corporation, before it makes the transfer, to use due care in determining whether or not the transfer will result in a breach of trust. Since it is often difficult to determine just what due care is, the corporation, in order to protect itself fully, imposes requirements which seem unreasonable to many persons.

To protect all parties concerned, and to facilitate stock transfers, numerous rules are necessary. Some of these are found in the common law, some in the statutes, and others in the rules of stock exchanges and transfer agents.[2] This chapter will state the most important of these rules and discuss their application to situations which arise most frequently in practice.

Negotiability of Stock Certificates.—Although stock

[2] See the Rules of the New York Stock Transfer Association; also the rules of the New York Stock Exchange, particularly those of the Committee on Securities.

certificates represent one of the most important forms of commercial paper, they lack nearly all the requisite elements of negotiability.[3] As stated by Dos Passos in his explanation of the doctrine of negotiability as applied to stock certificates: [4]

"Stock certificates, as we have seen, are not, technically, negotiable instruments. They are not promises to pay money, and, in a word, lack almost every element necessary to constitute negotiability. . . . The courts have everywhere with marked unanimity placed them in the category of non-negotiable instruments."

To overcome the disadvantages of non-negotiability, the courts permit stock certificates to pass freely from hand to hand, without an actual transfer in each instance, through the use of an assignment and power of attorney executed in blank and attached thereto. There is a sample assignment and power of attorney form on page 269. It should be noted that it contains three distinct features, namely, (1) the assignment; (2) the provision for the irrevocable appointment of an attorney to make the transfer; and (3) the delegation to this attorney of full powers of substitution.

The owner of the certificate may fill out all blank spaces in the assignment and power of attorney when he delivers it in fulfillment of a sale; or he may merely sign it in blank (sign his name at the bottom) at the time of delivery, thus permitting any bona fide purchaser to fill out the other spaces which

[3] According to the Negotiable Instruments Laws, an instrument, to be negotiable, must conform to the following requirements:

1. It must be in writing and signed by the maker or drawer.
2. Must contain an unconditional promise or order to pay a certain sum in money.
3. Must be payable on demand, or at a fixed or determinable future time.
4. Must be payable to order or to bearer; and,
5. Where the instrument is addressed to a drawee, he must be named, or otherwise indicated therein with reasonable certainty.

[4] Dos Passos, J. R., *Treatise on the Law of Stock Brokers and Stock Exchanges,* Vol. I, p. 700.

are provided for the names of the transferee and attorney. Most certificates are delivered in blank form because the transferor does not know who the next owner will be.

If the name of the attorney has been inserted in the assignment and power of attorney form, such attorney may, if he

Sample of Assignment and Power of Attorney

FOR VALUE RECEIVED.....hereby sell, assign and transfer unto.....

..... shares of the Capital [5] Stock represented by the within Certificate and do hereby irrevocably constitute and appoint.....

..... Attorney to transfer the said stock on the Books of the within named Company with full power of substitution in the premises.

Dated.....19

.....

In the presence of

.....

wishes to substitute another attorney, place the following power of substitution on the back of the stock certificate: [6]

I (or we) hereby irrevocably constitute and appoint.....

.....my (or our) substitute to transfer the within named Stock under the foregoing Power of Attorney, with like Power of Substitution.

Dated.....

.....

In Presence of

.....

[5] On certificates without nominal or par value the word "Capital" may be omitted.

[6] See p. 274 for an explanation of the uses of detached assignments.

Negotiability Through Equitable Doctrine of Estoppel Limited.—In the preceding paragraphs it was stated that a certificate of stock, when endorsed in blank, may be passed from one holder to another, and that any bona fide purchaser may present it to the corporation for transfer to any transferee whose name is properly inserted in the assignment blank. The courts uphold such transactions on the theory of estoppel, i.e., the owner when he assigns the certificate in blank is estopped from asserting his title against a subsequent holder for value. It should be noted, however, that the application of this doctrine gives negotiability under circumstances other than where there is an endorsement in blank for the purpose of making delivery to fulfill an agreement of sale. Thus, where a customer endorses a stock certificate in blank and deposits it with his broker as collateral to secure a margin account, he thereby confers upon the broker the indications of ownership with an apparent right to transfer title. If the broker converts the stock by selling it to an innocent purchaser for value, the latter obtains a title which the customer cannot question. Also, if the stock has been endorsed in blank and left with the broker for safekeeping and the broker appropriates it for his own use, an innocent purchaser will obtain unquestionable title.

Nor should it be assumed that under the common law an endorsement in blank overcomes all the disadvantages resulting from stock certificates being classed as non-negotiable instruments by the courts. While in most cases the courts have applied the doctrine of equitable estoppel to protect an innocent purchaser of stock endorsed in blank, the common law is not uniform on the subject. Where the principle of estoppel cannot be applied, an innocent holder for value of stock certificates endorsed in blank acquires no better title than the transferor had. In such cases, the purchaser must take the certificate subject to any claims which the corporation or third parties may have against the transferor. Thus, it has been held that where a certificate endorsed in blank has been stolen, an in-

nocent holder for value acquired no title as against the true owner. The same principle has been applied where the owner of a stock certificate endorsed in blank gave it to a messenger who was to take it to a place of deposit, and the messenger unlawfully disposed of it to an innocent purchaser. In general, under these rulings the owner can assert his title when he has been deprived of stock endorsed in blank through theft, robbery, or fraud. In all such cases, however, the thief must not have apparent authority to make the transfer. If, for example, an agent, or one who has joint possession of a certificate, makes an unauthorized transfer when it has been endorsed in blank, the owner will be estopped from asserting his title against an innocent holder for value if the agent or joint holder had authority to make such a transfer for any purpose.

The doctrine of estoppel cannot be applied to stock which has been converted or stolen if the owner has not endorsed it in blank. In such cases the owner can assert his title against an innocent purchaser for value. Thus, if an unendorsed certificate is deposited with a broker for safekeeping and the broker forges an assignment thereof, an innocent purchaser acquires no title to it as against the owner. Furthermore, the true owner may proceed against the innocent purchaser for the value of the stock.

Uniform Stock Transfer Act.—We have seen that under the common law stock certificates are not negotiable, but that due to the demands of modern business the courts have tried to diminish the harshness of the strict common law rules through the application of the doctrine of equitable estoppel. The common law, however, is far from uniform on the subject, and the degree of negotiability so attained is not satisfactory. In order to obtain uniformity in the law relating to stock transfers and to provide a greater degree of negotiability, the National Conference of Commissioners on Uniform State Laws approved in 1909 a Uniform Stock Transfer Act. Since that year twenty states and Alaska have placed this statute

on their books.[7] In drawing up the Act, the authors attempted to follow the majority rule on most points of law, since this would involve the least number of changes. However, the advantages to be gained from a greater degree of negotiability for stock certificates led the Commissioners to insert certain rules protecting an innocent holder for value more fully than was the case under the common law. Probably this is the most striking change brought about by the act.[8]

The statute, as effective in the State of New York, contains the following four sections which have an important bearing upon the subject of negotiability of stock certificates: [9]

"*Sec. 162. How title to certificates and shares may be transferred.* Title to a certificate and to shares represented thereby can be transferred only: (a) By delivery of the certificate endorsed either in blank or to a specified person by the person appearing by the certificate to be the owner of the shares represented thereby, or (b) By delivery of the certificate and a separate document containing a written assignment of the certificate or a power of attorney to sell, assign or transfer the same or the shares represented thereby, signed by the person appearing by the certificate to be the owner of the shares represented thereby. Such assignment or power of attorney may be either in blank or to a specified person.

"*Sec. 166. Who may deliver a certificate.* The delivery of a certificate to transfer title in accordance with the provisions of section one hundred and sixty-two is effectual, except as provided in section one hundred and sixty-eight, though made by one having no right of possession and having no authority from the owner of the certificate or from the person purporting to transfer the title.

"*Sec. 167. Endorsement effectual in spite of fraud, duress, mistake, revocation, death, incapacity or lack of consideration or authority.*

[7] Ark., Col., Conn., Idaho, Ill., Ind., La., Md., Mass., Mich., N. J., N. Y., Ohio, Pa., R. I., So. Dakota, Tenn., Va., W. Va., Wis., and Alaska.

[8] Ehrle, Clarence G., "The Uniform Stock Transfer Act," 5 *Marquette Law Rev.*, 91.

[9] Christy, Francis T., *The Transfer of Stock*, Baker, Voorhis & Co., 1929, p. 762. A synopsis of the New York Law is contained in Samuel P. Gilman's *Stock Exchange Law*, pp. 93–95.

The endorsement of a certificate by the person appearing by the certificate to be the owner of the shares represented thereby is effectual, except as provided in section one hundred and sixty-eight, though the endorser or transferrer: (a) was induced by fraud, duress, or mistake to make the endorsement or delivery, or (b) has revoked the delivery of the certificate, or the authority given by the endorsement or delivery of the certificate, or (c) has died or become legally incapacitated after the endorsement, whether before or after the delivery of the certificate, or (d) has received no consideration.

"*Sec. 168. Rescission of transfer.* If the endorsement or delivery of a certificate: (a) was procured by fraud or duress, or (b) was made under such mistake as to make the endorsement or delivery inequitable; or if the delivery of a certificate was made (c) without authority from the owner, or (d) after the owner's death or legal incapacity, the possession of the certificate may be reclaimed and the transfer thereof rescinded, unless: (1) The certificate has been transferred to a purchaser for value in good faith without notice of any facts making the transfer wrongful, or (2) The injured person has elected to waive the injury, or has been guilty of laches in endeavoring to enforce his rights.

"Any court of appropriate jurisdiction may enforce specifically such right to reclaim the possession of the certificate or to rescind the transfer thereof, and, pending litigation, may enjoin further transfer of the certificate or impound it."

Under the common law the bona fide purchaser, in the absence of estoppel, acquires no better title to stock certificates which have been endorsed in blank, than the transferor had. Under the statute provisions quoted above, the stock certificate, when endorsed in blank, becomes endowed with all the qualities essential to a negotiable instrument, and an innocent purchaser thereof is protected in the same manner as a like holder of any negotiable instrument. This holds true, moreover, where the transfer has been caused by fraud, duress, mistake and similar circumstances, which at common law might prevent the holder from obtaining good title.

The true owner is protected, however, if the assignment is

forged, or if it is not legally sufficient, even though the purchaser bought it in good faith. The reason here is that the corporation cannot make a transfer, except upon authorization of the owner; and since the owner did not make an assignment, his title to the stock is not affected.

A transfer of the stock of any corporation becomes subject to the Uniform Stock Transfer Act when the Act is a law in the state where the corporation is domiciled.[10]

Use of Detached Assignments.—Assignment of a stock certificate upon its reverse side is not obligatory in order to make the certificate a good delivery. Instead, a detached assignment, more commonly known as a "stock power" or "fly power," may be used, if it is properly filled out and accompanies the certificate. Such an assignment is identical with the one found on the reverse side of a stock certificate, except that, since it is a separate paper, it must include an exact description of the stock certificate to which it refers.[11]

Under various circumstances the use of a detached assignment is preferable to the signing of the stock power on the reverse side of the certificate itself. Thus, when sending stock certificates through the mail uninsured, it is highly important that the same be not assigned in order to avoid loss through possible wrongful conversion. Yet the holder of the certificate may wish the addressee to receive it in deliverable form. This can be accomplished by sending the unsigned certificate in one enclosure, and a properly executed detached assignment, explicitly describing the particular stock, in another. Upon receipt of both enclosures, the addressee will be in a position to transfer the security or to deposit it as collateral for a loan. Should one of the enclosures be lost, however, no particular harm would result since the detached assignment is valueless

[10] Christy, Francis T., *op. cit.*, p. 118.

[11] Rules 4 and 5 of the *Committee on Securities,* New York Stock Exchange, require that a separate assignment be provided for each certificate, so that the buying broker can sell any portion of the block without having the stock transferred.

without the certificate to which it refers. Similarly, the stock certificate is unavailable for wrongful use since it is not signed.

Detached assignments are also used generally when stock certificates are deposited as collateral. Upon repayment of the loan, the lender will return to the borrower both the certificate and its accompanying detached assignment, which latter paper may then be destroyed. The borrower thus has succeeded in giving the lender full control over the certificate during the life of the loan through an actual assignment, and upon repayment has had his certificate returned to him in unsigned form. Needless to say, owners of stock should never expose themselves to the danger connected with the assignment of stock certificates before they are actually ready to part with the title thereto. Accordingly, whenever depositing a stock certificate as collateral, or when leaving it for sale at some fixed price, a detached assignment should be used. The loan will be repaid and the collateral returned, while the contemplated sale of the certificate may never be effected. By destroying the detached assignment, the owner will always have a "clean" certificate, irrespective of the number of times it may have been deposited as collateral or left with the broker for sale. On the contrary, if the reverse of the certificate is once signed, the owner will remain exposed to the danger connected with possible loss of the certificate and wrongful use thereof by an unscrupulous finder.

Stock Exchange Rules Designed to Secure Uniformity and to Eliminate Unnecessary Risk.—To secure uniformity of action and to eliminate unnecessary risk, the form of stock certificates as well as the assignment and transfer of them are governed largely by the rules of the various exchanges as far as listed securities are concerned. These rules were referred to in Chapter IX on the Listing of Securities,[12] but the following requirements of the New York Stock Exchange may again be summarized briefly at this point.

[12] See pp. 156–63.

1. Corporations whose shares are admitted to dealings are required by the New York Stock Exchange to maintain a transfer agency and a registry office in the City of New York, Borough of Manhattan, and both the transfer agent and the registrar must be acceptable to the Committee on Stock-List. The registrar [13] must file with the Secretary of the Exchange an agreement to comply with its requirements in regard to registration, and it is further provided that a trust company or individual may not act at the same time as both transfer agent and registrar of a corporation. Nor may a company act as a registrar of its own stock. If the stock of a corporation is to be transferred at its own office, a transfer agent must be appointed by specific authority of the Board of Directors to countersign certificates in said capacity, which individual must be someone other than an officer of the corporation authorized to sign certificates of stock.

2. The entire amount of capital stock of any corporation listed upon the Exchange must be directly transferable at the transfer office in New York, and, if transfers are made in other cities, the certificates issued in such cities must be interchangeable and identical in form and color with the New York certificates, except as to names of transfer agent and registrar.[14] No change in the form of the certificate, the transfer agent, or the registrar can be made without the approval of the Committee on Stock-List.

3. The exact form as well as the manner of making the

[13] The registrar is usually a bank or trust company appointed by a corporation to keep a record of its stock and to certify that the name on the certificate is that of the owner of record. In other words, the registrar acts as a check on the transfer agent, and certifies when a new certificate is issued that the old certificate has been canceled, thus avoiding the possibility of an over issue or duplication of stock.

[14] Out of a total of 1,307 listed issues on the Exchange on Dec. 15, 1930, 486 issues, or 34.2% were transferable in one or more American cities besides New York; 20 issues, or 1.5% were transferable abroad; and 21 issues, or 1.6% were transferable in other American cities and abroad as well. See the *New York Stock Exchange Bulletin,* July, 1931, p. 1.

certificate, is prescribed by the Exchange with a view to giving the greatest possible security against counterfeiting in any manner whatsoever. Various rules also provide that the different classes of securities must contain features that will enable one security or denomination to be readily distinguished from another. Thus, in the case of bonds, the imprint of each denomination must be of such distinctive appearance and color as will make it readily distinguishable from other denominations. For each class of stock issued there must be a distinctively engraved plate for 100-share denominations, and certificates issued for smaller amounts must have a plate distinctive in color and design, must bear the words, "Certificate for less than one hundred shares," and also must bear some engraved device whereby the exact denomination of the certificate can be distinctly designated by perforation. Important conditions such as those relating to a redemption by sinking fund or otherwise, and of conversion into other forms of securities, must be shown in the text of the bond; and in the case of stock, important provisions such as those relating to preferences or privileges, if any, must be stated. A sample certificate of each issue of bonds or stock must be referred to the Committee on Stock-List for acceptance as to form, character, and recommendations. Furthermore, no stock certificate or bond will be approved by the Exchange unless engraved by some company whose work the Committee has authorized.

4. The receiver of the shares, the purchaser, is given the option of requiring delivery to be made either in (a) certificate therefor, or (b) by transfer thereof. In case, however, personal liability attaches to ownership, the seller is given the right to deliver by transfer. When the transfer books are closed, the buyer, according to the rules, cannot require delivery by transfer.[15]

5. The blank form of assignment and power of attorney is prescribed by the Exchange, and in order for a certificate to

[15] *Rules of the New York Stock Exchange*, Chapter III, Section 2.

constitute a good delivery the form and manner of filling it out must meet the requirements of the Exchange in every respect.

Other Rules of Exchanges and Transfer Agents Relating to Assignment and Transfer of Stock.[16]—The requirements that transfer offices insist upon, preliminary to transferring title to stock certificates, differ materially with different corporations. But whatever the requirements may be, transfer agents are obliged to act with such care that the regulations of corporations are often regarded as unnecessarily technical. The extreme care exercised is due to the liability that may fall upon the corporation if it does not fully satisfy itself as to the genuineness of the certificate and the power to transfer. In transferring securities the corporation acts on its own responsibility. It assumes the risk of being misled by forgery or fraud and cannot claim, as against the rights of the true owner of the stock, that it has acted with due care and in good faith upon what it considered to be genuine authority. It is for this reason, as will be pointed out later, that corporations find very valuable the practice of having brokers guarantee signatures to assignments and powers of attorney.

One very important requirement which must be met in order to make a stock good delivery is that the endorsement or signature on the assignment must be in strict accordance with the face of the certificate, that is, if the stock stands in the name of "John Henry Smith," it must be assigned by John Henry Smith, and all abbreviations, alterations, and enlargements must be avoided. Irregularities, resulting from a failure to comply with this rule may result in the necessity of having the stock transferred into deliverable form.[17] The same situa-

[16] For a complete list see the rules of the *New York Stock Transfer Association,* and those of the *Committee on Securities* of the New York Stock Exchange.

[17] Rule 8 of the *Committee on Securities* of the New York Stock Exchange reads: "The signature to an assignment or power of substitution must be technically correct, i.e., it must correspond with the name as

tion is occasioned also if clients, in sending stock to their broker, should assign it to him, instead of only filling in the broker's name as attorney, and leaving the assignee's name space blank. Should the broker have the stock assigned to him by his client, he can put the stock into deliverable form only by first transferring it to his own name.

Various other rules deserve special mention because of their frequent application. The rules of the New York Stock Exchange provide that if a married woman assigns a stock certificate, it is a good delivery only when the transfer books are closed and a joint acknowledgment of an executed assignment has been made by the husband and wife before a notary public. An acknowledgment of an assignment before a notary public is also required in the case of stock standing in the name of an unmarried woman without the prefix "Miss," or in the name of a widow. Such a notarial acknowledgment, however, is not required when stock stands in the name of an unmarried woman with the prefix "Miss," and when signed "Miss." [18] In view of the risk which the members of the Exchange assume in the guaranty of signatures of assignors, and to insure the purchaser a good title, rules of this kind are considered necessary. There are still quite a few states in which the disabilities of married women to transfer title to securities have not been entirely removed.[19] Also, frequently there are cases where stock

written upon the certificate in every particular without alteration or enlargement, or any change whatever, except that 'and' or '&', 'Company' or 'Co.,' may be written either way." According to the listing rules of the Exchange a similar requirement must be printed on the back of stock certificates in connection with the assignment and power of attorney form. This requirement, however, is sometimes waived by New York transfer agents upon receipt of a guaranty to the effect that the endorser is the owner named in the certificate.

[18] Rules 10, 11, and 12, *Committee on Securities*, New York Stock Exchange.

[19] As a result of an investigation in 1925 the New York Stock Exchange found that there were 16 states which had not, by statute, removed all the disabilities of married women to transfer title to securities. See the

is registered in the name of a married woman who lives abroad, and in these cases the foreign law must be taken into account. It is not practical for exchange members to investigate the place of residence of each registered holder of stock before guaranteeing the signature, and even if it were, the place of legal residence is often difficult to determine.

The law governing the assignment and transfer of stock certificates by trustees, executors and administrators differs greatly in the various states.[20] For this reason the rules of the New York Stock Exchange provide that a certificate with an assignment or a power of substitution executed by a trustee or trustees, an executor, or an administrator, is not a good delivery.[21] When the stock stands in the name of a trustee the most important document required by the transfer agent, in addition to the assignment, is an original or certified copy of the instrument under which the trustee is acting. Where stock certificates standing in the name of a deceased person or his estate are presented for transfer, the transfer agent will usually require one or more of the following documents: (1) an assignment executed by the administrator or executor; (2) proof of the appointment of the administrator or executor, of a reasonably recent date; (3) a copy of the will, if the decedent died testate, certified to by a clerk or judge of the probate court; (4) a certified copy of a court order authorizing the transfer if a state statute makes this necessary; [22] (5) evidence of compliance with other statutes such as those requiring proof

Report of the President of the Exchange for the year ending May 1, 1926, p. 20.

[20] Transfers of this type are extremely complicated. For a full discussion of the subject, particularly with reference to individual state requirements, see Christy, Francis T., *op. cit.*, Chapters IX and XI.

[21] Rule 16, *Committee on Securities*. A certificate assigned by trustees acting in the capacity of a board of directors of a corporation or association is a good delivery under this rule.

[22] In some states statutes have been passed which take away the common law rights of the administrator or executor to sell securities at private sale without the supervision of the probate court.

that all creditors have been paid. Usually the corporation will not transfer stock to a trustee, executor, or administrator, individually, unless the will or trust agreement specifies that the stocks are to be held in the individual's name; or unless the transfer is made to carry out a proper distribution under the will or trust deed; or, unless it is a purchase from the estate for cash for the full market value. In any such case, in order that the corporation will not be held liable for an illegal transfer, the transfer agent will require proper proof that the transfer should be made.

In the case of stocks standing in the name of corporations or institutions, the New York Stock Exchange and the transfer agents require that a number of documents accompany the application for transfer. The assignment must be executed by a duly authorized official of such corporation or institution and must be accompanied by certain evidence of the authority of such official to make the assignment. This evidence may consist of an abstract from the minutes of a meeting of the board of directors or trustees setting forth that at a specified meeting the board, which has full power to sell or direct the transfer of any shares of the stock owned by the corporation, has by a special resolution designated a particular person to make the transfer. A copy of the special resolution should be attached to the stock certificate. If the resolution is a general one for use at any time, certification must be made by the secretary of the corporation to the effect that the resolution is in force at the time of making the transfer. Similarly, if the transfer of securities is authorized by a by-law, the secretary must furnish a copy properly attested as being in force at the time of the desired transfer, and also a statement showing that the endorser of the certificate is the person authorized by the by-law to make such transfers.

Guaranty of Signatures by Brokers.—In view of the great care that corporations must exercise in the transferring of stock, both the corporation and the investing public have

been relieved of much inconvenience by the practice of having brokers guarantee the execution of assignments on securities. The rules of the New York Stock Exchange provide that "an endorsement by a member or his firm of (or the signature as a witness by such a member of a signature to) an assignment or a power of substitution is a guarantee of its correctness." [23] The courts have interpreted the guaranty of signatures in such a way that the broker who guarantees a signature really assumes responsibility for both the genuineness of the signature and certificate, and also for the legal authority and capacity of the individual whose name is guaranteed.[24] The broker's responsibility in connection with such guarantees is therefore extremely great. Hence, where securities are sent to brokers, it is important that the representative shipping them should place his signature upon the assignment as a second witness unless it already appears as the original witness. If the representative is not certain of the genuineness of the signature, the assignment should be acknowledged before a notary public or guaranteed by some prominent financial institution.

To make sure that the signatures of guarantors are genuine, transfer agents in New York City usually keep on hand for comparison, signatures of all persons who have been authorized to guarantee signatures by firms connected with the New York Stock Exchange or the New York Curb Market. No guaranty is necessary where a certificate is being assigned by a firm, or bank or trust company, if the signature of the assignor is acceptable as a guaranty.

Methods of Effecting Transfer of Stock by Corporations.—When a stock certificate together with a proper assignment is presented to the corporation or its transfer agent, the blank space provided for the attorney's name is not filled in. The transfer agent fills in his own name as attorney, thereby

[23] Rule 21, *Committee on Securities.*

[24] Jennie Clarkson Home *v.* M.K. & T. Ry. Co., 182 *N.Y.* 45; 74 N.E. 571; 70 L.R.A. 787.

authorizing himself to make the transfer for the stockholder who does not wish to appear in person. If a name has already been inserted in the power of attorney form when the transfer agent receives it, the person who has been appointed attorney will be requested to fill out a power in substitution, either in blank or naming the transfer agent attorney.

Various methods are used by corporations in making the transfer on their books of record. In the case of small corporations, the certificates are kept in the custody of some designated official, either in a volume with a stub for each certificate, or are held detached from the stub. Upon the issuance of the new certificate, the stub is filled out, and this together with the old certificate constitutes the record and becomes the evidence of the transfer. Sometimes the corporation keeps an additional record in the form of a stock ledger. The larger corporations and corporation transfer agents do not use the stubs ordinarily, but enter the transfers on journal sheets and later post the ledger therefrom. The journal is usually a loose-leaf book, each leaf containing columns indicating the name of the stockholder, the signature of the attorney, the number of the certificate surrendered, the number of shares surrendered, the name and address of the transferee, and the number of the new certificate issued. The stock ledger shows at any time the total number of shares belonging to any particular owner, the person transferring stock being debited with the stock transferred and the transferee being credited.[25] The new certificate, together with the old canceled one, is sent to the registrar for his signature. After noting the cancellation of the old certificate, the registrar countersigns the new one, and both are then returned to the transfer agent. The new certificate is then presented to the transferee or to the person who is entitled to receive it.[26]

[25] Three kinds of ledgers are used: the bound ledger, the loose-leaf ledger and a ledger composed of separate cards for each stockholder. The last type of ledger is generally used by the largest corporations.

[26] Transfer agents in New York City receive so many applications for transfers that they find it impossible to examine all and give formal re-

Replacement of New for Lost, Stolen, and Destroyed Certificates.—Under the common law, and now by statute in most states, the owner of stock certificates which have been lost, stolen or destroyed, may take action to compel the corporation to issue duplicate certificates. It has been the custom, however, for corporations to issue new certificates in such cases, without requiring the owner to resort to his rights under the law. The requirements set forth by the corporation are usually similar to those contained in statutes governing the subject. Before a new certificate will be issued to the loser, a proof of loss and a corporate indemnity bond are required by the corporation or its transfer agent. New York transfer agents make it a practice to require the bond to be at least double the par or market value of the stock, whichever may be higher at the time, in order to be sure that it will cover costs and any future appreciation. If the stock fluctuates greatly, the amount of the bond may be higher. This surety bond, the cost of which varies with the conditions surrounding the loss, is a protection to the corporation against the future appearance and wrongful conversion of the lost certificate. Advertisement of the loss of the shares must also be made in accordance with the demands of the corporation—usually once a week for four weeks—in some designated newspaper. Proof of such advertisement must be furnished to some designated authority of the corporation.

Transfer of Securities Other Than Stock Certificates.—In general, the principles which govern the transfer of stocks apply to registered bonds, receiver's certificates, voting trust certificates and certificates of deposit. The owners of these securities have their title registered, and the securities which represent such ownership, may be transferred upon application

ceipts. The practice is to take the stock in "over the window" and to give the persons presenting the certificates a "window ticket" which contains nothing more than the name of the stock and a number. A similar slip is attached to the certificate. When the new certificate is made out it is presented to the person holding the "window ticket," who is required to sign it when he turns it in for the new certificate.

to the proper authority. In the case of a registered bond, the trustee has the duties of the registrar, and the trust indenture under which the bonds are issued will specify the method of transfer. Receiver's certificates have to be signed by a registrar designated by the receiver. Voting trust certificates are usually transferred by a bank or trust company which receives its appointment as agent either under the terms of the trust agreement or by a decision of the trustees. Certificates of deposit are transferred generally by the depositary, who is appointed transfer agent by the deposit agreement, or by the committee acting under the deposit agreement, or by the corporation whose securities are being deposited.[27]

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[27] Christy, Francis T., *op. cit.,* Chapter XXV.

CHAPTER XVI

CONVERTIBLE SECURITIES

Definition and Extent.—Convertible securities, commonly called "convertibles," are those which, under certain conditions, are exchangeable for some other type of security. In almost all cases the option regarding conversion rests with the owner of the convertible security. Usually both the convertible security and the one obtainable in exchange are issues of the same corporation. At times, however, the security offered in exchange is an issue of another company closely allied to the corporation issuing the convertible. For example, the Midvale Steel and Ordnance Company 5's, due March 1, 1936, are convertible into 5 shares of Bethlehem Steel Corporation common stock for each $1,000 bond.

It has been estimated that $4,000,000,000 worth of convertible securities were placed on the market in 1927, 1928, and 1929.[1] The following figures, compiled from Moody's Investment Manuals, show the number of convertible issues outstanding in 1933, classified into industrial, public utility, and railroad groups:

	Industrials	Pub. Utilities	Railroads	Total
Conv. Stock Issues	489	61	18	568
Conv. Bond Issues	263	114	27	404
	752	175	45	972

[1] Weinstein, Meyer H., *Arbitrage in Securities*, Harper & Brothers, New York, N. Y., 1931, p. 85.

The most common types of convertible securities are bonds convertible into either preferred or common stock, and first preferred stocks convertible into either second preferred or common stock. Frequently the convertible issue must be exchanged for two kinds of securities. Thus, each $1,000 par value of Alleghany Corporation's Collateral Trust 5's, due February 1, 1944, is convertible into 7 shares of cumulative 5½% preferred "A" stock (ex-warrants) and 10 shares of common stock, to and including February 1, 1944. Less frequently bonds are convertible into other bonds. The Paris-Orleans Railroad Company 6's, due December 1, 1956, are convertible into consolidated 6% bonds of equal amount, and Hackensack Water Company secured 5% notes, due 1938, are convertible until July 1, 1936, in a like amount of General and Refunding "B" 5½'s, due in 1977. Short term notes containing the convertible privilege usually permit conversion into preferred or common stock. For instance, American Rolling Mill 5% notes, due November 1, 1938, are convertible into 40 shares of common stock for each $1,000 note. A few stock issues have contained a privilege permitting the holder to convert into a preferred stock or a bond, but in such cases the corporation has retained the option regarding the conversion.[2]

As of a recent date, 246 convertible bond issues, with their convertible features in operation, were important enough to be listed and rated by a prominent investment service.[3] Par values of these issues approximated one billion dollars. One hundred and seventy-one of these bond issues were convertible into common stocks, 55 were convertible into preferred stocks, 10 were

[2] The Knoxville Gas Company has 6% cumulative preferred stock which is convertible into bonds at the company's option. Another unusual convertible condition was contained in the debenture 8's of the Mount Royal Hotel Company, dated December 1, 1920, and due July 1, 1923. These bonds were convertible at the option of the company into its preferred stock. Shortly after the bonds were issued the company exercised its option in order to avoid a default.

[3] Standard Statistics Company's *Standard Bond Investments*, General Section, October 14, 1933. The list does not include government bonds.

convertible into both preferred and common stocks, 8 were convertible into other bonds, and 2 were convertible into either preferred or common stocks, at the option of the bondholder. Classified from the standpoint of type of issuing company, 19 were railroad bonds (9 of which were Boston and Maine Railroad issues), 89 were public utilities, 136 were industrial bonds, and 2 were foreign municipal bonds. Classified according to the security underlying the convertible, there were 68 debentures, 20 first mortgages, 19 notes, and the remainder consisted of general mortgages, serial bonds, collateral trust bonds, etc.

The number of preferred stocks with the convertible feature, as indicated above, is somewhat larger than that given for bonds. The following are some prominent preferred stocks with convertible features which are in force at the present time. Hershey Chocolate Corporation $4 cumulative no-par preferred, not callable, and convertible into 1 share of common for each share of preferred; New York, New Haven and Hartford Railroad 7% cumulative preferred, callable at 115, and convertible into 1 share of common for each share of preferred; Grand Union Company $3 cumulative no-par preferred, callable at 60, and convertible into 1½ shares of common for each share of preferred; United Light and Power Company $6 cumulative class "A" no-par preferred, callable at 105, and convertible until July 1, 1934, into 2 shares of class "A" common for each share of preferred; Hudson and Manhattan Railroad 5% non-cumulative preferred, non-callable, and convertible at par into common stock at $110 per share; Wesson Oil and Snowdrift Company, Inc., $4 cumulative no-par preferred, callable at 85, and convertible into 1 share of common for each share of preferred; Gillette Safety Razor Company $5 cumulative no-par preferred, callable after November 1, 1935, at 105, and convertible into 1 share of common for each share of preferred.

After the World War, and particularly during the bull market ending in 1929, corporations raised much capital by issuing

bonds and preferred stock with warrants attached.[4] The securities thus issued are not convertible, but the warrant entitles the holder to purchase some other security, usually common stock, at a definite price during a definite or indefinite period of time. The warrant thus enables the holder to participate in the future prosperity of the company. At the present time there are on the market at least 141 issues of bonds with warrants attached.[5]

Conditions Prompting the Issuance of Convertibles. —Various conditions may exist that will make the issuance of convertible bonds attractive. The inclusion of the convertible privilege makes the security speculatively attractive and enables the issuing corporation to raise its capital on better terms than it could without the use of such a privilege. In other words the purchaser of the convertible, because of the chance to participate in future earnings, will buy at a little higher price, or will accept a smaller return on his investment, or will require less protection for his principal, than he would if the convertible feature were omitted.

In the issuance of convertibles, however, some companies have in mind principally the reduction of their fixed interest charges, which will ultimately take place through the conversion of bonds into stock. Other managements, when issuing such securities, are actuated chiefly by a desire to retain control of the company at a time when they are unable or not disposed to purchase enough of any new stock issue to maintain such control. The sale of convertible bonds represents the possible issuance of future stock but the voting power does not accrue until after conversion takes place, and by the terms of the convertible feature the right to demand the stock can be postponed until some future date. An increased issue of stock to raise needed funds, on the other hand, might endanger the

[4] Moody's Manuals for 1933 contain 302 securities with unmatured stock purchase warrants, of which 209 are industrials, 89 utilities and 4 railroads.

[5] Bonds with warrants to the extent of this number were included in the Standard Statistics rating list, previously referred to.

control of the corporation by the existing management. Again, a corporation may not care to work a hardship upon its stockholders by unduly depressing the price of their shares through the issuance of a large additional amount of stock. Instead the company might find it possible, not only to defer the issuance of stock by the sale of convertible bonds, but, also, to issue bonds at a rate of interest lower than the current stock dividend. By this means the company effects a saving, and in addition, avoids depressing the market price with an immediate issue of a large amount of stock.

Market conditions may be such that the corporation cannot raise the desired capital through the sale of stocks. In order to raise the capital bonds are issued, but the convertible feature may be included to bring about a future reduction in the total amount of bonded indebtedness, particularly when the ratio of bonds to stock is already too high. Or, if interest rates at the time of issuance are considered to be too high, short term notes may be issued, convertible into long term bonds after some future date.

The convertible feature is commonly placed in preferred stocks of industrial corporations to enable the corporation more readily to market the issue. If profit possibilities are great, the inclusion of such a feature often makes an ordinary preferred stock an exceedingly attractive security. The convertible feature, also, is sometimes used in preferred stocks when a reorganization is being effected. In order to help compensate holders of bonds who are receiving preferred stock in exchange, a convertible privilege is sometimes included in the latter giving the holder the right to convert it into common stock.

Conditions Governing the Conversion Privilege.— Our limited space forbids an explanation of the numerous conditions governing the conversion privilege that are disclosed by an examination of the many outstanding issues of convertibles. Not only has the conversion privilege been extended to practically all kinds of securities, but the conditions under

which the privilege can be exercised present the greatest possible variety, there being few issues of the many in existence that are just alike in this respect. Suffice it to say that such securities, particularly in the case of bonds, usually stipulate the following with respect to the conversion privilege:

1. A statement as to the number of shares to be obtained or the price at which the issue may be converted; and, where the issue converts on a basis that leaves fractional shares, an agreement as to the method of adjusting such fractions.

2. A statement as to the time when conversion may be effected. Frequently the privilege begins with the issuance and extends throughout the life of the convertible. At other times it does not become operative until some future date, and in still other instances may exist for only a limited period.

3. A statement to the effect that at the time of conversion the company will allow accrued interest to the holder of the bond and charge him with the accrued dividend at the current rate on the stock into which the bond is converted, the difference, if any, to be paid in cash by one party or the other. Usually interest and dividend-paying dates are made to coincide. Sometimes, however, corporations differ with respect to the fixing of the time from which the accrued dividend is computed, some fixing this time from the date of the last payment, others from the date when the dividend was last declared, etc.

4. A statement reserving to the corporation the right to call the convertible for redemption prior to maturity. This redemption feature is frequently of the greatest importance, since redemption of the convertible securities by the company may deprive the holder of a valuable conversion privilege. But, as a rule, conversion may be effected up to or within a stipulated number of days prior to the date named for payment, in case the company exercises the right of redemption.

Basis of Conversion or Parity Price.—The price conditions regulating the exchange of the convertible are probably more misunderstood than any of the other features mentioned

above. There are two common methods of expressing the price conditions in the convertible security. Under one method it is stipulated that a certain amount of the par value of the convertible will be exchangeable for a certain amount (usually 1 share) of the new security to be received. The amount of the par of the convertible which is necessary to obtain 1 share of the new security is called the parity price. Thus, Chicago, Rock Island and Pacific Railway 30-year 4½'s, due May 1, 1960, are convertible into common stock at 125 to and including May 1, 1940. The parity price in this case is 125, since one share of common stock will be given for each $125 of par value of convertible bonds turned in. The provisions regulating the exchange may specify that the exchange is to be made on a par for par basis, in which case, for example, a $1,000 par value bond is exchangeable for 10 shares of stock with a par value of $100 for each share. Or the parity price may be under 100. If it is set at 50, the holder of the convertible bond will obtain, say, two shares of stock with a $100 par for each $100 par of bonds turned in. Sometimes the conditions may be more complex, as for example, the permission to convert at 75 into stock at 150. Under these conditions, the bonds are worth 75 cents on each dollar of par in payment for stock at a price of $150 per share. Parity price is often called the conversion ratio, since it is the ratio at which one security is convertible into another.[6] In the example last cited the ratio could be expressed in a more convenient form by stating that the bonds are convertible at par into the stock at $200 per share.

Another common method of specifying the basis of conversion is to state that each bond is convertible into so many shares of stock. Thus, each $1,000 bond of the convertible 6's of the Parmalee Transportation Company, due April 1, 1944, is con-

[6] Some persons use "conversion ratio" in this connection and use "parity price" to mean the market price at which the security to be obtained in exchange should be selling when the convertible is quoted at a given figure.

vertible into 33⅓ shares of common stock. The parity price in this instance is 30.

Where one bond is convertible into another the basis for the exchange may be even, or a cash adjustment may be required to compensate one of the parties for a different type of bond issued in the exchange. A $1,000 refunding 6½% bond of the California-Power Company, due May 1, 1942, is exchangeable into an equal amount of refunding 6's, due 1962, plus $50 in cash. The parity price here is really 95, since the holder of the convertible bond obtains in exchange a bond with a $1,000 par value and $50 in cash.

Adjustment of Fractional Shares Where Issues Do Not Convert Evenly.—When conversion is actually effected, some inconvenience may be experienced in cases where the issue converts on a basis that necessitates an adjustment of fractional shares. The difficulties encountered will depend upon which of four possible plans the company may have adopted for such adjustment. Assuming a $1,000 bond exchangeable for stock at 130, the holder, upon effecting conversion, is entitled to 7.6923 shares. While the corporation will deliver the seven full shares, some adjustment must be made of the fractional share of .6923.

The plan most commonly used is the issuance of a warrant which entitles the holder to a fraction of a share. This warrant may be sold, or enough additional warrants may be bought, which, together with the one held, can be presented to the corporation for a full share of stock. Sometimes the company offers to pay cash for the fraction. Or, instead of paying cash, the corporation may issue convertible bond "scrip" for the fraction, which, when presented in amounts equal to the conversion price of full shares, can be exchanged for the stock. As in the warrant plan mentioned above, the holder is obliged either to sell the scrip or to buy an additional amount so that the total may equal the amount necessary to obtain a full share.

Usually the warrant and the scrip is non-dividend and non-interest bearing, and each must be exchanged for stock prior to the closing of the corporation's books in order to participate in the next dividend. Again, the corporation may permit the holder to convert the bonds only when presented in amounts evenly divisible by the conversion or parity price.

Under the warrant and scrip plans, the holder of the convertible is saved much inconvenience if he does not have to present warrants or scrip in exact amounts necessary to obtain one share of stock. Under the more convenient arrangement the holder may present warrants or scrip in any amount, and after receiving as many full shares as he is entitled to, will receive new warrants or scrip for any fractions that may still remain. The fourth method has been characterized as particularly unfair, especially where the bonds are issued only in denominations of $1,000. In the case of the assumed bond, convertible into stock at 130, this method would require the holder, in order to convert, to present not less than $13,000 of bonds, since no other amount is evenly divisible by 130. While bonds might be purchased in the market to make the aggregate holding large enough for conversion purposes, the inconvenience of such a requirement must be apparent.

Reducing Current Quotations of Bonds and Stocks to a Common Basis.—In comparing bond and stock prices, it is necessary to take into account the difference in the method of quoting the two types of securities. Stocks sell "flat," that is, the price includes the dividend that has accrued since the last dividend date. Bonds, on the other hand, are generally quoted "with interest" or "and interest," meaning that the purchaser must pay the quoted price plus the interest that has accrued since the last interest-paying date. To place stock and bond quotations on the same basis it is essential, therefore, to deduct from the quotation of the stock the accrued dividend. In other words, to ascertain how the market price of the convertible bond compares from the standpoint of conversion with the

market price of the stock into which it may be converted, it is necessary to find the market worth of the stock, exclusive of the accrued dividend, and thus reduce it to a "with interest" basis, which is now almost universally adopted throughout America as a basis for quoting bonds. For example, Atchison, Topeka and Santa Fe Railway Company 4½% debenture bonds, due December 1, 1948, are convertible into 6 shares of common stock for each $1,000 bond until December 1, 1938. If the bond is selling at 112 and at the same time the common stock is selling at 188, is it profitable for a holder of the bond to convert? Before this question can be answered it is necessary to take into account the difference in method of quoting the two types of securities.

To render easy the exclusion of the accrued dividend from the current price of the stock, so-called "accumulated dividend tables" are used by arbitragers and others who frequently deal in convertibles. Such tables are arranged in double columns, representing the rates of dividend upon the different stocks. The single columns under each rate of dividend are respectively headed, "days" and "interest on $1,000," the first containing "the number of days at which $100 must be at interest at the dividend rate to nearest approximate the fractions opposite," and the second containing "the amounts of accumulated dividends expressed in fractions, increasing by intervals of ⅛ per cent, which is the minimum New York Stock Exchange fluctuation." [7] Thus let us assume that Atchison, Topeka and Santa Fe common sold at 188 on April 8, that the preceding dividend date was April 1, and that the stock paid 10 per cent in dividends.[8] Next we must find either by computation, or by

[7] See *Convertible Securities* by Montgomery Rollins for a copy of such a table. Interest is figured at 365 days to the year.

[8] No dividends are paid at present on Atchison common stock. Atchison 4½'s, due in 1948 were issued December 1, 1928 and are convertible any time on or after December 1, 1930, until December 1, 1938. $30,204,000 were authorized and $28,070,500 were issued. To date $2,133,500 have been converted. They are redeemable after December 1, 1938, at 102 plus interest.

reference to an accumulated dividend table the amount of the accumulated dividend which must be deducted from the market price. By referring to the 10 per cent column of an accumulated dividend table, and opposite number 9 in the column headed "days," the nearest approximation to eight days, we find that ¼ of a point represents the accumulated dividend for eight days, expressed by the nearest fraction used on the Exchange in quoting stocks. This ¼ must be deducted from the stock quotation of 188, thus giving 187¾ as the market worth of the stock, exclusive of accrued dividend. Had 82 days elapsed since the last dividend date, the accrued dividend would have amounted to 2¼ points, and it would have been necessary to deduct this amount from the price of 188, giving 185¾ as the value of the stock, reduced to a "with interest" basis.

Ascertaining the Conversion Equivalent.—In determining whether or not conversion is profitable in the above case, it is necessary to know the "conversion equivalent"—the price at which the stock must be quoted to be on a conversion equality—at which conversion is neither profitable nor unprofitable. A logical way to find the conversion equivalent is to assume that the holder of an Atchison 4½ per cent bond converts it and sells the stock which he obtains on the market. That is, instead of selling the bond at $1,120 he turns it over to the corporation and receives therefor 6 shares of common stock. If he is to sell these 6 shares on the market with no profit or loss he should receive $1,120 from the sale. Therefore, the conversion equivalent when the bond is selling at 112, should be $1,120 divided by 6, or 186⅔. Since we determined above that the stock was selling on April 8 at 187¾, on a "with interest" basis, the holder of the bond, if he converted, would make as a profit the difference between the conversion equivalent of 186⅔ and the market price of 187¾ on 6 shares of stock, or $6.50. Or, we may figure the profit by deducting the price at which the holder could have sold the bond on the market from the price he receives from the sale of the 6 shares

on the market. Thus, $1,120, the market price of the bond, deducted from $1,126.50, the proceeds of the sale of 6 shares of stock at 187¾, gives a profit of $6.50 by converting.[9]

A second method of calculating the conversion equivalent may be explained. In the above illustration it takes $166⅔ par value of bonds to obtain one share of common stock. Also, when the stock sells on the market at 166⅔ ("with interest" basis), and the bond sells at 100, there will be no profit or loss in converting, since under these price conditions the holder of the bonds must turn over to the corporation $166⅔ in par value of bonds, which sells for exactly this amount on the market, for 1 share of stock, which also has a market value of $166⅔. When, therefore, the price of the bond is 100 it is only necessary to multiply it by the conversion or parity of 166⅔ (parity price is used as a percentage figure), and the result is the conversion equivalent. To the conversion equivalent it is necessary to add the accrued dividend to determine whether the market price is higher or lower than it should be. Following the same rule, when the market price of the bond is 112, the conversion equivalent is 112 times 166⅔ per cent, or 186⅔, as shown above. According to this method, then, when the market price of the bond is known and it is desired to find the market conversion equivalent for the stock, it is necessary to multiply the bond price by the parity price, used as a percentage, and add the accrued dividend to the result. If the price of the stock is given and the bond conversion equivalent is desired, the method requires, first, a deduction of the accumulated dividend from the stock price, and second, a division of the result by the conversion or parity price. Thus, when

[9] A gross profit of this amount would hardly be sufficient to cover the extra expenses involved in the conversion of only one bond. The odd-lot of 6 shares would have to be sold at a small fraction under the market price for round lots, and a minimum commission, of say $3.00, would have to be paid. Also, some corporations make a slight charge for conversion. See p. 300 for the commissions and taxes on the conversion of a larger amount of bonds.

Atchison stock sells at 186⅔, on a "with interest" basis, the bond price should be 186⅔ divided by 166⅔, or 112.

The conversion equivalent may also be found by proportion. Under the terms of the Atchison convertible 4½'s mentioned above, the holder of a $1,000 bond is entitled to 6 shares of common stock and the parity price is 166⅔. At what price, then, must the stock be selling when the bonds are quoted at 112, in order that there may be no profit or loss in converting? The conversion equivalent would evidently be in the same proportion to 112 as 166⅔ is to 100 because there would be no profit or loss in converting when the stock sells at exactly 166⅔ and the bond sells at 100. We have, therefore, the proportion: X (conversion equivalent of the stock) is to 112 as 166⅔ is to 100; or, to re-arrange the proportion, 100 is to 166⅔ as 112 is to the unknown price of the stock. By working either of these proportions we find that the price at which the stock must be selling, in order that conversion may be neither profitable nor unprofitable, is 186⅔ per share.

To render convenient the prompt finding of conversion equivalents of any bond when the stock into which it may be converted is selling at a certain price, exclusive of the accrued dividend, so-called conversion tables have been prepared for the leading issues of convertible bonds. These tables are used by arbitragers and others who are interested in the market price of convertible securities. The tables consist of two columns, one headed "Price of Stock," giving quotations by intervals of one-eighth, the minimum fluctuation on the Exchange, and the other headed "Bond Equivalent," giving immediately opposite each stock quotation price the mathematical equivalent of the bond, that is, the price at which the bond must sell, with the stock selling at the indicated price, in order that the conversion may be neither profitable nor unprofitable.[10]

Arbitraging in Convertibles.—The holder of a convert-

[10] See *Convertible Securities* by Montgomery Rollins for a copy of such a table.

ible bond need not actually convert it in order to realize the profit attaching thereto when the stock into which the bond is convertible sells considerably above its exchangeable price. By way of illustration, let us assume that seven days following the last dividend date Atchison common stock sold in New York at 190¼, and at the same time the convertible 4½'s sold at 114. By computation, or by reference to the accumulated dividend table, we will find that ¼ of a point of accrued dividend, the nearest statement by one-eighth of the accumulated dividend for seven days, must be deducted from the quotation, thus giving 190 as the worth of the stock when quoted on the same basis as the bonds. Another computation, or reference to a conversion table, shows that with the stock selling at 190 the bond price equivalent of the Atchison convertible 4½'s is 114. Because the stock advanced 23⅓ points above its exchangeable price of 166⅔, the price of the bond also advanced sympathetically in the ratio of 100 to 166⅔, or to the extent of 14 points. The benefit of this rise in the price of the bonds the holder could have obtained without actually effecting a conversion, by simply selling the bonds in the open market and taking his profit.

Holders of convertible bonds are enabled to sell them promptly and take their profits largely because of the existence of dealers who find it profitable to arbitrage between bonds and stocks into which such bonds are convertible, whenever the bonds sell so far below their conversion equivalent that the payment of commissions is more than justified. With Atchison common stock selling, as per our previous illustration, at 190¼ and the bonds, let us say at 113, the operation of the arbitrager may be explained as follows: He first reduces the price of the stock to a "with interest" basis, and finds that 190 represents the value of the stock, exclusive of the accrued dividend. He next notes that the bond equivalent is 114. He now knows that conversion is profitable since the bond is selling sufficiently below its conversion equivalent to more than pay taxes and

commissions. He, therefore, let us assume, buys $100,000 par value of bonds at 113, and at the same time sells short 600 shares of stock at 190¼ per share, the equivalent of 190 plus the accrued dividend, his intention being to make delivery on his sale of stock with the 600 shares received by converting the bonds he purchased. His profit on this arbitraging transaction may now be computed, as follows: [11]

Commission on $100,000 par value of bonds bought ($2.50 per $1,000 par value)	$ 250.00
Commission on 600 shares of stock sold ($25.00 per 100 shares when sale price is not less than $100 and under $200 per share)	150.00
Federal and State Transfer Taxes on sale of 600 shares ($9.00 per 100 shares in this case)	54.00
Total Commission and Taxes	454.00
Sum received from sale of 600 shares at 190	114,000.00
Cost of $100,000 par value of bonds at 113	113,000.00
Profit	1,000.00

Because of a favorable adjustment in the prices of the bond and stock it is possible that the arbitrager need not even effect a conversion in order to net a profit. Thus with the stock remaining stationary and the price of the bond rising to 114 the arbitrager might close out both transactions, that is, buy in the 600 shares of stock and sell the bonds at the increased price. Moreover, the arbitrager, if a member of an exchange, may not have to make allowance for the payment of commissions.[12] In any case, irrespective of the plan followed, the practice of arbitraging in convertible securities renders great service. Not only is the market in such securities made more continuous in character by the practice, but the prices of the bond and the stock, where a conversion value attaches to the bond, are con-

[11] Any smaller amount of bonds will, when converted, give the holder an odd number of shares.

[12] See Chapter VII on Arbitraging.

stantly made to stand in proper relation to each other. The holder of the bond is, therefore, not only assured a better opportunity to sell, but is (1) relieved of the necessity of constantly ascertaining the conversion equivalent of the bond with every fluctuation in the price of the stock; and (2) enabled to obtain his profit by merely selling the bond in the open market.

Price Movements of Convertibles.—As the quotation of the stock into which the bond may be converted rises above its parity price, the price of the bond will move in sympathy. Thus, the Atchison, Topeka and Santa Fe convertible 4½'s of 1948 will tend to move in sympathy with the common stock if the latter approaches or exceeds the parity price of 166⅔. When in 1929 the stock rose to 298⅝, the bond, although not convertible until December 1, 1930, at one time sold at 165, or very considerably in excess of its intrinsic worth as an investment at 4½ per cent. In 1930 when the common stock sold at 242½, the bond sold at 141½, which was approximately the conversion equivalent, if the accrued dividend is deducted from the stock. But if the stock into which the bond is convertible should sell much below the exchangeable or parity price, the value of the bond must be judged from the standpoint of its worth as an investment and its price will not reflect sympathetically the decline in the price of the stock. When Atchison common stock sold during the liquidation in 1932 as low as 17⅞ the bonds at no time sold under 68, although had their price action been entirely sympathetic, they would have declined to almost 10.

When the convertible privilege does not become effective until some future date the sympathetic price control of the stock upon the bonds may be little or great, depending upon the market price of the stock and the amount of time which must elapse until the conversion privilege becomes effective. The higher the stock price above the parity price and the shorter the period of time before conversion is permitted, the greater will be the effect of the conversion privilege on the price of the

convertible. Naturally as the conversion date approaches, if the stock is selling above the parity price, speculative interest will cause an increase in the price of the bonds, possibly to a point beyond that at which they should sell in order for no profit or loss to result if conversion could then take place.

The effect of the conversion feature on the price of convertible bonds, both prior to and after the convertible period, can be shown by an examination of the prices of several issues of securities of the Atchison, Topeka and Santa Fe Railroad. The 4½'s of 1948 were issued in 1928 and the convertible period extends from December 1, 1930 to December 1, 1938. The 4's of 1960 were issued in 1910 and the convertible period extended from June 1, 1913, to June 1, 1923. Both bonds are of the debenture type, but the 4's of 1960 were convertible par for par, whereas the 4½'s are exchangeable for 6 shares of common stock for each $1,000 par of bonds. The general 4's of 1995 are Atchison's leading bonds from an investment standpoint.

The prices of the convertible 4½'s due 1948 show that these bonds were influenced by the price of the stock from the time they were issued in 1928, even though conversion was not possible until December 1, 1930. In 1928 the high of these bonds was 127, which was a little higher than the conversion equivalent of the stock when it was at a high of 204. In 1929 the bonds sold at 165, or almost at a proper relationship with the high for the stock, with the accrued dividend deducted. According to their 1930 highs they were even closer to their proper relationship, but at their lows of that year the bonds did not sell lower than 108¼ when the stock sold as low as 168. With the stock at 168, the bonds should have sold at a little above 100. With the low prices prevailing for the common stock in 1931, 1932, and 1933, the bonds sold largely on their investment merits. In 1932 both the high and low prices of the 4½'s were under the general 4's of 1995.

The 4's due in 1960 were convertible from 1913 to 1923, par

HIGH PRICES OF ATCHISON SECURITIES—1920–33

Security	*1920*	*1921*	*1922*	*1923*	*1924*	*1925*	*1926*
Common Stock	90⅜	94	108½	105⅛	120¾	140½	172
Conv. 4½'s of 1948							
Conv. 4's of 1960	91	93	107¾	104¼	83	84	87¾
Genl. 4's of 1995	82¾	86⅝	95¼	91½	91¼	92½	93¼

Security	*1927*	*1928*	*1929*	*1930*	*1931*	*1932*	*1933* *
Common Stock	200	204	298⅝	242½	203⅜	94	80⅛
Conv. 4½'s of 1948		127	165	141½	122	93¾	102
Conv. 4's of 1960	93⅞	91	90	92¼	95½	80	81
Genl. 4's of 1995	98⅞	99	95	98½	101	95	97⅛

LOW PRICES OF ATCHISON SECURITIES—1920–33

Security	*1920*	*1921*	*1922*	*1923*	*1924*	*1925*	*1926*
Common Stock	76	76¼	91¾	94	97⅛	116¼	122
Conv. 4½'s of 1948							
Conv. 4's of 1960	77¼	79	91¼	77⅞	80¼	81	83½
Genl. 4's of 1995	69	73⅜	85	84¼	86	88¼	89½

Security	*1927*	*1928*	*1929*	*1930*	*1931*	*1932*	*1933* *
Common Stock	161¾	182⅜	195⅛	168	79¼	17⅞	34⅝
Conv. 4½'s of 1948		118	108½	108¼	81	68	79
Conv. 4's of 1960	86	88¼	81⅝	89¼	94¼	73	73
Genl. 4's of 1995	92¾	91½	90	91⅝	81½	75	82¾

* To and including November 17, 1933.

for par. During the convertible period (only part of which is shown on the table) the bonds sold at their proper relationship to the stock. Also during each year of this period the convertible 4's of 1960 sold at higher prices than the general 4's. However, when the convertible privilege of these bonds expired in 1923, their price fell considerably, and since then they have sold consistently under the general 4's of 1995.

Mention should also be made of the effect that the existence of a large issue of convertible bonds may have at times upon the market value of the stock. The rise of the stock to a point so far above the exchangeable price as to net a considerable profit by converting the bonds and selling the stock thus obtained, may cause conversion on such a large scale and a consequent selling of the shares in the market in such large volume as to depress materially the price of the stock. Moreover, an issue of convertible bonds may deter an otherwise probable advance in the price of a stock that pays dividends greatly in excess of the rate of interest paid on the bonds. As the bonds, upon their conversion, will appreciably increase the outstanding issue of the stock, such increase, because the dividend rate greatly exceeds the interest rate on the bonds, will result in the company's profits being much more heavily drawn upon.

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CHAPTER XVII

PRIVILEGED SUBSCRIPTIONS OR "RIGHTS"

Definition, Reasons for, and Importance of "Privileged Subscriptions."—A "privileged subscription," or a "right" as it is commonly known in stock market terminology, may be defined as the privilege given by a corporation to its stockholders to subscribe to additional stock, and sometimes bonds, at a price lower than the current market price of the stock under consideration. Such privileged subscriptions are offered by corporations for a great variety of reasons. Having accumulated a surplus during previous years, the corporation may, by the issuance of new stock, capitalize this surplus. Or the corporation may decide to raise needed funds through the sale of stock because it does not wish to increase its fixed charges, or because the money market may at the time happen to be such that bonds or notes cannot be issued except at excessively high interest rates, or because funds are absolutely necessary to provide for improvements that do not correspondingly increase the income. If for any of these reasons large blocks of stock were thrown on the open market, prices might decline sharply. By offering the shares to stockholders, however, at a price considerably below current quotations, the company is practically assured of success in obtaining the funds and any decline in the market price of the stock will be comparatively small. In the past, privileged subscriptions were also issued by many corporations as a means of capitalizing their present and future earnings, and many instances are on record where leading corporations, whose stock recently sold at par or higher, dis-

tributed large amounts of stock free, although they possessed no surplus at the time to justify the distribution.

The importance of privileged subscriptions in their relation to the stock market becomes apparent when we note the frequency with which large corporations have used this method of raising capital and of distributing profits. Thus, between February, 1902, and October, 1909, the Canadian Pacific Railway Company increased its outstanding stock by nearly 170 per cent through the issuance of privileged subscriptions; the stock of the Chicago, Milwaukee and St. Paul Railway Company shows an increase by this method between 1882 and 1906 of 254 per cent of common stock plus an additional 101 shares of preferred stock; the Great Northern Railway Company had nearly seven times as much stock in 1907 as in 1893, not taking into account the 495 ore certificates issued to its stockholders in 1906 for each 100 shares of stock held in 1893; the United Gas Improvement Company in 1909 had nearly six times as much stock outstanding as it had in 1896; while between 1887 and 1909 such leading corporations as the Pennsylvania, New York Central, and Illinois Central Railroads, respectively, increased their outstanding stock through privileged allotments to stockholders, by 285, 145, and 263 per cent. Numerous other corporations might be mentioned which have doubled and trebled their outstanding stock during the past two decades by offering allotments of new stock to stockholders at prices lower than the current market quotations at the time. Usually rights are issued most abundantly during periods of great prosperity, like 1919–20 and 1928–29, when stocks have reached a high price-level, whereas during periods of depression, like 1921–22 and 1930–34, when nearly all stock issues sell considerably below par, rights are but rarely announced.

Meaning of the Term "Rights."—In the New York market a right is "the privilege of one old share to participate in the new issue," although on certain markets the term has

had reference to the "privilege of subscribing to one share of new stock." Thus let us assume that "A" is the holder of 100 shares of stock in a corporation which has given its stockholders the privilege of subscribing to new stock to the extent of 25 per cent of their holdings. In New York, where the term "right" pertains to the privilege of each old share to participate in this 25 per cent allotment, "A" becomes the possessor of 100 rights, each representing his privilege as owner of one of the old shares to subscribe to one-fourth of a share of new stock. "A" must, therefore, be the holder of four old shares, giving him four rights, in order to have the privilege of obtaining one new share at the lower price, and his holdings of 100 shares entitle him to 25 new shares. Had our illustration assumed an allotment of only 10 per cent instead of 25 per cent "A", as holder of 100 old shares, would again have been the possessor of 100 rights, one right per each old share, entitling him to 10 new shares.

Computation of the Mathematical Value of Rights.—Since the new shares are allotted at a price lower than the current market price of the stock, it follows that the right to such favorable subscription is of value to the holder of the old shares. This value will depend, of course, upon the price at which the old shares are selling above the subscription price of the new shares, and can easily be computed. Thus let us assume that a company grants to its stockholders the privilege of subscribing to new stock to the extent of 10 per cent of their holdings at a price of $150 a share, although the current market price of the stock at the time of the allotment is $242 a share. In other words, the holder of 10 shares of this company's stock is permitted to subscribe to one new share at a price $92 below the price at which the stock is then selling. Apparently such a large difference between the subscription price and the market price indicates that the right to participate in the new issue has a considerable value. The computation of this value may be illustrated as follows:

10 shares of old stock at $242 per share	=	$2,420.00
1 new share at $150	=	150.00
Total cost of 11 shares (old and new shares combined)	=	2,570.00
Average cost of 1 share (2,570 ÷ 11)	=	233.63

The value of each right in New York, i.e., the right pertaining to each of the old shares to participate in this favorable subscription, is the difference between $242, the price of the old stock, and $233.63, the average price per share of all the stock, new and old combined, or $8.37, or about $8⅜. The same computation might be made, and is usually made, on the basis of 100 shares; that is, the price of 100 shares at $242 ($24,200) plus the price of 10 new shares at $150 ($1,500), or $25,700, divided by 110 (the new and old shares combined) equals $233.63, which, subtracted from $242, again gives $8.37 as the value of the "right" attaching to each of the 100 old shares which were allowed to participate in the allotment.

Meaning of the Terms "Rights On" and "Ex-Rights." —As previously explained, stock quotations on American exchanges always include the accumulated dividend, i.e., the current price, exclusive of all other factors, should gradually increase week after week as the dividend is being earned. Then, when the stock sells "ex-dividend," its price, *other things being equal,* should drop by the amount of the dividend. In the same way the issuance of rights is discounted in advance, and the value is included in the market quotation for the stock. Rights are "declared," as a rule, a month or even longer before they are actually issued, the corporation's announcement stating that the privilege of subscribing to the new stock is given to stockholders as they shall stand registered on the books of the company at the close of business on a certain stipulated date. Until this date the stock sells "rights on," the value of the right being *included* in the price of the stock; while on the next day the stock sells "ex-rights," the value of the right being *excluded* from the price of the stock since its purchase on this day or thereafter no longer entitles the buyer to the privilege of sub-

scribing to the new shares. The price of our company's stock, referring to our previous illustration, should therefore, exclusive of all other factors, have opened about 8⅜ a share lower on the day when the stock sold "ex-rights" than it closed at on the preceding day. The actual issuance of the new stock, however, may not take place until a month or even longer after the date at which the stock sells "ex-rights." Corporations usually permit stockholders to pay for the new shares on the installment plan, allowing interest upon the installments, and usually the new shares are issued at a price so much lower than the market price that it is possible for the subscriber to borrow the funds necessary to pay for the new shares and then use them as collateral to secure the loan.

Extent to Which Privileged Subscriptions Are Discounted by the Market.—It rarely occurs that the declaration of rights by a corporation is not discounted substantially in the market quotations for the stock. This may be shown by selecting any considerable number of privileged subscriptions, using corporations whose shares are regularly quoted. Such a list will show that in the great majority of cases, making proper allowance for the general upward or downward trend of the market as a whole, the stock begins to discount the prospective issuance of rights months before official announcement thereof is made, and that the highest quotations are reached, with few exceptions, shortly before or immediately after the publication of the news. Immediately following the advertisement of the rights, and sometimes even before such advertisement, a well defined selling movement generally commences and continues until the expiration of the period during which subscription is allowed. A general upward trend of the market, however, or local conditions affecting the particular stock, may be strong enough in individual instances to reverse the usual tendency. Many examples of rights may be mentioned where the stock declined from the time that rumors of the new financing were first heard. This is especially the case in stock issues

which are extremely large in their outstanding amount, whose ownership is widely distributed, which are selling only slightly above par, and which can show but little more than present dividend requirements. Under such conditions the ability of the market to absorb a new issue is frequently questioned, and the rumor or announcement of the privileged subscription is often the signal for the starting of a heavy selling movement in the particular stock. According to Dr. C. A. Kulp's [1] investigation of 140 stock dividends and rights, covering the period of 1904–22, the degree of discounting was remarkable. In slightly less than two-thirds of the total number of instances the effectiveness of the discounting fell "within 1 per cent of accuracy," i.e., "on the day of the announcement the results show discounting in 62.9 per cent of the cases." Dr. Kulp explains further: "If the results are analyzed with 2 per cent accuracy as the standard, the announcements are discounted in approximately three-quarters of the cases." According to his classified table, 95 per cent of the cases indicated discounting within 5 per cent of accuracy on the day of announcement.

Past records also show that, in the great majority of instances, the issuance of rights has been discounted within a much shorter time than is generally the case with dividend increases. Several reasons may be offered as an explanation for this. In the first place, the average investor does not consider privileged subscriptions as regular income in the same sense that he so regards dividends. Instead, privileged subscriptions are considered by most investors as a sort of bonus, the granting of which cannot be counted on in the same way that one can look forward to the securing of regular dividends. Even if the corporation has been pursuing for years a policy of financing by this method, there is no assurance that such a course will be pursued in the future, and discounting such action on the part of the corporation long in advance is hardly considered safe. The return from rights is much less certain to the investor

[1] Kulp, C. A., *The Discounting of Dividends by the Stock Market*, 1923.

than the returns from dividends. The latter are paid regularly and the investor is better able to anticipate with reasonable assurance the amount he will receive and the time of payment. This cannot be said of rights. It is impossible for the great mass of investors to know when they are coming, or how much they will be. Their issuance depends upon the action of the corporation, and what that action will be in the future is difficult to tell. Merely because a corporation has been liberal in the past in authorizing stock allotments is not regarded by the average investor as sufficient cause for the stock to be constantly selling at a price level which indicates an expectation of profits from rights in the future at the same rate as has prevailed in the past.

Procedure Followed by Corporations in Offering Privileged Subscriptions.– Briefly outlined, corporations usually adopt the following method in announcing the subscription allotment and in issuing the new stock:

1. The corporation announces by circular to its stockholders the detailed conditions governing the issuance of the new stock, i.e., the reasons for the issue, the extent of the allotment, the subscription price, the date when the right to subscribe to the new stock will cease, the terms of payment, the dates and method of issuing and surrendering "warrants" and "assignable receipts," and the manner of converting or redeeming fractional shares.

2. Following the detailed announcement of the terms of subscription, the corporation will issue "warrants" [2] specifying the amount of stock to which each stockholder is entitled to subscribe under the privilege. If the amount of stock to which any stockholder is entitled involves a fractional lot, a separate "fractional warrant" is issued. In the circular already referred to, the corporation announced that "warrants" would be mailed at about a specified date to the addresses indicated on the permanent dividend mailing orders filed in the office by the

[2] For sample copy of a "warrant" see Appendix V.

stockholders, unless other instructions were received prior thereto. In other words, stockholders of record at the close of business on the stated date receive these "warrants," unless they had previously parted with their right to subscribe to the new issue.

The warrant, it is apparent, is merely an evidence of the right of the holder thereof to subscribe to the amount of new stock designated therein. Each warrant is numbered and dated, and where the stocks have a par value, is issued for a designated "Par Amount $ ....." It usually reads as follows:

This is to certify that (here follows name and address of the holder) or Assigns, is entitled to subscribe at the rate of $..... per Share of $.....par value, for.....par value of the stock of the.....Company, pursuant to the provisions of the circular dated....., signed by ....., Treasurer of the..... Company.

Following this introductory portion, the warrant contains a description of the most important conditions announced in the circular issued to stockholders, especially the conditions governing the payment for the stock in full or by installments, interest and dividend payments, the issuance of subscription or assignable receipts, and the date after which the warrant will be void and of no value. Moreover, the warrant states that "failure to pay any installment when and as payable will operate as a forfeiture of all rights in respect of the subscription, and the installments previously paid." Provision is also made for the sale and transfer by assignment of the warrant, executed in the form described and printed thereon. Two such forms are printed on the reverse side of the warrant, the first to be filled out and signed by the stockholder if he wishes to take the stock himself, and the second, which is an assignment requiring a witness, if he desires to dispose of the subscription privilege. If the stockholder wishes to subscribe for only a portion of the stock covered by the warrant and dispose of the balance, or desires

to dispose of a portion to one person and the balance to another, the corporation will, upon the return of the original warrant, issue new warrants in accordance with the instructions submitted.

3. Until a stated date the warrants will pass by delivery. Thereafter "subscription" or "assignable receipts" take the place of the warrants. According to the company's circular announcement, which information is repeated in the warrant, payments can be made in full or in a specified number of installments. When the first installment is paid, the "warrant" is surrendered and an "assignable receipt" is issued in its place, which in turn must be surrendered to the company upon payment of the second installment. When the second installment is paid, an "assignable receipt" covering both the first and second installments is issued, which in turn must be surrendered to the company upon payment of the third installment. When payment in full is made on the date of subscription, or whenever payment of the three installments is made as allowed, stock certificates for whole shares are mailed to the stockholders. The circular usually further announces that full-paid stock receipts for fractions of shares will be issued, which will not carry any dividend or interest until converted into stock. They can be so converted only when the fractions surrendered make whole shares, provided such surrender is made on or before a stated date, on which date such fractional receipts not converted will be redeemed in cash at a specified rate per share, without interest.

Methods that Stockholders may Adopt in Disposing of Their Rights.—Having explained the method of procedure that corporations follow in announcing and distributing allotments of new stock, we may next consider the various methods open to stockholders who wish to dispose of their rights. One way of doing this is to sell all of the old stock, as soon as the rights are announced, with a view to the repurchasing of an equal number of shares when the stock sells "ex-rights." The

price obtained will, of course, include the value of the rights. In view of the discounting function of the market, as regards the rights, there is every likelihood that an early sale will yield the best price. An apparent drawback, however, is that the stockholder has divested himself of his investment, in the thought that he will recover the same later by a repurchase, a step which he may never take. Aside from this possible procedure, any one of the following courses of action may be selected, depending upon the special circumstances attending each allotment of stock.[3]

1. *The stockholder may sell his rights* since a market for them is made as soon as the corporation announces its stock allotment. He need not even wait for the receipt of the warrants since the sale is made on the basis of a contract that provides for payment against delivery when the rights are issued. Owing to the practice of arbitraging, the price of rights is bound to follow the price of the stock, and, as already noted, both the stock and the rights generally sell at their highest price, other things being equal, at about the time the privileged subscription is declared. Stockholders, therefore, by selling their rights as soon as their issue is announced, will generally obtain for them a better price than could be secured if sold later.

Not only does this plan generally serve to give the best price to stockholders, assuming that they intended to sell their new shares in any case and not to take them up as a long-time investment, but it affords the additional advantage of making the proceeds of the sale immediately available. Profits, in other words, are realized at once, instead of being deferred until the issuance of the new shares. "An uncertain future profit" is converted by this immediate sale into "a certain present profit." But in using this plan it must be remembered that, as explained

[3] The various methods which may be adopted in this respect are described in detail by Dr. T. W. Mitchell in his article on "Stockholders' Profits from Privileged Subscriptions," *Quarterly Journal of Economics*, February, 1905.

in connection with arbitraging in rights, the current quotations on rights do not quite represent their full value. Instead rights generally sell slightly under their actual worth. This follows from the fact that rights are usually sold to speculators and arbitragers who are only willing to offer a price which will assure them a margin of profit. For this reason stockholders in disposing of their rights do not receive all that the premium on the stock warrants, and, in some instances, could probably make a more profitable transaction by adopting the next plan to be described.

2. *The stockholder may sell such on amount of his original holdings of stock as equals the number of new shares to which he is entitled, and replace the shares sold with the new stock when issued.* This method keeps his investment intact, and enables him to realize on his sale the full market price of the stock instead of compelling him to sacrifice a sum equal to the discount that is connected with the sale of rights. He obtains the immediate use of the proceeds of the sale and loses no interest on the money borrowed to pay his subscription. There is also no uncertainty under this plan as to the amount of profit accruing.

As opposed to these advantages it should be recalled that, judging from the past, the stock is usually quoted at its highest when the allotment of new stock is first advertised. To be entitled to the subscription privilege pertaining to all the shares held, the stockholder under this plan, would be obliged to wait until the stock sold "ex-rights" before selling any portion of his holdings. But by waiting until that time he is apt to lose the full benefit of the better price usually prevailing when the rights are first announced, and the subsequent depreciation would in all likelihood much more than offset the discount in price that he sacrifices to arbitragers when they buy his rights. Thus under a 10 per cent allotment, if the holder of 100 shares sells 10 shares when the allotment is announced, he will have only 90 shares left at the time the stock sells ex-rights, thus

entitling him to only nine new shares. Upon receiving these shares, he would have only 99 shares, or 1 share less than the original investment of 100 shares. To keep his investment intact, it would be necessary to go into the market to buy this one additional share.

3. *The stockholder may subscribe for his allotment of the new shares with the intention of selling them after they have been issued by the corporation.* Under this plan the subscribing stockholder must take the new shares upon their issuance and pay for them in accordance with the terms of the subscription privilege. The stockholder may be required to pay all of the subscription price sometime before the new shares are received, while if payment is allowed in installments, the interest paid by the corporation on such installments may be less than the rate paid on the borrowed funds. Even following the issuance of new shares, the holder may be obliged to wait a long time before an opportunity presents itself to sell them at a profit. Or, if obliged to dispose of the new shares for some reason, the shareholder may have to sell at a price much below that which might have been received at the time the subscription was announced.

4. *The stockholder may immediately sell short the amount of stock to which he is entitled, borrow stock to fulfill delivery on his contract, and return this stock loan when the new shares are issued.* Such a transaction would be conducted in all respects like an ordinary short sale. If a stockholder's subscription allotment amounts to 100 shares, he will instruct his broker to sell that number of shares short at the current price and to borrow the 100 shares from some other broker for the purpose of delivery. The broker will retain the proceeds of the sale and pledge the same with the lender as security for the stock loaned. He will also ask the customer to deposit a margin of, let us assume, $2,000 as security. Then, upon the issuance of the new shares, the stockholder will instruct his broker to use them in repaying the stock loan, whereupon the broker will credit

to the customer a sum representing the proceeds of the sale plus the $2,000 margin with interest thereon, less the value of the rights and the customary brokerage commission. The profit to the customer will consist of the difference between this sum, after deducting interest on the money borrowed to pay for the subscription and to provide for the $2,000 margin on the one hand, and the subscription price for the new shares on the other.

Under this plan the stockholder is usually afforded the opportunity of selling his stock at a better price than could be obtained at the time of the issuance of the new shares. Although he is short of the stock, his right to obtain the new shares serves as a protection. The plan, however, may seem complicated to the average investor and in exceptional instances may result in much inconvenience. A sharp advance in the price of the stock would necessitate giving the broker additional margin to protect the short sale, which would have the effect of reducing the profits of the transaction because of the loss resulting from a possible difference in the rate of interest paid and received on the extra margin. The creation of an overextended short interest in the stock might cause it to become so scarce for borrowing purposes as to cause the stock to lend flat, or even at a premium, thus further decreasing the profit. A still greater danger is the possibility of a corner in the stock which, by making it impossible to borrow the stock at all, might necessitate a settlement, or a purchase of the stock, at a greatly increased price. It is also the general practice not to pay any interest to the customer on the proceeds of the short sale which have been pledged with the lender of the stock, although the customer is liable for the payment of all dividends that may become due during the continuance of the loan.

Arbitraging in Rights.—Holders of rights, who wish to sell them in the market, are greatly assisted through the operations of arbitragers in rights. In other words, a certain group of dealers arbitrage by selling short the outstanding shares of a given issue and by buying the "rights" to receive an equal

amount of new shares of the same issue. The practice may be illustrated by referring to one of the Pennsylvania Railroad Company's announcements of rights at par ($50) to the extent of 10 per cent. At the time the stock was selling at 57¾, or $5,775 for 100 shares. The holder of 100 shares was thus given the privilege of subscribing to 10 shares at par, so that 110 shares could be acquired at a total cost of $6,275, or an average per share of $57.045. The difference between $57.75 and the average cost of $57.045, or $.705, is the mathematical value of the right.

Arbitragers are willing to buy rights provided they obtain them slightly below their mathematical value, and in order to permit of a continuous market in such rights exchanges usually permit minimum fluctuations between prices of one-sixteenth instead of the customary one-eighth. Accordingly, let us assume that an arbitrager is offered 2,000 rights at 60 cents, costing him $1,200. In accepting this lot of rights the arbitrager immediately sells short, as a hedge, 200 shares of the stock at the current price of $57.75, or for $11,550. He then waits until he receives the 200 shares of stock, to which his 2,000 rights entitle him, from the corporation at the par value of $50, or at a total cost of $10,000. These shares he will then return to the lending broker to replace the 200 shares which he was obliged to borrow in order to fulfill delivery on his original short sale. The stock received from the corporation has cost the arbitrager $10,000, and the rights $1,200. Moreover, he has lost the interest on $1,200, for, let us say, two months, amounting to $12, thus making a total cost to the arbitrager of $11,212. Since the stock was sold short at $11,550, our arbitrager has made a profit of $338, less (1) the State and Federal transfer taxes, (2) any commissions that the operation may cost him, and (3) the value of 200 rights which, as a short seller of 200 shares, he owes to the lender. It may be added that by conducting such operations arbitragers greatly help in creating a continuous market in rights for those who wish to sell rights, and

also keep the quotations of rights in line with the quotations of the stock already outstanding.

Extent of Profits Derived from Privileged Subscriptions in Case They Are Held over a Series of Years.—As Dr. T. W. Mitchell states in his article on "Stockholders' Profits from Privileged Subscriptions":

> "It is not to be denied that the proceeds from these privileges in many instances constitute a very material addition to the current dividends which are received by the stockholders, and that they are to be reckoned on when one is estimating the yield on his investment. But these extraordinary gains come in at irregular intervals. To obtain any accurate idea of their extent, it is necessary to state them in the form of equivalent returns coming in at regular intervals, like dividends."

While the future value of such privileges cannot be foretold, two excellent presentations of the approximate value of past privileges have been published.[4] Both show that by subscribing to and holding all the new shares offered, the stockholders in some of our leading corporations, which have repeatedly made allotments, have been given an excellent opportunity to reduce the average cost of their holdings. Full subscription to all privileges over a series of years has in some instances proved exceedingly profitable, since such subscriptions may be said to compound like interest, each successive percentage allotment of new stock increasing the basis for future allotments.

B. B. Burgunder, with a view to showing the profitableness of past privileged subscriptions, selected a substantial number of leading corporations for the purpose, and, in connection with each, computed the "net annual yield on the cost" that accrued to a stockholder who purchased 100 shares of the stock in a certain year and subsequently took and held all new stock

[4] *Ibid.*, and B. B. Burgunder, "The Declaration and Yield of Stockholders' Rights," published in the volume on "Stocks and the Stock Market," *Annals of the American Academy of Political and Social Science, 1910.*

allotments until November, 1909.[5] The net annual yield, as computed by Burgunder, includes not only the average annual dividend return, but also the market gain on all the holdings, between the date of purchase and November, 1909, spread as an annuity over the period under consideration. Since the profit to the stockholder will vary greatly as the price of the stock fluctuates in the market, November, 1909, was selected as a fair basis for the computation, because the quotations at that time represented a normal market with prices neither reflecting a boom or a depression. The computation, furthermore, assumes that all the new stock was paid for by the stockholder with money borrowed at 5 per cent, and that, since the dividend return upon the stock issued was generally greater or lower than the assumed interest rate on the borrowed money, the difference between the two rates was treated in the computation as either a profit or a loss. Arranged in the form of a table, Burgunder's computations for 13 corporations are given on page 321.

Importance of Not Permitting Successive Issues of Rights to Cause the Investor to Violate the Application of Averages to a Limited Portfolio.—So often it is argued that stockholders would do best to exercise their subscription privileges for investment purposes, rather than have them dispose of their rights by some one of the methods previously explained. It is often urged that such accumulation of stock in leading corporations is reasonably certain to prove extremely profitable in the long run, since "the United States is a bull country." But there is another side to the question, which should be carefully weighed by investors interested in corporations which make frequent allotments of new stock, namely, that the holder may allow too large a part of his capital to become invested in one property, thereby making too large a portion of his income dependent upon the business prospects of that one concern.

[5] B. B. Burgunder, *op. cit.*, pp. 79–85, and 87–96.

Company	Date of Original Purchase of 100 Shares	Net Annual Percentage Yield on Cost to November, 1909
American Telephone and Telegragh Company	1901	6.818
Atlantic Coast Line Railroad Company	1902	7.622
Baltimore and Ohio Railroad Company	1900	10.031
Canadian Pacific Railway Company	1901	25.03
Chicago, Burlington and Quincy Railroad Company	1880	8.14
Chicago, Milwaukee and St. Paul Railway Company	1882	7.326
Chicago, Rock Island and Pacific Railway Company	1880	6.924
Great Northern Railway Company	1893	33.113
Illinois Central Railroad Company	1887	7.809
New York Central Railroad Company	1893	7.526
Pennsylvania Railroad Company	1887	6.194
Northern Central Railroad Company	1900	10.691
United Gas Improvement Company	1896	19.665

Mr. Burgunder clearly indicated that the stockholder's profit will vary greatly as the price of the stock fluctuates in the market. His article was written years before the major depression of 1929–34, with its enormous depreciation in stock market values. The "net percentage yield on cost," as indicated in the preceding table, may seem very favorable for the average period ending November, 1909. Yet by June, 1932, the great majority of the corporations selected by Mr. Burgunder had passed their dividends entirely, and the dollar valuation of their shares reached almost the vanishing point. Great Northern Railway stock, for example, listed with a net percentage yield on cost of 33.11%, sold down to $5 a share, despite the fact that nearly all new allotments were made at $100 a share, and only two at

$80 and $60, respectively. Pennsylvania Railroad shares, although all allotments were made at $50 or over, sold down to $6½ a share. Using the foregoing table as a basis of illustration, the 1932 low quotations for most of the corporations listed by Mr. Burgunder were as follows: Atlantic Coast Line R. R. $9.75, Baltimore and Ohio R. R. $3.75, Chicago, Milwaukee and St. Paul Ry. $0.75, Chicago, Rock Island and Pacific Ry. $1.50, Illinois Central R. R. Co. $4.75, New York Central R. R. $8.75, and Canadian Pacific Ry. $7.25.

Only with respect to three of the listed corporations was the showing other than a disastrous one. The frequent issue of "rights" by certain corporations has a tendency to lure the investor on towards the creation of a lop-sided investment basket. The law of averages is the foremost law of safe investment. One can easily imagine the worries and fears of many, during this memorable depression, who had unconsciously placed their reliance, through rights upon rights, in the destiny of just one or a few of America's leading corporations. For a time ever so many faced the specter of insolvency, and the loss of all the fruit of their thrift. Such one-sided investment procedure never pays. No matter how many times rights may be issued, investors must seek to have a well diversified portfolio. From that standpoint it is often highly desirable that holders of rights should dispose of the same, and should therefore possess an acquaintance with the several methods by which such disposal may be effected.

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PART III

FACTORS AFFECTING SECURITY PRICES

CHAPTER XVIII

THE MONEY MARKET IN ITS RELATION TO SECURITY PRICES

Price Movements and Price Factors Classified.—In a consideration of the various factors which influence security prices, it is important to recognize the distinction between *price* and *value*. The first term refers to the current market quotations of the security in question, which are constantly changing and which show considerable variations in even the course of a week, or a month. *Value,* on the contrary, has reference to the worth which an individual places upon a security in view of its apparent continued income producing power, i.e., its so-called *intrinsic worth.*

Many investors or speculators, especially those who invest with a view to the upbuilding of a permanent investment portfolio or who speculate for a long-term turnover only, take the position that the all-important factor is the inherent investment worth of the bond or stock. In other words, the important factors which they consider are the safety of principal, the continuity of interest payments of the bond, and the continued adequate earning capacity with respect to the stock. In this viewpoint they are entirely correct. When desiring, therefore, to determine the approximate safety of securities as judged by the corporation's record, or to make a selection between several investments, they analyze the past showing of the corporations involved. They are not interested primarily in the fluctuations of a year, or even an entire industrial cycle. Their attitude is that of "investor," as distinguished from "speculator." They are emphasizing the *permanency* of their holdings, irrespective

of what may transpire by way of price fluctuations during temporary periods.

The intrinsic value of both stocks and bonds must be ascertained by much the same methods of analysis of the corporation's financial reports. A good financial report should contain detailed information along at least three different lines, namely: (1) the physical characteristics, involving a statement of the location and extent of the property owned, the volume and character of the business conducted, the volume and description of equipment, and in the case of certain corporations, the character of the contiguous territory; (2) an income account presenting a detailed statement of the gross earnings, operating expenses, net operating revenue, income from investments and other sources, fixed charges of all kinds, appropriations for equipment and betterments, dividend payments, and sums carried to profit and loss; and (3) a balance sheet dealing with the financial characteristics of the corporation and giving a detailed description of the capital assets, current assets, capital liabilities, and current liabilities. Each of the aforementioned parts of a financial report is essential to a proper analysis, since all bear an intimate relationship to one another. Moreover, in analyzing these various kinds of data it is essential (1) not to judge a property on the basis of one or even a few years' showing, and (2) to bear in mind that, since all things are relative, comparisons must be made on the basis of certain fixed standards.

Such an analysis of corporate financial reports represents a highly specialized science of so many ramifications as to require a separate volume for full explanation. Ascertainment of the intrinsic value—the inherent investment worth over long periods—is all important, and belongs more appropriately to the science of "investment" than it does to a discussion of "speculative markets." Suffice it to say that the important judgment to be reached from such an analysis is with respect to that of "permanency," or "the result of the decade," which averages

the record for both poor and prosperous years. Numerous highly specialized investment services have been set up to make these detailed analyses for the public on the basis of long periods of observation as well as by fixed standards of comparison—such as Moody's, Babson's, The Standard Statistics Company, etc.—and the published results of which are easily obtainable by those not qualified to make the analysis themselves. Moreover, numerous sources publish the "margin of safety" [1] prevailing with respect to the earnings of a corporation applicable to various issues of securities, both bonds and stocks.

Viewing the matter from the standpoint of a period of years, stock market prices have reflected fairly well the earning power of corporations. Yet numerous instances may be cited where the most careful appraisal by outstanding investment services proved grossly wrong from the standpoint of the future. Innumerable instances may also be mentioned to show that prices frequently depart far from so-called inherent worth, even for considerable periods of time. On the one hand, we observe the numerous temporary fluctuations that constantly occur in practically all the securities admitted to dealing—the ceaseless backing and filling of prices during periods of a day, a week, a month, or even several months—and most generally the result of temporary conditions which in no way indicate any change in the real worth of the security under consideration. But in contrast to such temporary fluctuations there are the so-called primary price movements, which extend to the market as a whole—to all classes of securities irrespective of their so-called investment worth—and often require several years to run their course. The stock market is essentially "a market for incomes," and prices in the long run, despite many variations, tend to coincide with true worth. Temporarily, however, many factors are instrumental in bringing about enormous fluctuations in prices, sometimes as regards individual securities and at other times with respect to practically the entire list. It is to this group

[1] For an explanation see Chapter XIX.

of factors, as distinguished from the formulation of one's judgment through an analysis of financial reports, that this section of the volume is devoted. Briefly classified, these price factors may be grouped under the following heads:

1. The condition of the money market.
2. Financial crises and business depressions.
3. Rising or declining commodity price and interest levels.
4. Special terms governing the security under consideration.
5. Other factors—such as a variation in crops, wars, and the like—of a character not easily susceptible to discounting.
6. Manipulation.

Relation Between the Security and Money Markets.—So close is the relationship existing between our security and money markets, and so huge is the volume of credit required in stock-market operations, that the condition of the money market probably constitutes, with the one exception of intrinsic worth as judged by earning power, the most important of all the factors affecting prices. Its vital significance will become more apparent in the next chapter on Financial Crises and Business Depressions, the underlying cause of which in the past has been over-extension of the credit system, a situation that can be corrected only through drastic liquidation. The close connection between our stock and money markets is indicated by the following factors:

1. *The Large Volume of Demand Loans Based on Stock and Bond Collateral.*—Frequent reference has been made to the practice of employing demand loans extensively for security-market purposes. Such demand or "call" loans in this country are one-day loans, subject to termination at the will of either party. Of course, these loans in nearly all instances are allowed to run from day to day, the interest rate being changed to meet the prevailing rate for credit in the call-loan market. As contrasted with this system, leading European countries have a so-called "fortnightly settlement system," according to which

loans are renewed and the new rate of interest determined at the end of each two weeks. This means that borrowers of such loans in Europe are certain of the interest rate for a period of two weeks and, should conditions in the money market be such as to foreshadow a radical increase in interest rates, ample time is given in which to make new arrangements. In this country, however, our daily call-loan system does not give the borrower such an advantage, since either party may terminate the loan at will. In case of a stringency in the money market, which makes necessary a calling of loans, the bankers will first of all seek relief by calling in their demand loans that are protected by readily salable stock and bond collateral. If these call loans cannot be paid promptly, there will be necessarily a sale of the collateral securing the loans, a practice that frequently has been responsible for wide declines in the leading speculative stocks dealt in on our exchanges. In periods of money stringency, the security market is made to bear the brunt of the situation because call loans are protected so largely by stock and bond collateral enjoying the benefit of a continuous market.

2. *The Large Volume of Margin Transactions.*—A very large proportion of the demand loans mentioned above are created when stocks are purchased on margin. When the buyer does not deposit with his broker the full purchase price the broker will usually finance the transaction by borrowing from the banks or other brokers, using the purchased stock as collateral. On active stocks, depending upon the state of the market, the banks will lend from 50 to 80 per cent of the market value of the stock. Whether one believes in margin dealing or not, the fact is that an exceedingly large proportion of the total credit outstanding in our important financial centers is thus borrowed. Even bond houses, in taking up issues of bonds with a view to their distribution to the public, originally obtain these bonds on borrowed money which is largely taken out in the form of "call" or "demand" loans. The volume of margin transactions is particularly large in the United States, as compared with foreign

countries. Moreover, the volume of such transactions is usually largest during periods of great prosperity, or at the very time when security prices and money rates are highest.

3. *The Need for Temporary Unsecured Credit.*—As previously explained, most securities purchased on "regular way" contracts must be delivered and paid for on the second full business day following the day of the contract. But the seller of these securities will not deliver them until payment is made, while the buying broker, if called upon to carry these stocks on margin, is unable to pay for them until he can obtain the necessary credit from the banks. In other words, the securities will not be delivered until paid for, and payment cannot be made until they have been obtained so that they may be deposited as collateral. Some one must take the first step, if the transaction is to be consummated.

Prior to the development of the money clearance services performed by the Stock Clearing Corporation, it was a common practice for the banker to permit the broker to overdraw his account on some agreed basis, by extending to him temporary credit. The understanding was that as soon as the securities were paid for and obtained, they would be delivered to the banker as collateral for the loan. Within recent years the need for temporary bank accommodation in the form of unsecured "day loans" has been greatly reduced. The clearing system, in so far as it applies to cleared securities, has been instrumental in bringing about this reduction. Thus, clearing figures for 1929 show that the value of contracts totalled more than $123,000,000,000 and that only a little more than $22,500,000,000 were actually required in settlement. The funds obviated during this year exceeded $100,000,000,000, or more than 81 per cent of the total.[2]

Definition of the Money Market.—A money market exists wherever a given set of supply and demand forces oper-

[2] *Annual Report of the President* of the New York Stock Exchange for 1929–30, p. 112.

ates in connection with the gathering of funds from different sources and the transferring of these funds to borrowers. In a broad sense there is but one money market in the United States, national in its scope. The commodity traded in, the dollar, is standardized and is so easily transferred from one part of the country to another that any shortage of funds in one locality can be immediately filled with funds from any distant locality. This has been particularly true since the passage of the Federal Reserve Act which established the Federal Reserve system of transferring funds by wire. In a narrow and more practical sense, however, this single money market is composed of a number of smaller money markets, the most important of which are located in the large financial centers. In other words, within each of our large cities a money market exists in which certain types of loans are made; and each type of loan with its interest rate may be regarded as being made in a market separate from the markets for other types of loans. An explanation of the structure of the money markets in our largest cities will help the reader to understand better, not only the nature and scope of these markets, but also their relation to trading in securities.

Structure of the New York Money Market.—The money market in New York City may be divided into two large divisions: the market for long-term loans, and the market for short-term loans. The second division may be divided into two type of markets: the open market, and the customers' market. These two types of markets may be further subdivided, as follows: [3]

A. The Open Market
   1. Bankers' acceptances (bills)
   2. Commercial paper
   3. Short-term United States Treasury obligations
   4. Security collateral loans (Brokers' loans)

[3] See Woodworth, G. Walter, *The Detroit Money Market*, University of Michigan Press, 1932, p. 175.

(a) Call or demand loans
(b) Time loans

B. The Customers' Market
1. Commercial loans
2. Security collateral loans
(a) Call or demand loans
(b) Time loans.

It is with the open market that we are here principally concerned. The open market differs from the customers' market in two important respects.[4] The chief difference applies to the relationship which exists between the lender and the borrower. In the open market the relationship is entirely impersonal. Each loan transaction is made without any obligations other than those contained in the loan agreement. In the customers' market the personal factor is important. The bank is acquainted with the customer, makes its loans according to his needs, and is obligated somewhat to take care of future needs of the customer. In turn, the customer usually has certain obligations towards the bank; for example, he may agree to keep a certain amount of funds on deposit. Another difference between the two markets lies in the source of the funds. Funds loaned in the open market, particularly the call loan market, are those which are not needed in the customers' market; they are surplus funds, which at the time cannot be used in the local market. This latter difference explains why the interest rates established in the open market are extremely sensitive to changing conditions. The surplus funds invested in the open market are secondary reserves, available when needed, for the purpose of adjusting the reserve position of the lender. They may be regarded as marginal funds, since most current financing is accomplished in the customers' market.

Importance of the New York Money Market.—The New York money market is the nation's best example of a

[4] See Riefler, W. W., *Money Rates and Money Markets in the United States*, Harper & Bros., N. Y., 1930, p. 9.

well-developed money market. Regardless of the basis on which a comparison is made, the predominant importance of the New York market is apparent. One of the most important reasons for the superiority of the New York market is the existence of its open market with extremely sensitive interest rates. The development of this market has established New York as the nation's market for surplus funds. No other city has an open market to compare with it, and in many of the larger cities there is no open market at all. In a few of the larger cities there is important trading in acceptances, commercial paper and short-term obligations of the United States Treasury; but even in such cases there is a tendency to carry out the purchases and sales in the open market in New York City.

There is only one important call loan market in the United States, and that is located in New York City. The law of New York provides that any call loan of not less than $5,000 in amount may carry such interest rate as is agreed to by the parties to the transaction. In recent years action has been taken in the states of Illinois and Pennsylvania to legalize any rate of interest on call loans for the purpose of developing call loan markets in Chicago and Philadelphia. However, in these centers the volume of call loans has not reached large proportions. Most call loans made in these cities (and elsewhere except in New York City) are, legally, demand or call loans, callable by either party; but by common agreement the loan is not to be called for a certain period. These loans are more like "time" security loans. Furthermore, they are not made in an open market, but are made in the customers' loan market. Rates of interest on such loans obviously will not correspond with those established in the call loan market in New York City.

The Market for Brokers' Loans in New York City.— Banks extend loans which are either unsecured or secured. The secured loans may be protected either by financial collateral in the form of stocks and bonds, or by commercial collateral in the form of commercial paper. Loans secured by stocks and

bonds may be created in several ways: a business may borrow for industrial or commercial purposes, using stocks and bonds as collateral; an individual may borrow in a similar manner for any purpose; and a broker may borrow on financial collateral to finance his or his customers' purchases. This last type of transaction is called a broker's loan.

Brokers' loans may be classified in different ways. They may be classified on the basis of maturity into call or demand loans and time loans. Legally, call loans may be terminated at any time by either party to the agreement. In practice, however, it is the custom not to call loans after noon, in order to protect the borrower by giving him ample time to arrange for the payment before the market closes. Loans called before noon are to be paid the same day. By custom, also, the borrower, when he desires to terminate the contract, is expected to repay loans during the first half of the business day. Time loans are similar to call loans except that they run at a specified interest rate for definite periods of time, usually three, six, nine, or sometimes twelve months. The amount of both call and time loans outstanding at any one time varies according to conditions, but call loans usually exceed time loans by a substantial amount because lenders prefer the call contract.[5] For this reason, also, the interest rate on time loans usually exceeds the rate on call loans. Brokers prefer the time contract for the funds which are needed for long periods, particularly if it is thought that interest rates will soon rise.

Brokers' loans differ with respect to the type of collateral behind each loan. Banks prefer stock collateral to be in 100 share lots and listed on the Exchange. The collateral must be diversified in order to give greater protection to the lender. Years ago railroad securities were more acceptable than any other type. As industrial securities became more important on the Exchange they were included as collateral. Just before the World War loans were known either as "regular" or "mixed,"

[5] See p. 344.

the collateral in the "regular" loan consisting of all rails, and the collateral in the "mixed" loan consisting of about two-thirds rails and one-third industrials. During and after the War "regular" loans consisted of half rails and the other half industrials, due to the decreased importance of railroad securities and the increased popularity of industrial securities. All rail loans are now rarely made and all industrial loans are common.

The Market for Call Loans in New York City.—Call loans, with securities as collateral, may be made directly between borrower and lender, through professional money brokers, or through the "money desk" located on the floor of the New York Stock Exchange. The personal element is important in the first method, and hence these loans are usually made in the customers' loan market. Loans made through money brokers may be classed as customers' loans or as open market loans, depending upon the degree in which the personal element enters. The personal element is entirely lacking in the last method, and the interest rate established in this manner is regarded as the real indicator of supply and demand conditions in the call loan market.

The procedure followed at the money desk in bringing together the lender and the borrower is simple. Each day, usually during the hours between 10 A. M. and 2:30 P. M., firm members of the Exchange who need funds to finance new transactions, or to repay old loans which are being called, communicate with their members on the floor. The floor member registers the request with the clerk at the money desk. Bankers, who wish to loan money, get in touch with exchange members and request them to enter their offers at the money desk. The clerk merely brings the borrower and the lender together, following the principle of giving preference to the requests according to the time of registration at the desk. When they are brought together the borrower and lender arrange among themselves all details regarding the loan. As previously explained, once the

loan agreement is effected it may be cancelled legally by either party on demand, but by custom, notice is not given after the middle of the day. Most call loans are allowed to run more than one day and when a loan is renewed, unless either the lender or the borrower objects, the renewal rate, as explained hereafter, applies.[6]

Time loans are never made through the money desk on the Exchange. They are made either through money brokers or through a direct contact of the borrower with the lender.

Information Relating to the Money Market.—In view of the aforementioned close dependence of the security market upon credit conditions, it is highly important that there should be available at frequent and regular intervals some authoritative information relating to banking conditions. Borrowers should be able to judge not only the available supply of credit but also the future trends of money rates. Numerous statements of this character are available. The daily newspapers of large cities carry interest rates for call loans, time loans, commercial paper, bankers' acceptances, and the Federal Reserve discount rates for each district. The New York Stock Exchange Bulletin, published monthly, contains classified data relating to total call and time loans, and data showing interest rates established in the open market. The Federal Reserve Board publishes each week a combined statement showing the resources and liabilities of the twelve Federal Reserve Banks, and a similar statement showing the condition of each of the Reserve Banks. These statements are very complete, and are probably the most important sources of information from a money market standpoint. In addition the Reserve Board publishes each week a statement of the condition of member banks in principal cities,[7] classified by Reserve districts, and also the volume of bank debits in such districts by months. All of these statements, and

[6] See p. 346.

[7] Since March, 1933 this report covers ninety cities; formerly it covered one hundred and one cities.

a wealth of similar information, such as foreign money rates, money in circulation, gold movements, etc., are contained in the Federal Reserve Bulletin, published monthly. Less technical are the Monthly Reviews published by the various Federal Reserve Banks. Mention should be made also of the periodic reports of the Comptroller of the Currency, with respect to all the national banks; and the English, French and German central bank statements, which are published weekly and are often important because of the close international relationship that exists between the New York and European money and security markets.

The information provided by these statements covers a wide field and some of it is highly technical in character. It is proposed in the rest of this chapter to discuss the meaning and use of some of the more important items of information from a stock-market point of view. First, however, in order to provide a background which will aid in interpreting many of the items of information, attention should be called to the elasticity in the New York money market as it existed prior to 1914, and to the changes in this respect which the Federal Reserve Act brought about.

Effect of the Federal Reserve Act on Elasticity of the New York Money Market.—It has been stated that the New York money market is the nation's market for surplus funds and that when such funds are invested in the New York market they may be regarded as secondary reserves, to be drawn out by the lender when needed. Idle funds which enter the New York market come from many sources. Unusual supplies or demands are registered in the New York market, and in times of financial stringency the New York market is the first to feel the strain. If funds deposited or invested there cannot be withdrawn when desired a panic results.

The commercial banks in New York act in three capacities in their relations with the money market. They keep large amounts of their own funds invested in the market; they act

as agents for out-of-town lenders; and they act as bankers for the money market itself. Consequently, any outside withdrawal or deposit of funds is at once registered in the reserves of these banks. Continued withdrawal of funds results in a decrease in reserves.

Prior to the passage of the Federal Reserve Act in 1914, the reserves of the New York banks were the best indicators of the condition of the money market. Each week the Saturday report of the New York Clearing House banks [8] showed, among other things, the amount of loans, cash, net demand and time deposits, reserve required and surplus reserves (or deficit). Any unusual demand for or supply of funds during the past week from out-of-town sources was reflected in the reserve items. When funds entered the market the reserves increased and money rates fell; when funds were withdrawn reserves decreased, and as they approached the legal minimum interest rates would rise sharply. Under the law there was no way to increase immediately the reserves to meet the extra demand.

The establishment of the Federal Reserve system greatly increased the elasticity of the money market. Extra demands for credit, which under the old system, would reduce reserves to a minimum and thereby sharply increase interest rates, now are met by the member banks obtaining funds from the Federal Reserve Bank. Bills, United States securities and commercial paper may be used as collateral for loans, or bills and commercial paper may be discounted. The reserve items of the New York banks, therefore, no longer have any great significance, and sudden credit changes no longer reflect themselves in interest rates to the same degree as formerly. Changes in the demand for and supply of funds are now reflected principally in the operations of the New York Reserve Bank.

[8] This statement showing the condition of New York clearing member banks is no longer published as described above. Since March 31, 1928, the report, published weekly, shows nothing but time and demand deposits, and capital and surplus.

To some extent the establishment of the Federal Reserve system has served to decrease the importance of the New York money market. Reserve banks have in a measure assumed some of the functions formerly performed by the New York banks. Member banks throughout the country now deal with their local reserve banks, borrowing funds from the reserve banks when they are needed, and paying off their debts with surplus or marginal funds.

Volume of Brokers' Loans.—Statistics showing the amount of brokers' loans, both call and time, are compiled and published monthly by the Federal Reserve Board and by the New York Stock Exchange. The reports of the former show the loans made by the metropolitan member banks in the New York Reserve district and the reports of the latter show the amount borrowed by members of the Exchange. Both call and time loans, as reported by the Federal Reserve Board for member banks in New York City are divided into three classes: loans for the account of the member banks designated "own account"; loans made by the metropolitan banks for the account of American "out-of-town banks"; and loans made for the account of "others." Loans in the last class, prior to the passage of the Banking Act of 1933, consisted chiefly of loans made by the member banks for individuals, corporations (such as insurance and investment companies), and foreign banks. Section 11 (a) of the Banking Act of 1933 provides that "no member bank shall act as a medium or agent of any non-banking corporation, partnership, association, business trust, or individual in making loans on the security of stocks, bonds, and other investment securities to brokers or dealers in stocks, bonds, and other investment securities." Loans by non-member banks and "others" are further restricted under the provisions of the Securities Exchange Act of 1934. Section 8 (a) of this Act makes it unlawful for any exchange member, broker, or dealer, directly or indirectly, to borrow on any security registered on a national securities exchange (other than an exempted

security) "except (1) from or through a member bank of the Federal Reserve System, (2) from any non-member bank which shall have filed with the Federal Reserve Board an agreement, . . . to comply with all the provisions of this Act, the Federal Reserve Act, as amended, and the Banking Act of 1933," and all rules and regulations which apply to the extension of credit for the purpose of financing security transactions, or (3) "in accordance with such rules and regulations as the Federal Reserve Board may prescribe to permit loans between such members and/or brokers and/or dealers, or to permit loans to meet emergency needs." Section 7 (c) provides that it shall be unlawful for any exchange member, broker or dealer to "extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer on any security (other than an exempted security) registered on a national securities exchange, in contravention of the rules" of the Federal Reserve Board. Similarly section 7 (d) makes it unlawful for any person (not an exchange member, dealer or broker), "to arrange for the extension or maintenance of credit for the purpose of purchasing or carrying any security registered on a national securities exchange, in contravention of" the rules of the Federal Reserve Board. There are certain exceptions to this last provision, such as loans effected not in the ordinary course of business, loans to aid in the distribution of securities, loans by a bank on a security not an equity security, etc. The Stock Exchange statistics for total loans are presented in two ways: (1) call and time loans; and (2) loans "from New York banks and trust companies," and loans "from private bankers, brokers, foreign bank agencies, and others in New York City."

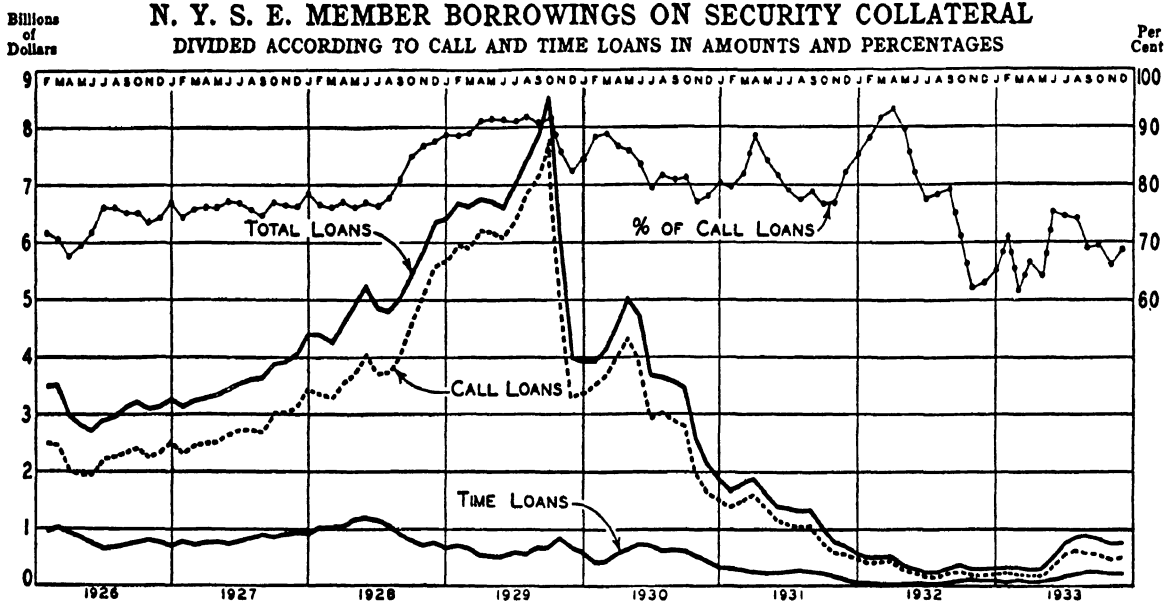
The reports of the Exchange and the Federal Reserve Board do not show the same total loan figures, since they are derived from different sources. The Stock Exchange report does not include the loans of non-members, while the Federal Reserve report does not include the loans made by non-member banks such as private banks and foreign bank agencies. The loans

reported by the New York Stock Exchange designated "from New York banks and trust companies" correspond closely to total loans as reported by the Federal Reserve Board.

The student of the money market will find both the Exchange and Federal Reserve reports extremely useful in determining the volume of credit which is being used in the security markets. He should use them according to the purpose which he has in view. Thus, he may prefer the Exchange reports if he is interested in total loans because they more adequately cover the field. Graph number one shows that total loans for all Stock Exchange members amounted to a little more than three and one-half billions of dollars on February 1, 1926 (when the Exchange began to gather and publish these figures). Total loans rose steadily from the middle of 1926 until October 1, 1929, when they reached their high of more than eight and one-half billions. Within the short space of two months these loans declined more than 50 per cent to four billions; and except for a slight rise during the first part of 1930, the decline continued until the middle of 1932 when they were only $241,599,-943. Thus from the first of October, 1929, until August 1, 1932, brokers' loans declined approximately 97 per cent.

Graph number one also shows the amounts of time and call loans. The amount of time loans relative to call loans should be noted. Some persons believe that a decreasing proportion of the former naturally indicates a growing element of uncertainty in the money market. It is interesting to note that during the period extending from the middle of 1928 to October 1929 call loans increased greatly while time loans declined during all except the last few months of the period.

The situation in 1928 and 1929 in connection with brokers' loans made the Federal Reserve Board's figures valuable to those interested in the money market. The situation referred to was the increased importance of the loans made for the account of others, as contrasted with loans made by the banks for their own account. The following figures show the total call and



GRAPH I

From *New York Stock Exchange Bulletin*, Dec. 1933.

time loans as reported by the Federal Reserve Board for certain dates in 1928 and 1929:

TOTAL BROKERS' LOANS *

(in million dollars)

For week ending	*Total*	*For own account*	*For acct. of out-of-town Banks*	*For acct. of others*
Jan. 4, 1928	3,810	1,511	1,371	927
Jan. 2, 1929	5,330	1,516	1,648	2,166
Oct. 23, 1929	6,634	1,077	1,733	3,823
Oct. 30, 1929	5,538	2,060	1,005	2,464
Nov. 20, 1929	3,587	853	704	2,031

* Reported by member banks in New York City.

Total loans increased almost 75 per cent from January 4, 1928 to October 23, 1929, but most of this increase was due to more than a 300 per cent increase in the amount of funds loaned for others. During this period loans for the account of the New York member banks decreased sharply, while loans for the account of out-of-town banks rose from $1,371,000,000 to $1,733,000,000. Loans for the account of others, however, rose from $927,000,000 to $3,823,000,000.

As early as 1928 the opinion was expressed that the increase in loans for others was a sign of weakness, since non-banking lenders had no public responsibility towards the money market. It was feared that such lenders would lend indiscriminately and then be inclined to withdraw their funds at the first sign of an emergency. This is actually what occurred. The great decline in stock prices started on October 24, 1929, when sales of stock amounted to more than twelve million shares. By November 14, the selling panic was over. During the week ending October 30, total brokers' loans declined $1,096,000,000; but, whereas loans for the account of others decreased $1,359,000,000 and loans for out-of-town banks fell $728,000,000, loans for the account of New York member banks increased $992,000,000. The New York banks assumed the burden of

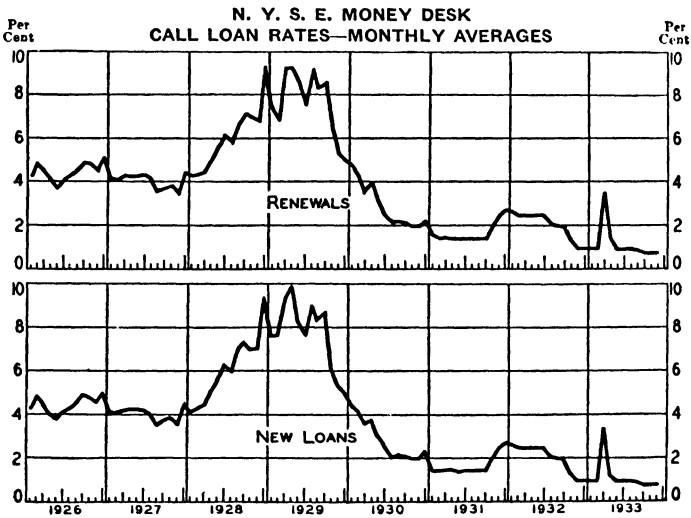
supplying temporary credit which had been suddenly withdrawn by the other lenders. By November 20, however, the New York banks had liquidated to such an extent that their loans were lower than those existing at the close of the week ending October 23.

Interest Rates on Brokers' Loans.—As previously stated call loans may be effected between borrower and lender directly, through money-brokers, or through the money desk on the floor of the New York Stock Exchange. Rates established at the money desk are regarded as the best indicators of call money conditions since the market there is the most highly organized and the freest of all the loan markets.

At any time during business hours two interest rates on call loans exist at the money desk on the New York Stock Exchange. One is the market rate which applies to new loans, and thus is subject to change from time to time during the day; the other is the renewal rate which is fixed in the morning and applies to old loans which are to be renewed that day. Neither the borrower nor the lender has to accept the renewal rate, but if neither party objects it is understood that the renewal rate applies for that day. Well over 90 per cent of all call loans are carried over from day to day and for this reason the renewal rate is of great importance. Because of the expert care exercised by the Executive Committee of the Stock Exchange Clearing Corporation in arriving at the renewal rate it is generally accepted as representative of supply and demand conditions. From 1922 to 1929 the average variation between the average of renewal rates and that for new loans amounted to only 0.04 of 1 per cent.[9] This close relationship is shown by graph number two for the years 1926 to 1933 inclusive. Because the graph is compiled from monthly averages it does not show the peak of 20 per cent which call loan rates reached in the spring of 1929.

[9] Meeker, J. E., *The Work of the New York Stock Exchange*, Ronald Press Company, 1930, p. 296.

Since the establishment of the Federal Reserve System call loan rates have not fluctuated as violently as formerly. Thus in 1890 call loan rates reached 186%; in 1892, 40%; in 1893, 73%; in 1895, 100%; in 1896, 127%; in 1899, 186%; in 1901, 75%; in 1905, 125%; in 1906, 60%; in 1907, 125%; in 1919, 32%; in 1929, 20%.[10] It should be remembered, of course, that



GRAPH II

From *New York Stock Exchange Bulletin*, Dec. 1933.

these rates are for new loans only, that they are on a per annum basis, and that in most cases they applied for one or not more than several days. However, high rates existed for weeks at a time during some of the above years. During 1907, for example, call rates ranged for several weeks between 50 and 100 per cent; and during the latter part of 1928 and most of 1929 call rates ranged around 8 per cent.

[10] Meeker, *op. cit.*, p. 630.

Rates for ninety-day brokers' loans correspond closely with renewal rates for call loans; in more normal times the time loan rate is somewhat higher than the call rate, but frequently during 1928 and 1929 the reverse was true.

Federal Reserve Board Weekly Statements of Conditions.—The Federal Reserve Board on Thursday afternoon of each week issues two important statements showing the condition of the reserve system as of the close of business on Wednesday. One statement shows the combined resources and liabilities of the twelve Federal Reserve banks; the other shows the resources and liabilities of each reserve bank separately.

The combined statement of condition, with forty-two items, is more complete than similar statements of most other banks of issue. Its completeness is all the more apparent when it is compared with the comparatively simple weekly report of the New York Clearing House published prior to 1914. The New York Clearing House statement was the leading bank statement prior to the passage of the Federal Reserve Act.[11] As previously stated, the reserve items on the statement were used by all money market students in their analysis of money conditions. The reserve items were significant because the New York City banks were the holders of the surplus reserves of the country. When the Clearing House statement showed reserves greatly in excess of those required, funds were plentiful and the money market was easy; when reserves were low or a deficit was shown, it indicated a shortage of funds and a tightening of credit.

With the establishment of the Federal Reserve system it was but natural that money market students should seek some one item in the weekly statements of the Federal Reserve Board which would be a substitute for the reserve figures given out by the New York City Clearing House. The item showing the

[11] The open markets in bankers' acceptances and short term treasury certificates were not developed until after the establishment of the Federal Reserve system.

ratio of total reserves of the twelve reserve banks to their deposit and note liabilities [12] appeared to be the logical successor to the old reserve items. It showed the position of the reserve system with respect to reserves, just as the reserve items in the old Clearing House statement showed the reserve position of the clearing members. This item, however, has been of little use as a money market index, principally because the large gold holdings of the Federal Reserve banks have kept the ratio far above its minimum most of the time. Furthermore, the gold holdings have kept the ratio so far above the minimum that its fluctuations have not been of any great importance.[13]

It is doubtful if any one item in the Federal Reserve weekly condition statements will serve in the same manner as the reserve items served prior to 1914.[14] Probably the best single item, however, which can be used as a substitute for the old reserve items is that of "total bills discounted." This item,

[12] This item has not been published since May, 1933. Instead the "ratio of total gold reserve and other cash to deposit and Federal Reserve note liabilities combined" has been used. The change was made because of a change in the law which eliminated the distinction between legal and non-legal tender. (See section 3 of the Agriculture Adjustment Act, passed May 12, 1933.) Because of this change the ratio is now somewhat higher than it would be on the old basis. The new ratio, however, is subject to the same defects as the old when used as a guide to money market conditions.

[13] In 1933 the ratio reached the low of 45.6 per cent on March 8, as compared with 53.5 per cent on March 1st and 61.2 per cent on February 21st. On March 15th the ratio rose to 49.1 per cent and on March 22nd it was 55.5 per cent.

[14] Increased data, which have been available since the establishment of the Federal Reserve system, have permitted a better explanation of money market changes; but no better single index of current money market changes than the old Clearing House statement of reserves has been found. Furthermore, because of the elasticity introduced by the Reserve Act, it seems unlikely that any comparable item will be found. Much of the period which has elapsed since the establishment of the Reserve system can be characterized as one in which money market statistics have increased enormously in volume. In recent years efforts have been directed more toward improving the quality of and analyzing available data, rather than increasing the volume thereof.

found on the Federal Reserve combined condition statement is one of three items which makes up the item of "total bills and securities." The other two items are: "bills bought in the open market," and "total United States Government securities." Since all three of these items, as well as their total, are valuable indicators of money market conditions, the money market student should have some knowledge of what they represent and how they may be used.

In a general way the item of "total bills and securities" may be used by the investor or speculator in securities as a money market index. Total bills and securities show how much credit, in total, the Federal Reserve banks are extending to their members in the form of loans and investments. The credit, so extended, is based upon the demand for funds. When demand increases relative to supply, total bills and securities go up; when demand decreases, total bills and securities go down. Viewed from another angle, it may be said that the reserves of the member banks are deposited with the Federal Reserve banks and that the amount of total bills and securities at any given time shows to what extent these reserves are being put to work through investments and the extension of credit based upon them.[15] Prior to the establishment of the Federal Reserve system the wise investor, banker, or business man would proceed cautiously when the New York Clearing House statement showed that reserves were nearing the minimum requirement. Now caution should be exercised when total bills and securities are rising and appear, in the judgment of the observer, to be too high.

A better index for the average money market student, and, as stated before, the one which is most comparable in value to the New York Clearing House statement of reserves, is the item "total bills discounted." A change in the item of total bills and securities, mentioned above, may be due to a change

[15] Prior to 1925 the item "total bills and securities" was called "total earning assets."

in the demand and supply factors affecting any one or more of the three items of which it is composed. The change may be brought about by the reserve banks taking the initiative in the purchase or sale of Government securities, or by the member banks taking the initiative in obtaining funds through the sale of bills, or discounting eligible paper. Changes in total bills discounted, however, are caused solely by member banks borrowing from the reserve banks by the discounting process. Member banks, when they have a deficit in reserves, will borrow from the reserve banks to meet reserve requirements. When, however, they become heavily in debt to the reserve banks, efforts will be made by member banks to reduce these debts by calling loans and selling investments. When member banks owe the reserve banks little or have credit balances with them, they tend to lend freely at low interest rates. Thus there is a close relationship between total bills discounted and interest rates.[16]

"Bills bought in the open market" represent largely the sale of bankers' acceptances to the Federal Reserve banks by dealers and by member banks when they wish to increase their reserve positions in this manner. If a bank has been losing money because of out-of-town withdrawals, or currency withdrawals, it may sell bills to the reserve bank and in this manner secure funds to restore its reserve position. Dealers in bills may also sell bills to the Federal Reserve banks under a sales contract whereby they agree to repurchase them within fifteen days. The bill market has brought about closer relations between the money market in this country and money markets abroad. Foreign banks are familiar with bills and since the

[16] For the years 1924 to 1929, inclusive, the coefficient of correlation between bills discounted and time money rates, based on average monthly data, was found to be .87. The coefficient between bills discounted in New York City and interest rates for this same period was found to be .70. See Burgess, W. Randolph, *Progress of Money Market Statistics*, Journal of the American Statistical Association, Suppl. 173A, March 31, 1931, p. 151.

establishment of a bill market in the United States, foreign bankers have at times invested large amounts of funds in American bills. The foreign funds so invested become available to borrowers in our money market. Whenever foreign purchases of bills impose an obligation upon a reserve bank they are listed on the condition statement under the last item called "contingent liability on bills purchased for foreign correspondents."

"Total United States Government securities" shows the amount of such securities held by the Federal Reserve banks as a result of open market operations. Open market operations of the Federal Reserve banks have such an important effect on the stock market that they will be explained in the following section.

Federal Reserve Open Market Policy.—Under the Federal Reserve Act the reserves of member banks must be kept on deposit with the reserve banks and they in turn are given power to regulate the use of the reserve funds in their possession. When additional funds are needed by member banks they must apply to the reserve banks for the needed funds and meet the requirements which have been imposed in order to obtain them. The Federal Reserve Board and the directors of the reserve banks have the responsibility of controlling the use of reserve funds so that business and other legitimate needs can be adequately met, without, however, fostering rising prices, inflation, speculation and other undesirable economic consequences.[17] The two chief means of controlling the use of reserve funds are the open-market operations and the discount rate.

In a broad sense, open-market operations include the pur-

[17] Open-market operations are now carried out through an open-market investment account, in which all twelve reserve banks may participate. The account, and the policy followed in its operation, are under the control of a committee representing the reserve banks, called the Federal Open-Market Committee. Open-market operations must be carried out in accordance with the rules and regulations prescribed by the Federal Reserve Board.

chase and the sale of bankers' acceptances, Government securities, and of other types of securities permitted under section 14 of the Federal Reserve Act. In a narrow sense the term includes only the purchase and the sale of Government securities because it is only in these transactions that the reserve banks can exercise initiative in buying and selling. The outright purchases and sales of Government securities made by the Federal Reserve Banks provide not only a means of influencing the money market, but as will be mentioned shortly, they may be used to prepare the money market for a change in the discount rate in order to make it effective. The immediate effect of open-market purchases of Government securities on money market conditions depends principally upon whether or not member banks are in debt at their Federal Reserve banks. If most banks are in debt with their reserve banks, then the reserve funds paid out for Government security purchases will be used by member banks to reduce their indebtedness. If the reserve banks sell Government securities the checks received in payment therefor will be charged against the reserves of the member banks on which they are drawn. This reduces member bank reserves and may cause member banks to borrow from the reserve banks or sell to them bills in order to restore their reserves. Thus, because member banks always tend to reduce their indebtedness to reserve banks, the reserve banks by increasing their holdings of Government securities can decrease the indebtedness of member banks; and by selling Government securities the reserve banks can increase member bank indebtedness. By such open-market activities the reserve banks are able to create easy or tight money conditions. Purchases of Government securities tend to decrease member bank indebtedness and hence cause lower interest rates. Sales tend to produce the opposite effect: they increase member bank borrowing and cause members thereby to adopt a less liberal lending policy. If member banks do not owe anything to the reserve banks, open-market purchases of securi-

ties will serve to put additional funds in the possession of the member banks and they in turn will deposit the funds with reserve banks, thus further increasing their reserves and their capacity to make loans and investments. If while open-market purchases are being made, conditions are such that loans and investments are not made, due to a lack of demand or some similar reason, member banks will continue to increase their credits at the reserve banks.

In the past purchases of securities have been made by the reserve banks during periods of declining business, price weakness and disturbed credit conditions. Sales, on the other hand, have been made during times of increasing activity in business, rising prices, and general business optimism. It is not possible to trace the exact effect of open-market operations on such subjects as business conditions, stock market prices, and commodity prices, mainly because other factors are always present to exert their influence in these fields. One point, however, should be mentioned in this connection. Prior to the enactment of the Banking Act of 1933 the reserve banks, through their open-market operations had control over the total amount of credit which they could extend, but they had no specific authority over how it was to be employed. They dealt only with member banks; the latter made their loans as they saw fit. The funds could be used by member banks for stock market loans, the financing of business transactions of various kinds, or in any other legal type of loan or investment. The Reserve system did not provide any safeguards against improper and unwise use of credit. The Reserve authorities could endeavor only to adapt the total amount of credit to the total business needs at any one time and possibly, through warnings and opinions regarding current conditions and dangers, influence the use of the credit in a proper manner. The changes which the Banking Act of 1933 brought about in the authority of the Reserve banks, and the Federal Reserve Board, over open-

market operations will be explained after a discussion of the discount rate.[18]

The Discount Rate.—Each of the twelve Federal Reserve banks, with the approval of the Federal Reserve Board, determines what rate will be used in its district for discounting purposes. The discount rate for a given district indicates the price which will be paid to member banks for commercial paper. It is the rate at which the reserve bank will lend its money in discounting eligible paper.

The factors which from time to time influence the reserve banks in determining their discount rates are numerous; only a brief mention of some of the more important ones may be made here. Experience has shown that usually the discount rate should be somewhere between the open-market rates for commercial paper and that for ninety-day bankers' acceptances. A discount rate so placed will provide the necessary funds for business, and usually it will not be so low as to induce borrowing for speculative purposes. Those who control the discount policy will watch changes in the volume of credit being extended by the reserve banks, and if speculative or other abuses appear, a change in the discount rate may be made in an attempt to correct the situation. For the purpose of studying credit changes throughout the country the Federal Reserve Board in 1917 began the collection of weekly data from several hundred member banks in more than one hundred principal cities. These weekly data are collected in itemized form so as to show, not only volume of credit extended, but also how the credit is being used. The weekly report of resources and liabilities for these member banks shows total loans, subdivided into loans on securities, and all other loans; and total investments subdivided into United States Government securities, and other securities.[19] Since January, 1926, New York City member

[18] See p. 356.

[19] This report now covers member banks in ninety cities. See p. 338.

banks have been required to report loans to brokers and dealers in securities when such loans are secured by stocks and bonds.[20] Other factors which influence the discount rate are: condition of business; price trends as evidenced by wholesale prices, wages, security prices, real estate prices, etc.; conditions in foreign countries; and the flow of gold.

In the past the open-market policy and the discount rate have been used together by the Federal Reserve Board to bring about the result desired. For example, the way may be prepared for a lower discount rate by the purchase of Government securities. Such purchases will enable the member banks to reduce their indebtedness to the reserve banks and thereby bring about easier credit conditions and lower interest rates. After the discount rate is reduced open-market operations may be continued in order to make the new rate effective.

Credit Policy in 1928 and 1929 and the Banking Act of 1933.—In 1928 the Federal Reserve Board was aware of the increasing use of credit in connection with speculative activities in stocks, and it took the usual steps to correct the situation.[21] In the first half of 1928 the discount rate at the Federal Reserve Bank of New York was raised three times, the total increase being from 3½ to 5 per cent. In addition the open-market operations of the reserve banks followed a policy of credit contraction. Such moves, however, did not correct the situation and it became evident by the first part of 1929 that some further steps would be necessary. Rather than raise the discount rate further, and thus make it more difficult for legitimate business to obtain funds, the Board decided to adopt a policy of "direct pressure." Accordingly on February 2, 1929, it sent a letter to all Federal Reserve banks in which it recom-

[20] See p. 341.

[21] For a more complete discussion of open-market and discount operations and the efforts of the Reserve authorities to control the use of credit during the recent bull market the reader is referred to Weyforth, William O., *The Federal Reserve Board, A Study of Federal Reserve Structure and Credit Control,* the Johns Hopkins Press, 1933, Chapters III and IV.

mended that reserve banks refuse their rediscount facilities to member banks when the funds were to be used "for the purpose of making speculative loans or for the purpose of maintaining speculative loans." [22]

The Reserve Bank of New York, and several other reserve banks did not approve of such a recommendation. The New York authorities felt that the Federal Reserve Act did not give them authority to refuse to rediscount for such a reason, when the paper presented was eligible and the requirements for rediscounting were otherwise met. The New York Reserve Bank also was of the opinion that attempts to control reserve credit in such a manner as to direct it into particular channels were ineffectual and impractical. On February 14, the New York Bank asked the Federal Reserve Board to approve an increase in its rate from 5 to 6 per cent. The Board would not approve the increase, and from this date until May 23 nine additional requests were made by the New York Bank. During the same period the Board also refused requests for an increase in the rates at the Boston and Chicago Reserve Banks. In all of these cases the increased rates were desired mainly to curb the reckless speculation in stocks. The New York and other reserve banks which wanted to increase rates thought that frequent raising of the rate would impress the public and thus increase the effectiveness of the policy which the system was pursuing. On the other hand, the Federal Reserve Board did not believe that the increased rate would curb speculative activity and felt that it would be harmful to legitimate business. The Board followed its policy of "direct pressure" until June, 1929. In August it gave its permission for an increase in the New York rate to 6 per cent.

The facts cited above reveal two conflicting situations. One had to do with the Board's authority over discount rates; and

[22] *Hearings before a Subcommittee of the Committee on Banking and Currency, United States Senate, 71st Congress, 3rd Session, pursuant to Sen. Res. 71, p. 142.*

the other, the authority of reserve banks over lending policies of member banks. Both were due to the indefinite phraseology of certain parts of the Federal Reserve Act. Section 14 of the Act states that every reserve bank shall have the power "to establish from time to time, subject to review and determination of the Federal Reserve Board, rates of discount to be charged by the Federal Reserve bank for each class of paper, which shall be fixed with a view of accommodating commerce and business." Various interpretations of this provision have been given, but authorities still differ regarding the powers of the Board and the various reserve banks over discount rates. Before 1933, due to the indefinite wording of the Reserve Act, there was no common agreement among Federal Reserve officials regarding the amount of discretion which the Federal Reserve banks might use in the granting of credit to individual banks. Furthermore, the policy of "direct pressure" which the Federal Reserve Board tried to carry out in 1929 raised questions regarding powers both of the Board and the reserve banks in the formulation and execution of credit policy. The Banking Act of 1933 contains a number of provisions relating to these points.

Section 3 of the Banking Act of 1933 expressly permits a Federal Reserve bank to exercise discretion in the making of loans to member banks, whenever after investigation the bank feels that credit is being used unwisely for trading in securities, real estate, commodities or in any other unsound manner. There is thus an abandonment of the old theory that Federal Reserve banks could not control in any way the banking policy of the member bank. In addition, the Banking Act provides that the Federal Reserve Board may, at its discretion, after giving proper notice and an opportunity for a hearing, deny to any member bank the right to use the credit facilities of the Federal Reserve System, if it finds that the member bank is extending its credit unwisely. The Board has this control over

the loan policy of individual banks even against the wishes of the local reserve bank.

Section 9 of the Banking Act makes it possible, for either the Federal Reserve Board or a reserve bank, after an official warning by either, to deprive a member bank of its privilege of borrowing from its reserve bank on its collateral note, if such member bank increases its own collateral loans secured by stocks or bonds, or loans made to dealers in securities for the purpose of purchasing and carrying securities.

Section 7 of the Banking Act provides that the Federal Reserve Board, upon approval of six of its members, shall have the power to determine the percentage of bank capital and surplus beyond which member banks within any district may not lend, when stocks and bonds are used as collateral. Furthermore, the Board is given the power to order any member bank to cease making for one year any further loans secured by stocks and bonds, under penalty of losing all rediscount privileges.

Section 30 of the Banking Act confers upon the Federal Reserve Board the authority to remove any officer or director of a national or state member bank who, after proper warning, continues to violate any law relating to such bank, or continues unsafe and unsound practices in the conduct of the business of the bank.

All the above provisions of the Banking Act enlarge the control of the Federal Reserve Board over the loan policies of individual banks. They are intended to prevent the unwise use of Federal Reserve funds in stock speculation. Each Federal Reserve bank is authorized to use "direct pressure" to curb speculation in stocks; and if the Federal Reserve bank does not see fit to take action, as the New York Bank did not in 1929, the Federal Reserve Board may on its own initiative put a policy of "direct pressure" into effect.

Other Bank Statements.—As previously stated the statement of condition of the twelve Federal Reserve banks is pub-

lished weekly in two forms: the combined statement of condition, and a similar statement showing the condition of each of the Federal Reserve banks. Since the two statements are very much alike, what has been said in connection with the combined statement applies equally well to the figures for any one reserve bank. The average investor will find that the combined condition statement will usually serve his purpose, and that he can generally ignore the figures for the individual reserve banks.

The weekly statement for member banks in ninety principal cities has already been described in connection with the discount rate.[23] The data in this statement, classified according to reserve districts, give a good picture of credit conditions in each region. Two items of importance, not mentioned above, are reserves and indebtedness at reserve banks. As stated before, when member banks are in debt to the reserve banks, there is a tendency, which amounts almost to a tradition, to call loans and sell investments in order to lower their debts. Since deposits, both time and demand are given in this statement, it is possible to calculate therefrom the ratio of loans or loans and investments to deposits. These ratios have been stressed by some as important because they are supposed to indicate the degree of pressure on banks for credit, and also to supply an indication of the soundness of the banking situation. The value of such ratios, however, is questionable, because a number of factors might cause a change in the ratio and it is often difficult to tell just what the change means. Thus, if there is a decrease in the ratio of loans to deposits during a given period the decrease might arise from an increase in the proportion of demand deposits as compared with time deposits. Larger reserves are required for demand deposits, and hence if total deposits do not change there will be less funds for loans and investments if demand deposits increase and time deposits decrease. Or, the decrease

[23] The data in this report are always a week behind those for the reserve banks themselves.

in the ratio may be due to an increasing proportion of the total business of the reserve district being done by city banks because these banks have to hold larger reserves than country banks. Other factors may explain the decrease, but the two mentioned are sufficient to show the difficulties involved in the use of such ratios in connection with the statement of condition of member banks.

Prior to the passage of the Federal Reserve Act the clearing houses in New York and other principal cities published weekly detailed statements showing the condition of clearing members. After the Federal Reserve Board began to publish its numerous data relating to the money market, the clearing houses in the various cities began to contract their statements. Since the country-wide bank moratorium in March, 1933, clearing houses in many cities have stopped publishing any form of clearing statement, and others publish only the barest kind of report. The student of the money market, if interested in individual banks, is unable at the present time to get worthwhile weekly data for individual banks for purposes of analysis; in many cases he must wait for the periodical report of the bank itself.

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CHAPTER XIX

FINANCIAL CRISES AND BUSINESS DEPRESSIONS

The Cause of Security Market Panics and Business Depressions.—Probably no phase of the stock market, unless it be that of manipulation, has claimed the attention of so many writers as our constantly recurring financial crises and business depressions. Attention has no doubt been attracted to this phenomenon because of the drastic character of the liquidation involved. In fact, the movement of prices accompanying our economic crises is in the nature of an upheaval, and often the decline of one or two years will suffice to cancel all the appreciation of the preceding five or ten years. This is true of both security and commodity prices, since our economic crises are caused by influences intimately associated with both types of markets.

While secondary causes may contribute to make economic crises more severe, or to shorten or prolong the duration of the same, the real underlying cause is over-speculation with borrowed funds, leading to an over-extension of our credit system. The situation is commonly referred to as one of "inflation," requiring "deflation" as its remedy. With scarcely an exception writers on the subject regard such over-extension of credit as the primary cause, and it is for this reason that the regular appearance of some index showing the condition of the credit market, such as comprehensive bank statements, is of such vital importance. In fact, economic crises, as pointed out by Professor E. D. Jones, had their origin with the beginning of the credit system. When credit has been over-extended through speculation along all lines of business activity—in real estate, manufactur-

ing, mining, wholesaling and retailing—and not merely in the security market, and much of this credit has been foolishly granted, as seems always to be the case during periods of great prosperity, a period of liquidation must follow to correct the situation.[1] Or, as some state the matter: too much action, as compared with normal, is sure to result in reaction.[2] Credit implies confidence on the part of the creditors that debtors will be able and willing to repay loans, and it is with this thought in mind that Professor Jones, in his chapter on Credit and Speculation, makes the following statement:

"To understand the dangers inhering in the use of credit it is necessary to observe the sensitiveness of the instrument. Depending as it does on confidence, it is as changeable as the course of public thought. . . . The extension of credit is accompanied by the realization that if any large part of the mechanism of trade should meet with disaster capable of shaking confidence, the result would be the withdrawal of credit and the consequent stringency in the money market. A nervous watch is, therefore, maintained for such occurrences and the dread of the headlong rush for liquidation, in which some must inevitably be crushed, always lurks in the background of modern industry."

Popular Psychology Underlying the Boom and Crisis Periods of the Industrial Cycle.—The customary procedure of popular thought during these periods of the industrial cycle may be illustrated with the experience of the past five years. During the prosperous years of 1928–29 innumerable people borrowed beyond their capacity in a high state of hope. The banker himself, being human, is just about as speculative as the rank and file, and almost stands at the door beckoning to humanity to come and borrow money at the fancy rates of 7 and 9 per cent, as they did in 1929, in order to buy securities which net only 2 or 3 per cent on the purchase price. The movement reaches proportions hardly believable, but the speculators

[1] See E. D. Jones, *Economic Crises.*

[2] This is the theory that underlies the Babson "Barometer Letter."

are frank in explaining that they are not buying for income, but simply because they believe that the market will go higher, thus affording them an opportunity to sell to the next man.

Everybody seems to love the bull racketeer, and probably the most hated individual in the financial community is the short seller. Yet he is an angel, as compared with the bull racketeer, who really lays the basis for all the trouble, as he did during the bull years of 1928 and 1929. Every device known to man is used to help the work of boosting. Thus we have preached to us the so-called "new era philosophy," which is by no means new and which has often in the past been paraded under one name or another, when those who know more are anxious to distribute their securities, real estate and other property to those who do not know so much. The multitude is told that: "things are different this time from what they have ever been before; don't be afraid; our banking system is new and it is sound. Nothing can happen because we live in an era which is different from any era before." Finally, however, the explosion comes, as it came in October and November of 1929, and following that explosion in the stock market, business begins to let up.

But no one takes kindly to the stock market as a forerunner of business conditions, and we are thus obliged to go through a process of very interesting economic reasoning—very wrong but nevertheless interesting. We are first told that what has happened in the stock markets of the country, although it amounted to the wiping out of some $50,000,000,000 of quoted values in the two months of October and November of 1929, does not mean anything, "because those are stock market quotations and do not represent intrinsic value." But sight must not be lost of the fact that from the standpoint of collateral behind loans, or for purposes of estate valuation, property is only worth what one can obtain for it, namely, the current quotation. We are also told at the beginning of the depression movement that the wealth which disappeared through the de-

clining quotations is only "paper wealth." That may be a consoling view to those who have lost, or who have borrowed, but after all what is all wealth but paper wealth? We measure our whole estate by the current quotations of bonds and stocks, real estate, life insurance and whatever we own. We also hear much under the convenient slogan of "fundamental conditions are sound."

As time goes on the economic situation gets worse; the vicious cycle has started; economy is being practiced by everybody because they all feel poorer. Then we enter into a new philosophic line of thought, namely the "buy movement," in the belief that prosperity will return only if everybody will undertake to buy things. This line of thought is also a mere repetition of what occurs in every one of our depressions. Posters are put up, speeches are made, and everybody is told that the only way to get out of the trouble is to buy. And the advice is particularly directed to the humble worker, the owner of a job only. But that humble worker is also displaying his good sense. He reasons with his family: "I feel we must be conservative; I don't know how long I shall have my job; I see workers all around me discharged almost daily; I stress caution in our expenditures." Along this line one may wonder why the leaders of business advise others to buy and do not practice the buying themselves. If asked: "Are you buying your raw materials now, your cotton, wool and wheat, in liberal quantities for future use," the answer will be: "No; you know these things are going lower, and it certainly isn't good business for me to load up with an inventory now which will depreciate on me." One may well raise the question with these leaders of business: "Why don't you start and set the example and get business to pick up if this buying campaign is the proper one to follow?"

Finally economic conditions gravitate from the blue to the jet black, as witness the conditions during the last half of 1932 and the first half of 1933. Usually the jet black period

becomes apparent when the sunshine philosophy, which has previously been preached so strenuously, has come to a stop. It is in this stage that we all begin to busy ourselves with the real problem—the cause of the crisis—namely debts, debts, debts. These debts must be substantially liquidated in some way, and governmentally and otherwise we set about to accomplish this purpose in one way or another. But it is interesting in this period again to have another new era idea presented, namely "forget the stock market; this time business will pick up first and then the security market will begin to improve." That new era idea is just as refreshing as the one of 1929, and it is also just as untrue. We can have no recovery in business with a constantly declining stock market. The stock market precedes and business follows, and not the reverse.

"When will the depression end?" is finally the most universally asked question. The best answer to that question is the stock market. It will tell us when we have turned the corner definitely and are headed for better things. There will come a time (as witness the huge rise of the stock market during the year from June, 1932, to July, 1933, despite the jet black news of that year) when the stock market will begin its rise, probably when we least expect it. The rise will continue until it passes through the last preceding high from which the last and lowest decline (which reached its culmination in June of 1932) of the depression made its start. That preceding high was passed by the bull market which started in the latter part of 1932 and culminated its first stage in July of 1933.

Speculation gets us into all of the trouble, but speculation alone can get us out of the difficulty. Speculation for the rise is simply another expression for the word confidence. The dinner pail, during periods of depression, is vitally associated with speculation. The stock market is the mercury which indicates the tendencies of the future and convinces shrewd business men that they had better begin their buying—not just for immediate use but for distant future delivery. Commodity prices will

then begin to rise and the wheels of production will begin to turn.

Effect of Economic Crises on Stock Market Prices.—The drastic character of stock market liquidation preceding our business depressions may be illustrated for 1907, 1914 and 1920–21 with the average price of a then well known high-dividend paying group of railroad stocks, comprising Atchison, Topeka and Santa Fe, Canadian Pacific, Chicago and Northwestern, Delaware and Hudson, Great Northern, Illinois Central, Lehigh Valley, Louisville and Nashville, New York Central, Northern Pacific, Pennsylvania, Reading, and Union Pacific. The average price of this group declined from a high of 165 in 1906 to a low of 91 in 1907, or 45 per cent; then rose to an average high of 153 in 1909, or 68 per cent; then declined to a low of 101 in 1914, or 34 per cent; then rose to a high of 124 in 1916, or 23 per cent; and then declined to the unusual low of 72 in 1920–21, or 42 per cent. In the case of certain individual stocks, however, the increases or declines were much greater than the average referred to.

For a group of non-dividend railroads, consisting of Erie, Kansas City Southern, St. Louis Southwestern, Southern Railway, and Texas Pacific, the increases or declines seem much smaller when considered absolutely, yet from a relative standpoint, expressed in percentages, such securities are affected much more during our economic crises than are the high-priced, dividend-paying securities. Thus the average price of this non-dividend group of stocks, comparing the average high price of 38 for 1906 with the average low of 13 for 1907, declined 66 per cent; then rose to an average high of 40 in 1909, or nearly 208 per cent; then declined to a low of 17 in 1914, or 58 per cent; then increased to a high of 33 in 1916, or 94 per cent; and then declined to 14 in 1920–21, or 58 per cent. With respect to three important and nationally representative industrials at the time—United States Steel, American Sugar, and American Smelting and Refining—the average price declined

54 per cent between 1906 and 1907, then increased 93 per cent between 1907 and 1909, then declined 51 per cent between 1909 and 1914, then increased 95 per cent between 1914 and 1916, and again declined 57 per cent between 1916 and 1920–21.

With respect to the depression of 1929–34, the violent character of stock market liquidation is indicated by the following table of monthly or yearly averages for representative groups of 20 railroads, 30 industrials and 20 coppers. As a result of

EFFECT OF 1929–34 DEPRESSION UPON SECURITY PRICES

(Monthly or Yearly Averages, Babson Figures)

Average	*Twenty railroads*	*Thirty industrials*	*Twenty coppers*	*Twenty bonds*
1929 Sept. (high)	189.11	381.17	80.7	90.9
1930 Yearly (high)	137.82	248.90	36.1	96.1
1931 Yearly (high)	81.91	149.86	16.5	92.4
1932 Yearly (high)	31.61	71.24	7.6	76.0
1932 July (low)	13.23	41.22	(June) 4.6	(June) 67.0
1933 Yearly (high)	41.44	89.77	13.8	81.8
1933 July (high)	56.53	108.67	(Sept.) 19.8	(Aug.) 89.1

the drastic panic of October and November, 1929, the railroad group declined from a high of 189.11 to 128.07, or 32 per cent, the industrial group from 381.17 to 198.69, or 48 per cent, and the copper group from 80.7 to 53.7, or 33 per cent. Thereafter the market established eight successive new lows, the last and ninth new low being reached in July of 1932. The entire maximum three-year decline from September, 1929 to July, 1932, amounted to the following for the three groups of stocks: for the railroads from 189.11 to 13.23 or 93 per cent, for the industrials from 381.17 to 41.22 or 89 per cent, and for the coppers from 80.7 to 4.6 or over 94 per cent. Investment bonds declined during the same period from 190.9 to 67.0, or 126 per cent.

Such tremendous fluctuations in the price of standard stocks should be a warning of the great dangers connected with deal-

ing on margin. Many of the indicated price movements, occurring within the course of a single year, represent the wiping out of from three to five margins of 20 points each. The folly of putting up the major portion of one's resources on margin transactions must be apparent. And even where the purchases are outright, the aforementioned figures are conclusive proof of the wisdom of spreading one's investment account over numerous securities, instead of placing sole dependence in one or a few. In the interest of safety of principal, it is infinitely better for the average humble investor to buy one share in each of twenty corporations than to invest all in twenty shares of a single concern.

One other important thought is suggested by the aforementioned violent fluctuations, and the matter is mentioned because of the general desire on the part of many unthinking persons to buy large quantities of "cheap" non-dividend stocks. The stock market, it must always be borne in mind, discounts the future, and when a stock with a par of $100 sells at $5 it means that the combined judgment of the speculative world has registered an unfavorable opinion with respect to the stock in question. In all probability a receivership has been discounted. Yet many either do not know this fact or ignore it, and rush in to buy a large lot of such stock. It must be apparent that it would be much better for a person with $1,000 to buy 10 good shares, selling at $100 a share because they are regarded as good, than to buy 20 times that many no-good shares, selling at 1/20 of par, because they are regarded unfavorably by the thinking element in the market. Most generally, the purchasers of such low-priced stocks soon become acquainted with the peculiar feeling associated with assessment payments. Instead of receiving dividends on 10 shares, our purchaser of cheap stocks is likely to pay an assessment on 200 shares. It may be argued, of course, that our foregoing explanation indicates tremendous advances in the average price of such securities during major bull market movements, namely,

over 200 per cent between 1907 and 1909, and nearly 100 per cent between 1914 and 1916, and 300 to 400 per cent between 1932 and 1933, and that the chances for speculative gain are therefore very inviting. But admittedly, this is a very hazardous chance. In 1907 and 1914 it happened that the period of business depression proved to be comparatively short. Should the opposite occur and the business depression be long drawn out, as in 1893–97 and 1929–34, for example, corporations whose securities sell at very low prices are usually the first to succumb to insolvency.

It is also important to note that the drastic liquidation of depression periods is by no means limited to the security market. It appears just as severely in connection with commodity and realty values. With respect to basic commodities used in business generally, a few illustrations will serve to show the slaughter of values during the present depression. Between September, 1929, and the close of 1931, the following price declines occurred: cattle from $13.50 per 100 lbs to $7.00; coffee, from 18 cents to 6.5 cents; corn from $1.02 to 40 cents; cotton from 18.3 cents to 6.1 cents; hides from 19.5 cents to 7.5 cents; lead from 6.9 cents to 3.7 cents; rubber from 20 cents to 4.5 cents; silk from $5.15 to $2.05; wheat from $1.25 to 49 cents, and wool from 93 cents to 59 cents. Subsequently prices for practically all of these commodities sank even lower. Babson's commodity price index for ten basic commodities, which stood at 163.6 in September of 1929, subsequently declined to 157.4 for December of that year, to 132.8 for December of 1930, to 109.7 for December of 1931, to 101.4 for December of 1932, and to a low of 94.1 for February of 1933. Thereafter a rapid rise ensued, bringing the average back to 136.0 for December, 1933. Similarly, it has been estimated that at least one-half of the dollar valuation of real estate in the United States, as it existed in 1928 and 1929, disappeared during the depression, with disastrous results to many mortgagees and to depository institutions dependent upon real estate loans.

With respect to both commodity and realty values, it may be truthfully said that fortunate was the man in 1929 who was poor in such values, and that unfortunate was the man who was a large possessor of the same. Many large business concerns declined deeply into the red, or into hopeless insolvency, for the simple reason that they were very rich in goods or real estate in 1929.

As has been repeatedly emphasized in this volume, the stock market discounts business conditions in advance. Thus in 1907, the violent stock market slump occurred between December, 1906, and November, 1907, or during the very period when business was being conducted on a scale larger than at any previous time in our history. The long and severe decline of 1920 also coincided with record-breaking business throughout the country. Again, in 1929, the violent stock market panic occurred during October and November, whereas nearly all of the outstanding business barometers reached their peak in that epoch-making year during either September or October. In all three instances the depression in general business followed the decline in the security market. When business showed signs of slowing down in 1907, stock market liquidation had substantially run its course, and when business was at its worst in 1908 the security market, again discounting the future, was rising towards a higher level. In 1921–22, the stock market likewise enjoyed a major advance, in anticipation of the business revival which subsequently followed. Similarly when business was at its worst in 1932, the stock market was entering its period of accumulation and subsequently, at the very time when news was the blackest, staged the remarkable bull movement which ended in July, 1933, again in anticipation of better things to come business-wise.

Importance of the "Factor of Safety."—Attention has been called to the importance of interpreting price variations in terms of percentages instead of absolute amounts. From this standpoint, any tabulation will show that the greatest

declines by far during periods of business depression occur in the stocks of companies whose "factor" or "margin of safety" is small, i.e., whose expenses of operation and fixed charges are so large as to leave only a small balance of net income for distribution to the stockholders. In fact, every security, be it a bond or stock, should be considered with respect to the amount of the net income, after proper maintenance has been allowed for, available for the payment of interest or dividends on the

		Suppose a 20 per cent Decline
Say Earnings	$1,000,000	$800,000
Expenses (70 per cent)	700,000	560,000
Net	$ 300,000	$240,000
If Fixed Charges 75 per cent	225,000	225,000
Surplus for Dividends	$ 75,000	$ 15,000 (Case I)
Decrease	.....	80 per cent
If Fixed Charges 25 per cent	75,000	75,000
Surplus	$ 225,000	$165,000 (Case II)
Decrease	.....	26 per cent

particular security under consideration. So important is this factor that elaborate tables have been prepared for the convenience of investors, giving the margin of safety for the securities of numerous corporations. Bond houses likewise emphasize this factor when they advertise their security issues.

Despite its importance, this factor is ignored by probably a majority of investors. Its importance, in view of the far reaching effect of business depressions upon the net income of our corporations, is well illustrated by the preceding brief table in Gibson's *Cycles of Speculation*.[3] The figures used aim to show the effect that "a 20 per cent decline in gross and net earnings" will have as regards (1) a corporation with fixed charges equal to 75 per cent of net income; and (2) a corporation with fixed

[3] Thomas Gibson, *The Cycles of Speculation*, p. 116.

charges of only 25 per cent. On the basis of the estimates used, a 20 per cent decline in earnings resulted in a decrease of 80 per cent in the surplus of the first corporation, but of only 26 per cent in that of the second.

Periodicity of Business Depressions.—For many years the belief prevailed that business depressions were likely to occur at regular intervals of about ten years, and it was common to refer to the so-called "ten year cycle." This belief was caused no doubt by the fact that for many years economic crises, both in this country and in leading European countries, occurred at approximately regular intervals of ten or eleven years. Thus prior to the Civil War we had such crises commence in 1817, 1827, 1837, 1847 and 1857. Then the Civil War changed the apparently clock-like regularity, and the next crisis occurred in 1873, to be followed by others in 1883, 1893, 1903, 1907, 1913, 1920, and 1929. It is also worthy of note that depressions in the United States have either been concurrent with, or were immediately preceded or followed by a similar phenomenon in other leading countries.

Too much importance should not be attached to the particular number of years comprising the so-called "trade cycle." The stock market panic of 1907, with its accompanying business depression of 1908, is certainly an exception to the so-called "ten year cycle" commonly referred to by certain authors, this depression following the preceding one of 1903 by only about four years. The stock market convulsions of 1920 and 1929, with the business depressions which followed them, are also exceptions. Similarly our business depressions of the past have differed greatly from one another in the length of their duration, sometimes spending their force in about two years and at other times extending over a period of three, four, and even five years.

The Trade Cycle Described.—Expressed in the form of a diagram, the so-called "trade cycle" really assumes the form

of a sort of semi-cycle, i.e., the four, five, or more years of trade improvement usually collapses substantially within a year or two. In other words, the downward movement has in the past been much more rapid than the upward one. The following outline indicates the main stages of a typical trade cycle, beginning with the period of business depression and then following in order to the periods of reviving business, of new enterprises, of intense prosperity, and finally, of violent security and commodity liquidation.[4] In connection with each of these periods, mention is made of leading conditions as they relate to (1) business, (2) banking, and (3) the security market. There is no intention, however, to give the impression that the several stages referred to can be sharply separated. Instead, they blend into one another and at times some of the conditions usually attributed to a particular stage may appear somewhat earlier or later. Nor is there any intention to indicate the duration of any of the stages, because the theory of regularity of time is no more applicable here than it is with respect to the cycle as a whole.

1. PERIOD OF BUSINESS DEPRESSION

(a) *Business.*—Great dullness prevails in business. Heavy liquidation takes place in the commodity markets, and there is a severe curtailment of production. Merchants and manufacturers, confronted with heavy losses, resulting from declining commodity prices, seek to cancel their contracts for purchases at higher prices. Profits are greatly reduced or disappear. Purchases for future delivery are placed only sparingly, and merchants buy only what can be immediately marketed. Many employees are discharged or placed on part time. Decreased

[4] This natural division of the cycle has been generally adopted by most writers on the subject. See especially R. W. Babson, *Business Barometers for Anticipating Conditions.*

2. PERIOD OF REVIVING BUSINESS

(a) *Business.*—Some apparently important event (or events), enthusiastically taken up by the press, tends to revive confidence, which is the basis of credit. The discerning, in expectation of better times, begin to acquire raw materials, finished goods, and industrial plants in advance of higher prices. The liquidation in commodity markets has not only run its course, but in certain lines prices show distinct signs of improving, which improvement is loudly heralded in the press. Sellers are now beginning to fix prices instead of having buyers do this as in the preceding stage. Buyers are purchasing quickly what in the previous stage would have been acquired cautiously. Labor has also been liquidated, and is now in the proper frame of mind to work. Industries generally are gradually increasing their output to normal capacity. Unemployment is gradually disappearing, and owing to the spirit of economy acquired in the previous stage, capital is rapidly accumulating.

(b) *Banking.*—Cash holdings are rapidly accumulating and pressure of capital is beginning to assert itself. Loans are increasing in view of reviving business. Interest rates are still low and credit is abundant. There is accordingly much arbitraging between interest and dividend returns on good securities and the low interest rates on borrowed funds.

(c) *Security Market.*—Arbitraging between the return on securities and the cost of interest on loans, as noted, is very prevalent. Operations of the "irresistible speculator" are becoming more and more apparent. Having accumulated large lines of stocks during the previous period, large operators are now bidding prices up. Stock and bond prices are rising rapidly, partly because a brighter future is being discounted and partly because of the advantages of the aforementioned arbitraging. The general public, still vividly recalling the enormous declines of the recent past, is skeptical and by no means convinced of a permanent improvement.

3. PERIOD OF NEW ENTERPRISES

(a) *Business.*—The momentum of the preceding stage reaches a point where industries are working to their full capacity and where the volume of business offered is such as to require the establishment of new projects. The promoter now appears on the scene with his numerous propositions in mining, real estate, manufacturing, etc. Sufficient capital has accumulated to assure the successful distribution to the public of the necessary stocks and bonds. Business men are also pyramiding, i.e., building their plants larger and larger with borrowed funds. Commodity prices generally are also rising materially.

(b) *Banking.*—Loans are rapidly increasing at the expense of cash holdings. A goodly proportion of these loans are unwisely placed and will later be lost. Credit is also finding its way to an increasing extent into properties that are not liquid in character. Interest rates are hardening although not yet exceptionally high.

(c) *Security Market.*—Stocks have reached a high level and are active. Previous accumulations by those who discounted the situation correctly are already being liquidated in part. The public is thoroughly interested. Bonds have reached their top, and influenced by rising interest rates on money, are showing a distinct tendency to halt or decline.

4. PERIOD OF INTENSE PROSPERITY

(a) *Business.*—Great prosperity prevails in business generally. A real estate boom exists more or less throughout the nation. Continued flotation of new enterprises is occurring on a large scale. Industries are working overtime, and yet are unable to handle the business. Practically all industries are in the market for additional funds, and securities are readily sold to a willing public that acts on the basis of the very favorable

news of the day. Pyramiding continues in all lines of business on a large scale. The attitude is quite general that good times will last indefinitely and the "new era" idea is given wide currency. Labor is exceedingly scarce, wages are high and rapidly increasing, and strikes often numerous. Great inefficiency of labor prevails nearly everywhere. Commodity prices are exceedingly high. There is an alarming absence of thrift, and a spirit of wastefulness. Newspaper comment is exceedingly rosy, and there is universal condemnation of all who dare to call attention to the hazards of the situation.

(b) *Banking.*—Loans are increasing alarmingly as compared with cash holdings. The proportion of unwise loans is increasing rapidly. Interest rates, both time and call, are very high, often being quoted at figures which should serve as a danger signal. Demand loans, supported by stock-exchange collateral, are frequently liquidated to prevent time-loan rates from soaring too high.

(c) *Security Market.*—Bond prices have declined materially, and show a very weak tendency. Violent activity exists in the stock market without, however, any radical change in the average price level, which as yet is only declining gradually. Just as during the period of business depression stocks were dull and firm and were being accumulated, so now they are active and weak and are being distributed. Those who know with respect to the future are now anxious to convert their securities into cash, just as during the period of business depression they were anxious to exchange their cash into securities. Manipulation is very prevalent and the market is made to look strong in spots in order to facilitate distribution in other places. Financial news is very rosy, and favorable interviews by prominent persons are very numerous. Frank statements with respect to the future are certainly not invited and the Street has little use for pessimistic talk. The general public is again acting on what is seen, heard, and read. Those who know are succeeding, therefore, in distributing their holdings to those

who do not know. Their work is facilitated by the publication of large corporate earnings, numerous dividend increases, and luscious melon cuttings. Many sales are made by those, who, anticipating much lower prices, are selling short securities which they do not own, but this group it may be added does not talk.

5. PERIOD OF VIOLENT LIQUIDATION IN THE SECURITY MARKET

(a) *Business and Banking.*—Industrial conditions are still booming and all the earmarks noted for the preceding period are still apparent. Money rates are exceedingly high and bank loans have reached peak conditions. In their effort to reduce loans, banks are calling demand loans and there is much liquidation of the stock and bond collateral securing such loans. Owing to credit stringency new security flotations are meeting with difficulty, although innumerable corporations are in the market for funds.

(b) *Security Market.*—What was known by the limited few only a few months previously is now gradually percolating into the lower ranks of intelligence about such matters. Dreams of still higher stock-market prices, it is gradually being realized by the rank and file, are not to become realities. At first prices decline slowly, but as they continue to reach a lower and lower level, one stratum of security holders after another becomes wise. Before long they nearly all seem to be of one mind, and nearly all desire to do the same thing, namely, sell. The momentum of liquidation increases until the market often experiences periods of demoralization. At such times short sellers fortunately enter the market as a stabilizing force to cover on their short contracts in order to take their profits. Leading financial interests also often step in to support such markets with buying orders. But despite such temporary and wholesome checks, spread more or less over the course of one or two years, the liquidation continues until the general price level reaches a

point sufficiently low to induce the discerning element in the market again to undertake the accumulation of securities. Following this drastic liquidation, which has sometimes but not always been accompanied by serious banking difficulties, the country will again enter into the period of industrial depression with which we began this outline of the trade cycle.

Barometric Indices of Trade.—The approximate determination of which of the aforementioned periods of the trade cycle the country is experiencing is necessarily a statistical one. For this purpose various groups of statistics, so-called "barometers" or "indices" of trade, are commonly consulted and periodically published in the leading financial journals. Whatever may be thought of the value of these data from the standpoint of forecasting future conditions, a matter that vitally affects stock-market prices, since the stock market is essentially a discounting agency, there can be no question that a correct compilation of the data furnishes a fairly accurate view of the condition of trade for the time being, and furnishes the basis upon which security owners, when comparing the present showing with that of previous periods, may exercise their judgment as to the future. The following list gives the principal barometers of trade as published periodically: "New building contracts awarded," "Bank clearings of the country," including and excluding New York City, "Business failures," "Labor conditions," comprising number of employed and payroll, "Bank statements," "Imports and exports," "Money rates," "American and foreign commodity prices," "Shares traded on the New York Stock Exchange," "Average price of leading groups of stocks and bonds," "Crop, metal and transportation statistics," "Pig iron production and price," "Unfilled tonnage of the United States Steel Corporation," "Revenue freight car loadings," "Railroad gross and net earnings per mile," "Railroad and industrial dividend payments," and "Corporate financing."

An examination of the statistical record of the various

barometers of trade, for any of the trade cycles which have occurred since such figures have been available to a substantial extent, clearly indicates that almost invariably the best showing is made at the time when the security market is either beginning or undergoing its violent liquidation, i.e., the stock market is discounting the coming industrial depression. Using the last depression of 1929–34 as an example, the first violent stock market crash, as already explained, occurred during October and November of 1929. Yet with few exceptions the various leading business barometers stood at peak figures for either the month of September or October. Check transactions, excluding New York City, reached their highest monthly average in 1929 for the month of October, and the same is also true for national bank clearings inclusive of New York City. As regards business failures, the smallest monthly average prevailed during September, and the smallest volume of liability during October. With respect to both the number employed in factories and the payroll, the highest figures of the year prevailed during September and October. For other leading barometers the peak was reached in the following months: exports in October, the price level of railroad and industrial shares in September, railroad gross earnings per mile in October, and new capital financing in September. Pig iron production totalled 3,588,000 tons for October, or only 300,000 tons below May—the peak month of the year, whereas the unfilled tonnage of the United States Steel Corporation stood at 4,417,000 tons for even December, or only 10,000 tons below the peak month of April.

In other words, when business conditions are the best, as judged by the past, there is ample reason for the exercise of caution as regards the future. With respect to the future, barometric statistics must be given an interpretation which is just the opposite of their showing for the present. That which seems to be the very best for the present takes on a sinister aspect when we visualize the future. Contrariwise, that which appears to be the very worst for the present, as judged by com-

parison with the past, should occasion distinct hope for a brighter future.

Needless to say, too much reliance should not be placed for forecasting purposes upon a single business barometer. In this particular, like in most economic matters, reliance should be placed upon the use of averages. Consultation of a large number of barometers, averaged to a common result, is certainly much safer than dependence upon a single set of figures. Various attempts are therefore being made by different statistical agencies to combine a considerable number of trade indices into a "composite plot." This is done, not with a view to emphasis upon that which the figures show for the present state of business, but to deduce rules which, in view of the showing indicated by the data for the time being, are considered by the authors of these composite plots as affording a valuable aid in judging future business tendencies.

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CHAPTER XX

FACTORS INFLUENCING THE GENERAL LEVEL OF PRICES OVER CONSIDERABLE PERIODS OF TIME

Special Terms Governing the Security under Consideration.—Thus far our discussion has centered upon intrinsic worth, the condition of the credit market, and the periodic occurrence of financial crises and business depressions as dominant price factors in the stock and bond market. But assuming the inherent safety and unquestionable investment worth of the bond or stock, i.e., from the standpoint of the principal of the bond or continued adequate earning capacity with respect to the stock, there are various factors associated with the special terms of the security under consideration which may have a decided effect upon the price of said security over considerable periods of time.

A bond or preferred stock may contain a "convertible" feature, which becomes so valuable because of the appreciation in value of the security into which conversion is allowed, as to raise the price of the bond or stock under consideration far beyond that warranted by the current interest or dividend. The bond or stock may contain a "callable" feature, giving a small premium upon retirement, in which event, over long periods of time, the market price of the security in question may cling closely to the callable price and lag far behind the rise in the price level of other similar securities which happen to be noncallable. Or the preferred stock may contain a "participating" feature, which might raise the market price of the security, in the event of large corporate earnings, far beyond the investment worth of similar issues which do not contain such a feature. Again bond issues may be "short term" or

"long term" issues. Short term issues of sound character, especially if they have only a year or two to run before maturity, will naturally be quoted near the maturing par value, irrespective of good or bad times. Long term bonds, on the contrary, may fluctuate greatly in price over long periods of time, affording the opportunity of gain from a substantial rise in the event of national recovery from a severe business depression, but likewise the risk of capital loss from a substantial decline in quoted value in the event of a national decline into a real business depression with its accompanying enforced liquidation of all classes of securities possessing the attribute of liquidity. These and other similar factors indicate the importance, from a price standpoint, of proper attention to the special terms which may surround various issues of bonds and preferred stocks.

Increasing or Decreasing Level of Commodity Prices and Interest Rates.—Three more important price factors need to be mentioned, namely an increase or decrease in the level of commodity prices, an increase or decrease in the level of interest rates, and a serious variation in the condition of the crops. These three factors, and especially the first two, affect security prices over considerable periods of time.[1]

Increasing or decreasing commodity prices exert their influence upon security prices gradually over periods of a decade or more, and without much regard for locality or the investment safety of the securities in question. Their effect, in fact, may be so gradual, especially when other factors operate temporarily to confuse the viewpoint, as to escape the attention of investors. Yet when viewed over the course of years, this factor stands out as one of the most pronounced forces occasioning a rise or decline in the price level of various classes of securities.

[1] Many regard serious variation in crop conditions as a short-time price factor. Bumper crops, or crop failures, however, do exert an unfortunate influence over two and sometimes more years.

For our purpose it is unnecessary to determine the factor or factors which bring about increasing or decreasing levels in commodity prices and interest rates. Many causes have been advanced, such as a rising standard of living, an increasing or decreasing gold supply, tariff legislation, price control through combination, growth in population, uneconomical marketing, etc., and the argument seems to be endless. The important fact is that, over long periods of time, commodity price levels and interest rate levels do go up and down, and that these major movements do influence vitally the price level of large groups of securities. This is indicated clearly by the following table, which will be discussed in detail in later pages.

Turning to the application of increasing commodity prices to security prices, we find that different classes of securities are affected in different ways. These may be considered as follows:

Effect of Increasing Commodity Prices on Bonds and Preferred Stocks, which, while Possessing the Advantage of Certainty, Have the Disadvantage of a Definitely Limited Income. —While bonds and preferred stocks, assuming such as have an unquestionable investment worth, possess the advantage of certainty in principal and income, they have the disadvantage of yielding an income that is *definitely limited.* It follows, therefore, that as commodity prices and interest rates rise, the possessor of low-interest bearing bonds or low-dividend yielding preferred stocks is placed at a great disadvantage. In the last analysis the buying of a bond represents "the purchase and holding of a value safely stored against future requirements." Present value—"present command over goods and services"—is "exchanged for a similar command over future goods and services." When, therefore, a $1,000 five per cent bond was bought in 1914, the purchaser had the misfortune to see his fixed principal of $1,000 and his fixed income of $50 dwindle enormously in value during the following seven years, i.e., from the standpoint of the goods or services (greatly in-

ANNUAL AVERAGES FOR BRADSTREET'S INDEX NUMBER, INTEREST RATES, BOND PRICES AND STOCK PRICES

	Bradstreet index of wholesale commodity prices	*Interest rates* Call	Time	*Bond prices* (*Babson's average*)	*Twenty railroads*	*Stock prices* (*low average*) (*Babson's averages*) *Thirty industrials*	*Twenty coppers*
1913	9.21	3 1/8	5 2/3	93.4	105.76	56.44 *	37.4
1914	8.99	3 3/8	4 7/8	92	98 72	56.94	37.8
1915	9.85	2	3 5/8	89	93.44	70.78	44.4
1916	11.82	2 1/2	3 1/2	91	103.04	91.07	53.9
1917	15.63	3 3/8	4 7/8	87	88.97	84.32	48.7
1918	18.71	5 3/8	6	81	81.33	78.68	40.5
1919	18.66	6 3/8	5 1/2	80	81.10	95 97	42.4
1920	18.81	7 1/8	7 1/2	73 (69 for May)	73.04	85 97	34.0
1921	11.37	6	6 5/8	77 (83 for Dec.)	70.81	70.97	26.4
1922	12.12	4 1/4	4 1/2	87	82.35	90.46	32.7
1923	13.40	4 7/8	5 1/8	84	80.69	92.07	28.8
1924	12.87	3 1/8	4 1/8	87	85	97 †	26
1925	13.94	4 1/4	4 1/8	90	99	130	28
1926	13.02	4 1/2	4 3/8	93	111	148	30
1927	12.77	4	4 1/4	97	131	171	35
1928	13.28	6	4 7/8	96	138	217	53
1929	12.66 (9 1/8 for July)	7 1/2	5 3/4	93 (91 for Sept.)	152 (189 high for Sept.)	288 (381 high for Sept.)	74 (88 high for March)
1930	10.74	3	3 1/2	96	128	223	36
1931	8.76	1 3/4	2 5/8	92	70	126	17
1932	7.10	2	2 3/4	76 (67 for June)	23 (13 for July)	57 (41 for July)	8 (5 for June)
1933	7.86	1 1/8	1 1/8	82 (89 for Aug.)	35 (57 high for July)	77 (100 high for July)	14 (20 high for Sept.)

* Figures for 1913–1923 inclusive represent 20 industrials.
† Figures for 1924–1933 inclusive represent 30 industrials.

creased in price during the same period) which could be purchased with these fixed sums. Bonds are purchased to yield an income, and said income is desired to purchase goods and services. When such goods and services are increasing in price, while the income from the bond, with which they are to be purchased, is fixed, it follows that the bondholder is losing in purchasing power. As a medium of exchange the bond is becoming less valuable, and this smaller value is reflected in the declining price registered in the market. In fact, many investment accounts are originally adjusted to yield a certain definite income, and must later be readjusted when such income becomes insufficient to meet current requirements owing to advancing commodity prices. This is done by exchanging the low interest bearing securities for those commanding a higher yield.

Likewise there is little reason to invest in bonds yielding only 4 or 5 per cent when money can be made to command higher rates of interest or to buy more goods and services elsewhere. The natural consequence is that dissatisfied bondholders will sell their bonds until the price reaches a point sufficiently low to make the interest yield fairly commensurate with current rates on good investments. With the current investment return at 5 per cent, a bond having 10 years to run to maturity, will sell at $1,000; but with the current investment market on a 7 per cent basis, our 5 per cent bond will sell at a price sufficiently low to make the annual $50 interest return more nearly equivalent to 7 per cent on the present purchase price of the bond, making due allowance for the gain in appreciation of the bond to its par value at the time of its maturity ten years hence. Thus we are told at one time that the bond market is on a 4 per cent basis, meaning that good investment bonds are selling at prices to yield that return, while at other times we are told that the bond price level is such as to yield 5, 5½, 6, or 7 per cent. The same reasoning applies to sound preferred stocks since their dividends are also limited, but to a less de-

gree since the rate of income allowed on this type of security in the past has usually been considerably larger than in the case of most bonds.

Many illustrations might be cited to show the effect that rising commodity prices and higher interest rates have upon gilt-edged, low interest bearing bonds. Thus British Consols were selling at 113⅞ in 1896 and declined as low as 86½ in 1906 during a most prosperous business era. In the United States the same situation asserted itself. Thus, between the years 1901 and 1907 many of the best three and one-half and four per cent railroad bonds, gilt-edged both as to principal and income, declined from $200 to $250 per $1,000 bond. Yet this period of 1901 to 1907 was one of the most prosperous business epochs in American history and was characterized by a tremendous rise in the prices of various other classes of securities. Common stocks experienced a rise in price of from 30 to 40 per cent during this period, whereas bonds of the same corporations declined from 15 to 20 per cent.

Again, between 1913 and 1920, 20 representative bonds [2] paying interest rates of from three and one-half to five per cent, declined from a monthly average price of 96 for January, 1913, to 69 for May, 1920, or a decline of 28 per cent, or $270 per $1,000 bond. It is interesting to note that the price average for these bonds stood at 107 in March, 1905. During the same period (see table on page 387) the annual average of Bradstreet's index number increased from 9.21 for 1913 to 18.81 for 1920. Subsequently during the business depression of 1921 and 1922 (when interest rates were low and the annual average of Bradstreet's index number only 11.37 for 1921 and 12.12 for 1922) the bond price level experienced an enormous increase, namely, from 69.0 for May of 1920 to 83.0 for December, 1921, or an increase of 20.3 per cent or $140 on a bond investment of $690. Following this sensational rebound these bonds continued to increase in price more or less gradually until they

[2] Babson's Bond Average.

reached a monthly high average of 99.0 for December of 1927. Then followed the greatly increasing money rates of the boom period of 1928 and 1929, call rates in New York averaging 7½ per cent for the entire year of 1929, and the monthly average for that year for July rising to 9⅛ per cent. During that very period, with the stock market rising stage by stage to the unprecedented levels of September of 1929, the aforementioned bond price level gradually declined from the high of 99.0 for December of 1927 to 90.9 for September of 1929. Then followed the stock market panic of October and November of 1929, and thereafter the business depression of 1930–34, with its declining commodity prices as well as interest rates (see table on page 387). It is interesting to note that bonds again enjoyed a violent rise in their price level, namely from 90.9 for September, 1929, to 98.5 for September, 1930, or an increase of nearly 8.4 per cent, or $76 on a bond investment of $909. Even by July, 1931, the average monthly price still stood at 97.9. Thereafter, however, the factor of forced liquidation began increasingly to assert itself, until one year later (June, 1932) the average monthly price reached the extraordinary low of 67.0, a decline in one year of 31.5 per cent, or $307 on a bond investment of $979. Following this extraordinary forced liquidation, with the Bradstreet index number at only 7.10 for 1932 and money rates at only 2 per cent for call and 2¾ per cent for time loans, bonds again enjoyed an almost unprecedented rise. From a low of 67.0 for June, 1932, the price level of the aforementioned bonds rose in fourteen months to 89.1 for August, 1933, an increase of 33 per cent, or $221 on a bond investment of $670.

Special attention should be directed to the factor of "forced liquidation" as it asserts itself near the bottom of a major business depression. Thus during the first half of 1932 bond prices declined from a monthly average of 79.3 for January to 67.0 for June, or a decline of $123 on a bond investment of $793, or 15 per cent. At times there was virtually no market to take care of distressed sellers, good investment bonds often

suffering a decline of $30 to $50 between sales before a buyer could be found. Such distress selling also affects stocks of all kinds, and particularly the good common and preferred issues (so-called "blue chip" issues). During the six months in question the Babson list of twenty railroad stocks declined from a monthly high of 41.30 in January to 13.23 in July, the thirty industrials from 85.88 to 41.22, and the twenty coppers from 9.1 to 4.6. Similarly the rebound, following the cessation of forced liquidation, extends to all classes of securities, stocks as well as bonds. Accompanying the aforementioned rise in the June level of bonds of from 67.0 to 89.1 during the year following June, 1932, there was also an extraordinarily swift increase in the price level of stocks, namely from 13.23 in June, 1932, to 56.53 in July, 1933, for the railroads, from 41.22 to 108.67 for industrials, and from 4.6 to 19.8 for the coppers.

Effect of Increasing Commodity Prices and Interest Rates upon the Common Stocks of Railroads and Most Public-Service Corporations.—The effect of high interest rates and commodity prices upon this class of securities may be offset by returns in the form of higher dividends or undivided profits or improvement in the property. These securities do not stand at the same disadvantage as do bonds and preferred stocks, since their income is not rigidly limited. But, while the return is not definitely fixed, railroad common stocks are seriously handicapped in another respect for which increasing commodity prices are largely responsible. All materials necessary for building, equipping, or maintaining railroad properties will cost more and more as commodities and labor rise in price. This handicap would be overcome if transportation, the commodity sold by railroads, could also be advanced equally and promptly. This, however, is a difficult thing to do in view of popular prejudice, the general prevailing agitation against increasing rates, and the tardiness and reluctance with which Government rate regulatory commissions have recognized the effect of economic forces. It is in this respect, it may be added, that street railway

and gas companies, as well as similar public-service utilities, seem to have been at a special disadvantage, and in many instances have been almost entirely unable to raise their rates, with disastrous consequences to the price of their common stock. It should be added that the objection mentioned with respect to bonds and preferred stocks does not apply equally in the case of convertible issues. If bonds and preferred stocks are given the privilege of conversion into common stock at will, then any special profit which changed conditions give to the stockholder may also be shared by the bondholders. The same may also be said of participating preferred stock, when by its terms it is given the right to participate with the common stock in the increased earnings of the company.

Effect of Increasing Commodity Prices upon the Common Stocks of Industrial, Mining, and Merchandising Corporations. —The price of common stock of industrial corporations will be affected differently, because here rising prices for commodities do not interfere so seriously with the earning power of corporations that produce and sell commodities, the price of which is not regulated by law. With respect to such corporations, an increase in the price of commodities that they are compelled to buy is apt to be counterbalanced by an advance in price of that which they manufacture. In some cases even, especially where the corporation represents a monopoly, there may actually be a gain for the corporation because the price of that which is manufactured may possibly be advanced to more than is necessary to counterbalance the increase in cost of raw materials and labor.

Crop Prospects in Their Relation to Security Prices. —Of current events that have a vital bearing upon security prices, for a year or two, few approximate in importance the annual condition of the nation's agricultural crops. The average value of these crops aggregates annually more than ten billions of dollars. This huge mass of new wealth, besides furnishing directly and indirectly a very large share of the high revenue

producing tonnage of the nation's railroads, also vitally affects numerous manufacturing and distributing industries whose securities are listed on exchanges. Reference may be directed to the present efforts of the national administration towards the raising of farm prices and the enhancement of the farmer's purchasing power, with insistence upon the thought that there can be no real recovery from the present depression until the vast farming community has been restored to a normal purchasing power. In fact, so intimate is the relation between the volume and price of our crops and our industrial life that many writers regard the condition of the crops as an outstanding fundamental barometer with respect to the earning capacity of our railroads and industrial enterprises; and the stock market, it should be recalled, is essentially a market for incomes.

While mining and forestry products are important, these are fairly regular on the average and are subject to control in accordance with the demands of business requirements. The products of the soil, however, are mainly dependent upon climatic conditions, and their output is, therefore, uncertain to an unusual degree. As is indicated by the following table, the annual yield of leading agricultural staples, such as wheat, corn and cotton, frequently varies from 25 to 50 per cent as compared with the preceding year. The significance of this fact becomes apparent when we realize that with respect to our three leading cereals, during a single year, winter wheat showed a maximum fluctuation between two seasons of 193,000,000 bushels, spring wheat of 196,000,000 bushels, and corn of 428,000,000 bushels. Assuming 1,000 bushels to the carload, the aforementioned variation in our three leading cereals, it is apparent, represents for a single year a stupendous change of 817,000,000 bushels, or 817,000 carloads, in the volume of our railroad traffic.

While the aggregate crop for the entire nation may show an average fluctuation not to exceed 10 to 20 per cent, the fluctuation in any particular staple, or for a given staple in a particular section of the country, may show a much greater variation, thus

vitally influencing manufacturing industries dependent upon said staple, or seriously impairing the earnings of railroads dependent for their income upon traffic developed in their particular territory. On many occasions stock market quotations have shown a relative shifting in the prices of the shares of different groups of railroads, because one group was seriously affected by a crop shortage or benefited by a crop increase as compared with another. It should also be noted that certain agricultural crops enter largely into our export trade, and, therefore, to a large extent represent a long haul for the railroads.

Considerations like the above emphasize the importance of the *volume* of the respective crops rather than their price. At times, however, especially during periods of great business depression, the *value* of the crops also becomes a matter of national concern, since it vitally affects the purchasing power of nearly one-half of the nation's population. Again, at times numerous speculators, heavily interested in the commodity market, also assume large commitments in the security market at the same time. Accordingly, there occur instances where a serious price decline in the grain or cotton markets will have a depressing effect upon security prices. The parties interested in the commodity market, in other words, might be forced to liquidate their securities in order to meet their losses in the commodity market, or *vice versa*. But as stated, the security market is normally most vitally concerned with the prospects of the volume of the crop. Since this is an uncertainty during the entire process of the growth of the crop—good prospects at the beginning of the season often changing materially later—speculators must keep a constant watch over the situation during the "crop-growing season." The prospects in this connection are discounted from week to week. It consequently follows that much of the news in the speculative market should be "crop news," and it is not at all surprising, in view of the variety of crops raised, the vast extent of the crop-growing area, the varying climatic and other conditions in different parts

ANNUAL YIELD OF LEADING AGRICULTURAL STAPLES (000,000 OMITTED)

	Winter wheat (bushels)		*Spring wheat (bushels)*		*Corn (bushels)*		*Cotton (bales) (000 omitted)*	
Year	*Production*	*Percentage increase or decrease with preceding year*	*Production*	*Percentage increase or decrease with preceding year*	*Production*	*Percentage increase or decrease with preceding year*	*Production*	*Percentage increase or decrease with preceding year*
1912	400	.....	330	.....	3125	.....	13,703	.....
1913	524	+ 31.0	240	- 27.3	2447	- 2.17	14,156	+ 3.3
1914	685	+ 31.0	206	- 14.2	2673	+ 9.2	16,135	+ 13.9
1915	674	- 1.6	352	+ 70.9	2995	+ 12.0	11,192	- 30.6
1916	481	- 28.6	156	- 55.7	2567	- 14.6	11,450	+ 2.3
1917	413	- 14.1	224	+ 43.6	3056	+ 15.1	11,302	- 1.3
1918	565	+ 36.8	356	+ 58.9	2503	- 14.8	12,041	+ 6.5
1919	730	+ 29.5	205	- 42.4	2859	+ 14.2	11,421	- 5.1
1920	578	- 20.8	209	+ 1.9	3232	+ 13.0	13,366	+ 17.0
1921	600.3	+ 10.3	214.6	+ 2.9	3069	+ 5.0	7,954	- 40.0
1922	586.9	- 2.2	280.7	+ 30.7	2906	- 5.3	9,762	+ 22.7
1923	572.0	- 2.5	225.4	- 20.0	3054	+ 5.2	10,140	+ 3.9
1924	592.3	+ 3.5	272.2	+ 20.4	2309	- 24.4	13,630	+ 34.4
1925	401.7	+ 1.6	274.7	+ 1.1	2917	+ 26.8	16,090	+ 18.0
1926	627.4	+ 56.2	203.6	- 25.8	2692	- 7.7	17,980	+ 11.1
1927	552.7	- 11.9	325.6	+ 59.8	2763	+ 2.7	12,960	- 27.9
1928	578.7	+ 4.7	336.2	+ 3.1	2819	+ 2.0	14,480	+ 11.7
1929	577.0	- 0.3	235.6	- 29.6	2535	- 10.0	14,830	+ 2.4
1930	599.6	+ 3.9	257.8	+ 9.3	2060	- 18.7	13,930	- 6.1
1931	818.0	+ 53.4	114.3	- 55.8	2589	+ 25.7	17,100	+ 22.8
1932	475.7	- 41.9	268.4	+ 135.0	2907	+ 12.3	13,000	- 24.0
1933	351.0	- 26.1	176.4	- 34.3	2330	- 19.8	13,180	+ 1.4

of the country, and the difficulties incurred in obtaining first-hand information and in arriving at an approximate conclusion as to the average showing throughout the nation, that each year should have its share of crop scare rumors. Were it not for some fairly accurate and unbiased system of crop reporting, first-hand information would be limited to a very few. The average person would be at the mercy of a flood of rumors, and manipulation would exist on a scale infinitely greater than at present. For these reasons, as well as because of the fundamental importance of the subject from a business standpoint, it is highly essential to have the Government issue reports which, as is the case to-day, indicate periodically the condition of about 95 per cent of the acreage and about four-fifths of the total of the nation's agricultural output.

CHAPTER XXI

MANIPULATION OF SECURITY PRICES

Relative Importance of the Factor.—Manipulation is difficult to define and conveys the idea of artificially influencing prices. Some writers have defined the term as meaning: "Putting prices up or down by virtue of ability to do so." Perhaps no other phase of the market has been so widely discussed as this one. Yet, in its effect upon prices in the long run manipulation has less bearing than the other factors discussed in this volume. Its effect upon individual securities is often very marked, but as regards the market as a whole, except in relatively few instances, the influence of manipulation is moderate. Substantial changes in stock-market prices, covering long periods of time, are primarily due to changes in the value of the properties represented, and manipulation, as an independent factor in price-making running counter to natural market tendencies, is only secondary in importance.

Fraudulent Methods of Manipulation.—*Circulation of False Information.*—Reference is had to (1) the fraudulent management of properties and the issuance of fraudulent or deceptive reports or prospectuses, and (2) the spreading of false "tips," rumors, or news. While important in the past, the first of these methods is constantly assuming smaller proportions owing to the standardization and the more frequent publication of detailed accounts on the part of corporations. The second method, however, is still exerting its baneful influence to an alarming degree. From the standpoint of the exchanges improper advertising, employment of representatives of the press, and the circulation in any manner of rumors of a

sensational character are strictly forbidden to all members.[1] But the enforcement of proper conduct upon exchange members will not prevent outsiders from continuing the objectionable practice. Improvement in this direction can be effected only through a better informed public, a higher standard of honor by newspapers, journals, and other publications in the acceptance of financial news for distribution, and a more thorough-going supervision by the state, as well as by private "better-business bureaus."

"Wash Sales" and "Matched Orders."—Although generally used interchangeably, probably because the resulting consequences are similar, these two terms really have reference to different practices.

Wash sales are purely fictitious in character, that is, pretended sales. One party, for example, who wishes to have a given stock appear in the official quotation list at a higher price than could be established through *bona fide* sales, will arrange with some other person to take the stock when offered for sale at the inflated price. The buyer, however, will not be held responsible financially since he acts merely as a co-conspirator with the seller who wishes to inflate the quotation. Besides inflating the quotation of the stock fictitiously, this method may result in one of two things: (1) it may keep the stock quoted in case it is an inactive security; or (2) it may arouse a sufficient interest in the stock on the part of the unknowing, owing to its apparent activity and strength, to cause

[1] See *Constitution of the New York Stock Exchange* (p. 80), relating to the publication of any advertisement of other than a strictly legitimate business character, and the prohibition of the use of catch phrases; p. 102, relating to the direct or indirect employment of representatives of the press with a view to obtaining advance or confidential information; p. 103, relating to the prohibition in any manner of rumors of a sensational character by members of the Exchange or their firms; and p. 76, relating to the remuneration of all employees by fixed salaries, not varying with the business.

Also see the New York Laws, relating to the fraudulent issue of stocks and bonds.

many to purchase at the inflated price. Wash sales are to-day prohibited by exchanges throughout the country. To illustrate, the rules of the New York Stock Exchange pertaining to wash sales as well as matched orders provide that: [2]

"A member who shall be adjudged by a majority of all the existing members of the Governing Committee guilty of making a fictitious transaction or of giving an order for the purchase or sale of securities the execution of which would involve no change of ownership, or of executing such an order with knowledge of its character, shall be suspended or expelled as said Committee shall determine."

Matched orders refer to the practice of using two (or more) brokers, one to buy and the other to sell the same stock at the same time, and in this way to get prices either to rise higher or decline lower than would be the case if the market were influenced solely by *bona fide* bids or offers. The transactions, however, are actually made on the floor of the exchange by the various employed brokers who, in executing the orders, may be entirely ignorant of the fact that their client has given opposite but corresponding orders to other brokers. In fact, success in this type of manipulation depends largely upon the operator's ability to conceal his purpose, which is either to liquidate or to accumulate the security in question when the desired price level has been established. Extensive campaigns of this sort are frequently conducted by pools, that is, a number of manipulators will combine their interests under a pool manager and, subject to the terms of some agreement, the manager will employ numerous brokers to accomplish the purpose of the pool or syndicate.

It is apparent that the effect of such tactics is similar to that produced by means of wash sales. Although the purchases and sales are actually made, there is really no *bona fide* change of ownership involved, since the same person, who is giving the

[2] *Constitution of the New York Stock Exchange,* Art. XVII.

opposite but corresponding orders, is either buying from, or selling to, himself. As in the case of wash sales, matched orders are used artificially to inflate or depress prices with a view to making the stock appear active when otherwise it might be inactive, and to cause unknowing participants in the market to be misled, owing to the apparent activity and strength or weakness of the stock, into buying or selling the security in question. Matched orders are prohibited by exchanges,[3] but the enforcement of the rule among members of the exchange will not prevent outside operators from resorting to the practice through the employment of brokers who might be entirely unaware of the actions of their principals. In 1913 the State of New York passed legislation directed against this practice,[4] but the efficacy of such legislation is very doubtful since the orders may emanate from outside the State of New York and the brokers involved may be ignorant of the fact that the sales and purchases do not represent a *bona fide* transfer of ownership.

Manipulative Campaigns Planned with Reference to Future Conditions.—When accumulating or distributing large lines of stock, individual operators or "pools" will often resort to the most skillful methods of accomplishing their purpose without attracting attention. Thus, after a violent period of liquidation, an operator may wish to accumulate a large line of one or more stocks in anticipation of a future rise. Time is required to make such an accumulation, since bidding for the stock will tend to raise the price unduly. Our operator will purchase whenever weakness develops, but should the price manifest an undue tendency to rise prematurely he will sell in order to depress the price. In other words, he buys and sells day after day, but is careful, since his purpose is accumulation, to buy gradually more than he sells. By skillful maneuvering he may make the market appear weak to the

[3] *Ibid.*, relating to the prohibition of the execution of any order that does not involve a change of ownership.

[4] *Laws of 1913*, Chapter 253.

general public at the very time when a careful analysis would show it to be firm. Generally, following a period of great decline in prices, such operations may cause the market to seesaw back and forth within comparatively small price limits and for so long a period of time as to tax the utmost patience of the average speculator or investor. Gradually the desired line of securities is accumulated, whereas the unknowing, influenced by the apparent weakness of the market and their impatience at not seeing the market improve, dispose of their holdings.

Again, following a long and substantial rise in prices, an operator may wish to distribute the line of securities he has accumulated at lower prices. Time is again required to accomplish such distribution. To throw the securities upon the market in large quantities would tend to depress prices unduly before our operator has accomplished his purpose. Accordingly, our operator will this time follow the plan of selling whenever strength develops, but should the price show an undue tendency to fall prematurely he will buy in order to steady or raise the price. He will again sell and buy day after day, for months, if necessary. But this time he is careful, since his purpose is distribution, gradually to sell more than he buys. Thus, again by skillful manipulation, he may make the market appear strong to the general public at the very time when careful analysis would show it to be displaying a weak tendency. Following a period of great increase in prices, such operations may again cause the market to seesaw back and forth within comparatively small price limits. The desired line of securities is gradually distributed, whereas the unknowing, influenced by the apparent strength of the market, become buyers.

Manipulation of this sort has been referred to as belonging to "the higher type," and to constitute "the fine art of buying and selling stocks to the best advantage." [5] Better to conceal his purpose, this type of manipulator usually employs a considerable number of brokers, buying through some and selling

[5] Pratt, Sereno S., *The Work of Wall Street*, p. 365.

through others at the same time. So many orders may be given, and his position with the several brokers he uses may be changed so frequently, as to make detection of his market position impossible. But through all the labyrinth of his numerous deals he is careful to make his profits exceed his losses so that the net result of all his transactions will be satisfactory. To dispose of one particular stock it may be necessary for this manipulator to strengthen the market by purchases in other directions. Or, as the saying is, certain stocks will be sold under cover of the strength of others. Referring particularly to this type of manipulation, Sereno S. Pratt draws the following excellent analogy:

"The manipulator in stocks is like the manipulator in politics, who pulls the wires, which are generally underground, in order to control conventions and make nominations. But the politician, while thus engaged, can not entirely ignore the potency of public policies, and can not defy too long the will of the people, or he may be overwhelmed. So the manipulator in stocks, by pulling concealed wires and by a scientific arrangement of his forces as intricate and fascinating as a game of chess, is able to make prices. But he must nevertheless not go too far from the true basis of value, or even he may be overwhelmed in the market."

Manipulation Designed to Make a Market for New Issues.—When unaccompanied by matched orders, this method is not necessarily objectionable, and may actually prove beneficial.[6] Experience has shown that large issues of new securities must, as a rule, be sold in the first instance to some underwriting syndicate, which will, in turn, dispose of the issues to middlemen, and through them, in the course of time, to investors. Market conditions must, however, seem attractive in order to induce investors to purchase the securities. Moreover, the sale of the individual security will be benefited if

[6] This view was taken by the Hughes Committee on Speculation in Securities and Commodities.

investors observe its regular appearance in the quotations of some exchange.

To effect these purposes, the flotation of large issues is often preceded by the judicious preparation of the general market. A declining market may be supported by purchases or may even be given a rising tendency to inspire confidence. When a portion of the issue has been floated, the quotation may be supported with buying orders so as not to have a decline in price produce suspicion among investors and thus interfere with the disposal of the balance. Again, by bringing about a proper movement of prices in one issue, the disposal of analogous issues may be facilitated. Frequently corporations also find it advantageous to maintain the price of their securities, particularly with a view to the bolstering of their credit. As reported by the Hughes Committee: "If the securities are really good and bids and offers *bona fide,* open to all sellers and buyers, the operation is harmless and is merely a method of bringing new investments into public notice."

Technical Position of the Market.—Readers of the financial press will frequently see reference made to the terms "oversold" or "overbought" market, "floating supply" of stock, and "technical position of the market." "Floating supply" of any stock refers to that portion of said stock which has not been definitely taken up by investors, and which is thus normally available (floating about) in the speculative market for either buying or selling purposes at ordinary price fluctuations. An "oversold" or "overbought" condition of the market means that there has been, in view of the normal floating supply of a given stock, or of the speculative market generally, an unusually large amount of short selling or of buying on margin, particularly if those who are thus speculating are not strongly fortified financially. Should this oversold or overbought condition be discovered, the opposing interest in the market will either seek to compel the shorts to cover or to force a decline in the market.

Such a situation, commonly known as the "technical position" of the market, is rendered worse at times by the existence of (1) pyramiding, and (2) an unusually large number of stop-loss orders. Pyramiding represents the dangerous practice of buying and selling on margin and of using the successive profits as margins for new transactions as the market continues its rise or decline. The result of the practice is that the operator of the pyramid accumulates or goes short of an excessive amount of stock on slender margin, since all of his paper profits have been utilized as margins to acquire or dispose of more stock of the same issue. A limited price movement will, therefore, often exhaust the pyramider's margin and compel liquidation. Again, if many stop orders exist in the market, some just a point or two below the current quotation, and others at successive intervals of an eighth in the price, and this fact becomes known or is believed to exist, the market may be depressed by short selling until the stop limits are reached, when the stock represented by the stop orders will automatically come on the market and depress prices further. Those who originally depressed the market through short selling will thus find it easy to cover by buying the supply of stocks coming on the market because of the execution of the stop orders. Should there be many stop orders in the market for the protection of short sellers, the process would be reversed, and the manipulators would raise the price by buying until the stop limits are reached, when the execution of the stop orders will automatically increase the demand and raise the price further.

Many of the daily and weekly fluctations in the market are attributable to the manipulative tactics of those who take advantage of the technical position of the market. With comparatively few exceptions, however, price fluctations occasioned by such market positions are not severe and long continued. The most notable exception—the so-called corner—is the next subject for discussion. Strictly speaking, corners represent an

aggravated technical condition of the market, since there is no available supply whatever of the stock to meet the demands of short sellers in fulfilling their contracts.

Corners.—*Definition of Corners.*—This type of manipulation has been responsible for some of the most violent price upheavals recorded in the annals of organized stock and commodity exchanges. Corners can be operated only because of the existence of a short interest in the market. In fact, the term is simply an abbreviation of the more comprehensive expression of "cornering the shorts." This situation is brought about by an operator (or a pool of operators) who succeeds in obtaining possession of all, or virtually all, of the shares of a given issue of stock available for delivery purposes upon outstanding short sales. Such short sales are first induced on a large scale by apparently unwarranted high prices or other methods, the purpose being to bring about a large volume of short sales with a view to making delivery in fulfillment of these sales impossible since the operator of the corner is in possession of all the stock and will refuse to sell except at his own price. Thus, let us assume the given issue of stock to comprise 200,000 shares, in which instance, the operator of the corner may acquire all these shares and at the same time buy another 100,000 shares from short sellers. In the meantime, however, while inducing short selling on the part of the unsuspecting public, the true situation is kept extremely secret. Short sellers must depend, of course, upon a continuous market for the borrowing or purchasing of stock for the purpose of fulfilling delivery. To camouflage the situation the operator of the corner will, therefore, usually lend his own stock freely and on ordinary conditions. Through matched orders, the operator, being both buyer and seller, will also produce the impression that there is a real continuous market in the stock.

When the time arrives for consummating his nefarious purpose, the operator will call in all stock he has loaned to short

sellers. Nor can any stock be purchased because the operator is in possession of it all, and does not offer it for sale. The operator, in other words, possesses all the stock called for by the contracts made by the shorts, i.e., the shorts are cornered. The only means of escape is to negotiate with the operator and settle with him at his own price, whatever that may be, or to repudiate their contracts.

While repudiation is permitted by law, such practice has not been countenanced in the past by the various stock exchanges. The result has been that in the case of large corners the victims have been obliged to obtain the means for settlement with the operator by selling their holdings of other securities, with the consequence that while the cornered stock rose to a prohibitive price, the balance of the market would experience a violent decline, if not, as in the Northern Pacific corner, utter demoralization.

In the case of commodity exchange markets, however, rules have been adopted generally which provide that in case of a corner a reasonable settlement price can be established by a properly constituted committee, thus protecting the short interest against the arbitrary whim of the manipulator. Such rules, it is believed by many, will remove the incentive for operating a corner, since the decision of the committee will have in view the establishment of a fair settlement price. The Hughes Committee also recommended that "the Stock Exchange might properly adopt a rule providing that the Governors shall have power to decide when a corner exists and to adopt a settlement price so as to relieve innocent persons from injury or ruin which may result therefrom. The mere existence of such a rule would tend to prevent corners." [7] But

[7] Despite the difficulties associated with this problem as regards the stock market, the New York Stock Exchange has adopted the following rule (Article III, Sec. 7):

"Whenever in the opinion of the Governing Committee a corner has been created in a security listed on the Exchange, or a single interest or group has acquired such control of a security so listed that the same can-

while this method of handling the problem may be resorted to easily in the commodity markets, its application in the stock market presents greater difficulties. Who is to say what constitutes a fair price for a given stock, especially when different contending interests, for the sake of obtaining control of a property through the voting power attaching to the stock, as was the case in the Northern Pacific corner, are willing to pay almost any price for that purpose?

Illustrations of Corners.—Numerous corners mark the history of the American stock market, and notable illustrations date back as far as 1835. In 1836, we are advised that the New York Stock Exchange appointed a committee to investigate corners, while a similar investigation of the subject was conducted by the New York Legislature in the early '80s.[8]

not be obtained for delivery on existing contracts except at prices and on terms arbitrarily dictated by such interest or group, the Governing Committee may postpone the time for deliveries on Exchange contracts therein, and may from time to time further postpone such time or may postpone deliveries until further action by the Governing Committee, and may at any time by resolution declare that if such security is not delivered on any contract calling for delivery thereof at or before the time to which delivery has been postponed or which has been fixed by the Governing Committee for such delivery, such contract shall be settled by the payment to the party entitled to receive such security or by the credit to such party of a fair settlement price, determined as hereinafter provided. If the parties to any contract which is to be settled on the basis of such fair settlement price do not agree with respect thereto, such fair settlement price and the date for the payment of the same may be fixed by the Governing Committee. The Governing Committee before fixing the same shall give the parties to the contract which is to be settled on the basis thereof an opportunity to be heard either before the Governing Committee or before a Special Committee appointed for the purpose. Any such Special Committee shall report the testimony together with its conclusions thereon to the Governing Committee, which may act upon such report without further hearing, or, in its discretion, may accord the parties a further hearing before acting thereon.

[8] Pratt, Sereno S., *op. cit.*, p. 369. Pratt cites the following notable corners: Morris Canal corner, 1835; Harlem Railway corner, 1835 (although only 7,000 shares of stock had been issued, 60,000 shares had been obtained from the shorts); two more corners in Harlem in 1863 and 1864; Prairie du Chien corner in 1865; Michigan Southern corner in 1866; Gold corner

During the period of the World War, it is not at all unlikely that the unusually high prices of some industrial stocks had their basis in the existence of a corner, but the matter was so engineered as not to involve a serious issue. The last outstanding illustration on the New York Stock Exchange to cause notoriety was the alleged corner in the stock of the Stutz Motor Car Company when the price of the stock rose to over $700.

All corners may be classified under one of two kinds: namely, (1) those that are deliberately engineered for the purpose of fleecing the shorts by forcing them to settle at some abnormal price; and (2) those that have their origin under some pardonable circumstances, such as a fight for control, and are not deliberately designed for mulcting purposes. But while corners of the second class are less to be condemned than those of the first, their disastrous consequences may nevertheless be equally great.

The Northern Pacific corner of May 9, 1901, is probably the most notable stock market corner in American history, and may be regarded as an example of a corner that was unintentional in character and not deliberately engineered. This corner had its origin in the desire of two powerful financial groups—the so-called Hill-Morgan and Harriman interests—to obtain control of the Chicago, Burlington and Quincy Railway system, with a view to obtaining an entrance for their own railway systems into Chicago. In this contest, the Hill-Morgan interests succeeded in acquiring substantially all the stock of the Burlington system. The Union Pacific interests, represented by the Harriman group, asked to be permitted to participate in this deal with the Hill-Morgan interests, representing the Great Northern and Northern Pacific Railroads. Such participation, however, was refused.

The Harriman interests thereupon undertook to acquire

in 1869; corner in Northwest in 1872, when the shorts were obliged to settle at $230; Lackawanna corner in 1884; and the Northern Pacific corner in 1901.

control of the Northern Pacific Railroad itself because of its half interest in the control of the Burlington System. Both interests purchased all the Northern Pacific stock obtainable. On January 21, 1901, Northern Pacific stock was quoted at $77 (using full quotations); on April 2, the price had risen to $101; on April 30 to $117; on May 3 to $115; on May 6 to $133; on May 7 the price fluctuated between $127 and $150; on May 8 between $145 and $180; while on May 9 the lowest quotation was $160 and the highest quotation $700, although it is stated that settlements were made at $1,000 per share. These quotations distinctly show that as the price of Northern Pacific stock rose the inflation was resisted by the shorts. In all nearly 636,000 shares of Northern Pacific common stock were sold during the week and nearly 90,000 shares of preferred stock. Many traders, not knowing that the two opposing interests were each attempting to secure a majority control, went short of the stock and thus placed themselves in a position where they were unable to buy or borrow the stock for purposes of delivery on their contracts.

At the time of the corner, according to published estimates, the Hill-Morgan interests held about $42,000,000 of the $80,000,000 of common stock (a majority), and $76,000,000 of common and preferred stock combined. The Harriman interests, it is estimated, held $37,000,000 of the common and $41,000,000 of the preferred, or a total of $78,000,000, that is, a majority of the common and preferred stock combined. It is stated that both interests had purchased more than the necessary majority of the stock, but of course a considerable amount of this could not be delivered. Although the Harriman interest had the majority of all the stock, it so happened that the common stock possessed the right to retire all of the preferred stock at par, which was done. Owing, however, to the large amount of common stock controlled by the Harriman interests the whole matter was compromised later on a satisfactory basis.

This corner furnishes an excellent example of the effects that a really great corner may produce upon stock market prices generally. Persons caught short of Northern Pacific stock were obliged to liquidate other holdings, many of which were financed on margin. Sales for the day exceeded 3,000,000 shares, a volume of transactions greater than had ever been recorded up to that time for any other daily session in the history of the New York Stock Exchange. In this particular instance, the effect of the corner upon the remaining market was disastrous through such forced liquidation. The following brief list of quotations indicates the disastrous decline that occurred on May 9, and the equally great recovery toward the close of that and the following day. Had it not been for the concerted action of leading financial interests to restore prices before the close of the market on that day to practically the level that prevailed before the commencement of the panic, it is reasonably certain that numerous important financial failures would have occurred.

	High on May 9	Low on May 9	High on May 10
Atchison (preferred)	104½	70	98
Canadian Pacific	105½	87	103½
St. Paul (common)	165	134	158½
Delaware and Hudson	165	105	160
Illinois Central	135	124	137
Missouri Pacific	103	72	108
New York Central	153	140	155
Pennsylvania	147	137	149½
United States Steel	47	24	45

The famous gold corner of 1869, usually associated with "Black Friday," may be cited as an example of a corner deliberately planned. It appeared in 1869 that the Government possessed by far the largest portion of the gold in existence in New York, and it occurred to the members of a certain syndicate that if the Government could be prevented from selling

any of its large holdings, estimated at approximately $100,000,000, the floating supply of gold in New York used by speculators in making their deliveries, estimated at about $20,000,000, could be cornered, and the price of gold raised to any figure desired by the syndicate. According to reports, the syndicate had all arrangements completed for the corner by September, 1869. President Grant had been decoyed beyond the reach of the telegraph and the Treasury Department had been persuaded to stop selling gold. Active buying started at 133½ on Wednesday morning, the syndicate, according to reports, having already purchased more gold than was obtainable in New York, with the exception of that held in the United States Sub-Treasury. By Thursday morning, according to reports, the syndicate had secured contracts for approximately $100,000,000 of gold from short sellers, and it was estimated that the total short interest in the market was considerably larger than this figure. On Friday morning gold opened at 143½; by eleven o'clock it had been forced to 150; five minutes later to 160; and then to 162½. Many firms settled at this figure but others refused settlement. Suddenly it was announced that the Government was selling its big supply of gold. The price fell abruptly to 131½ and many firms went into bankruptcy. One of the leading firms participating in the operation of the corner is said to have settled at 135, and is estimated to have lost some $13,000,000, besides disclaiming responsibility for the acts of many of its brokers.

Corners in Commodity Markets.[9]—In these markets corners have occurred with probably even greater frequency than in the security market. With few exceptions, such corners are deliberately created.[10] Moreover, in these markets, corners are

[9] An excellent explanation of the method of operating a corner in the produce market is found in Samuel *v.* Oliver (130 *Ill.* 73), and in the Matter of Chandler (13 Am. Law Reg. m.s. 310).

[10] In rare instances, we find the corner due to unforeseen and unavoidable circumstances. Thus, during the World War it is alleged that short sellers were cornered through the heavy purchases of American wheat

usually operated with reference to a particular delivery month, and the particular grades deliverable on contracts according to the rules of the exchanges.[11] Short sellers in our commodity markets, when selling for forward delivery in a future month, must deliver on the last business day of that month, and can only deliver those grades allowed by the rules of the exchange on which the contract was made. This gives the opportunity to some unprincipled manipulator secretly to buy up the commodity, say wheat, available for delivery purposes on the particular exchange under consideration, and then to buy considerably more from short sellers. Towards the close of the month, if the secrecy of the operation can be maintained, short sellers will find themselves in a position where they must deliver on the last business day of the month, but are unable either to purchase the wheat or to secure shipment, owing to the lack of time to obtain it from outside markets. No alternative remains, unless exchange rules intercede, but to settle the contracts with the operator of the corner at a price of his own choosing.

Because of such possibilities, the number of grades of wheat, corn, oats, cotton, coffee, etc., that may be delivered on exchange contracts, have been made sufficiently large to prevent frequent cornering. Corners in the commodity markets are, therefore, rendered extremely difficult, except for a particular monthly delivery period, when the operator of the corner,

by certain of the Allied Governments, with the result that the price rose to $3.50 per bushel on various exchanges. It is also stated that when it became apparent that wheat was unobtainable for the fulfillment of contracts, the said Governments, interested only in obtaining wheat, released the sellers from their obligations.

[11] Some attempts have been made from time to time, actually to corner the national supply of some leading staple such as wheat, cotton, copper, etc. Leading examples are the Leiter corner in wheat and the Sully corner in cotton. Almost without exception, such daring attempts at the cornering of the entire national supply of a leading product have ended in disastrous failure for the operators. The wonder is that such attempts should be repeated in view of the dismal record of the past.

having quietly obtained control of the supply, may succeed in hiding his purpose from short sellers to so late a day in the month as to make it impossible for them to have enough grain, etc., shipped into the particular local market within time to enable them to fulfill delivery on their short sales. But even here it is necessary to control various grades and not merely one. Thus, in the cotton market while the contract calls for "middling" cotton, the seller is nevertheless enabled to deliver a large number of grades either better or poorer than the particular grade stipulated. Hence, to operate a corner in the commodity market it becomes necessary to acquire control not merely of one grade of the commodity but of several.

Illegality of Corners.—Owing to their nefarious and noncommercial character, corners are opposed by both court and statute law, as well as by the rules of the various exchanges. In the Matter of Chandler, 13 Am. Law Reg. 310, affords an excellent illustration wherein those who had contracts with Chandler, the operator of a corner, with a view to breaking the price that he was endeavoring to maintain, were refused the right to recover their claims from the bankrupt estate of Chandler on the ground that they well knew that he was working a corner. Similarly, in Samuel *v.* Oliver, 130 Ill. 73, the appellants, brokers of the exchange, were denied reimbursement for commissions and other payments from their principals who were operating a corner. The court held:

"If in executing the instructions of these principals it became necessary for appellants to pay the money to adjust differences, they, if guilty of no fraud or violation of law, will be entitled to reimbursement by their principals. If appellants had not aided or assisted appellees in cornering the wheat market and in manipulating that market for an illegal or fraudulent purpose, so as to enable the latter to control the same for their own profit, and to the injury of all persons having occasion or knowledge of the wrongful and illegal purposes of the appellees they would have been entitled to reimbursement."

To make a corner profitable, the operator buys from short sellers what he knows cannot be delivered since all the available supply is already controlled by him. Moreover, to maintain the inflated price of the stock and to deceive the public into believing that there is a continuous market therein, he will resort to the practice of matching orders. Hence, the importance of the Exchange Rules and the New York law of 1913, already referred to, which prohibit execution of any orders which do not involve an actual change of ownership.

Requirements of the Securities Exchange Act of 1934.—A large portion of this Act (Sec. 9) is devoted to "prohibitions against manipulation of security prices," with respect to any member of a national securities exchange, as well as "any person, directly or indirectly." Some of the prohibitions referred to have for years been enforced by the nation's leading exchanges, such as those relating to fictitious sales and matched orders. The following acts, prohibited by this law, however, should be mentioned:

(1) The dissemination of information to the effect that any registered or unregistered security "will or is likely to rise or fall because of market operations of any one or more persons, conducted for the purpose of raising or depressing the price of such security."

(2) The making of any statement, with respect to any registered or unregistered security, "which was, in the light of the circumstances under which it was made, false or misleading with respect to any material fact, and which he knew or had reasonable ground to believe was so false or misleading."

(3) The dissemination of information, for a consideration, to the effect that the price of any registered or unregistered security "will or is likely to rise or fall because of the market operations of any one or more persons conducted for the purpose of raising or depressing the price of such security."

(4) Engagement "in any series of transactions for the purchase and sale" of any registered or unregistered security,

"which has the purpose of pegging, fixing, or stabilizing the price of such security in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors or without having prior thereto reported to the exchange authorities and to the Commission such information regarding the purpose and nature of such transactions or operations, etc."

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PART IV

LEGAL PRINCIPLES AND USAGES GOVERNING THE STOCK EXCHANGE BUSINESS

CHAPTER XXII

PRINCIPLES AND USAGES RELATING TO THE EXECUTION OF ORDERS

Numerous legal questions arise in the conduct of the stock-brokerage business. It is the purpose of this and the next three chapters to consider those legal principles with which the customer is most vitally concerned. In the interest of clearness such legal phases may be grouped conveniently under (1) principles and usages relating to the execution of orders; (2) rights and duties of broker and customer in margin transactions; (3) rules governing the re-pledging of securities; and (4) the extent to which customers' margins and pledged securities are protected in case of the broker's insolvency. In formulating a decision concerning any particular problem it is necessary to consider the court decisions and statutes of the state in question, and the rules and regulations of the exchange involved.

General Legal Nature of the Order.—A purchase or sale of securities through a broker really involves two contracts. The first, between the buyer and seller, is a contract of sale and is carried out by the brokers representing each party. While the buyer and seller are the ultimate principals, and as such are responsible for the contractual obligations, nevertheless, since in the great majority of cases the brokers act without disclosing the identity of their customers, they also are bound to each other as principals. The fact that a purchaser or vendor "dealing in his own name, without disclosing the name of his principal, is personally bound by his

contract," is based not only upon legal principles, but also upon the rules of practically all exchanges.[1]

The second contract is one between the broker and his customer and creates an agency relationship.[2] In the execution of an order, therefore, the broker acts as agent for his employer, the customer. Legally, the order serves a two-fold purpose, namely, (1) to express the customer's intent, and (2) to invest the broker, the customer's agent, with full authority to complete the transaction he has been asked to make. With respect to the first of these purposes, it is essential that the customer make his order clear in order to avoid all misunderstanding on the part of the broker. Probably no vocation involves so many technical terms and usages as the brokerage business, and by law the customer's failure to understand or even to know of the existence of such usages does not excuse him from being bound by them. With respect to the second purpose, the customer must necessarily authorize the broker, when executing the order, to observe the rules and usages of the exchange of which he is a member.

Assuming that the broker executes the order in strict compliance with its terms, and the customs and usages of the market, the customer is legally bound to assume all consequences that necessarily result from the authorized performance of his proposal (the order) to the broker. As summarized by Eliot Norton,[3] the customer agrees, in consideration of the broker's acceptance of the order "to reimburse and indemnify the broker for all outlays, expenses, liabilities, and losses necessarily or reasonably incurred in acting as his agent. This very obviously involves an offer to supply the stock broker

[1] Meyer *v.* Redmond (1912) 205 *N.Y.* 478, 483. See also *Rules,* New York Stock Exchange, Chapter I, Sec. 14.

[2] In a marginal purchase or a short sale the relationship between the customer and his broker assumes a dual nature. See *infra,* Chapter XXIII.

[3] Norton, Eliot, "The Purchase or Sale of Securities through a Stock Broker," published in "Stocks and the Stock Market," *Annals of the American Academy of Political and Social Science* (1910) p. 34.

with the securities or money needed to perform in the event of his contracting to buy or to sell; also an implied offer to pay the stock broker a commission in accordance with the requirements of his stock exchange."

Legal Interpretation of the Order.—Orders to buy or sell are generally given in the smallest number of words, and with certain firms the practice is simply to have the order blank contain the words "buy" or "sell." Irrespective of the wording used, however, the meaning of the order, according to the courts, must include all of the rules and usages prevailing in the market.[4] Thus, in the case of Bibb *v.* Allen the United States Supreme Court held that "where a principal sends an order to a broker engaged in an established market or trade, for a deal in that trade, he confers authority upon the broker to deal according to any well-established usage in such market or trade. . . ." [5] The form of the order usually assumes some such wording as: "(buy) or (sell) for my account and risk 200 AR at 40." This order, however, must be amplified in order to give its true legal meaning. The wording of the order is, therefore, repeated with references to the insertions that are legally understood to be included: [6]

(1) Buy (2) for my (3) account and (4) risk (5) 200 (6) AR (7) at 40 (8) (9).

(1) *"I Order You to Contract to Buy."* It is all-important to bear in mind that the order does not actually constitute a purchase or sale. Instead, it is simply *"an executory contract of sale,"* that is, a contract to make a purchase or sale. Although having contracted with some other broker for the purchase or sale of stock, the agreement may never be actually performed for some such reason as the inability of the other broker to deliver or receive the securities in question. Under such

[4] Clews *v.* Jamieson (1901) 182 *U.S.* 461; Bibb *v.* Allen (1893) 149 *U.S.* 481.

[5] (1893) 149 *U.S.* 481, 489.

[6] Norton, *op. cit.*, p. 31.

circumstances the customer cannot insist that his broker must deliver or receive the stock involved in the order to buy or sell. Since the broker in the execution of the order acts as the agent of his customer, in the absence of failure to execute the order in accordance with the customer's instructions, the broker cannot be personally held for the default of the party with whom he contracts. For reasons over which he had no control, the actual purchase or sale, which he had contracted in good faith to perform with some other broker, could not be consummated.

(2) *"Immediately on the Exchange of which You Are a Member According to All Its Rules and Customs."*—In the absence of a special agreement to the contrary, all orders to buy or sell must be executed in the open market on the floor of the exchange, and attention has already been called to the fact that every exchange compels all transactions on its floor to be made in strict compliance with its rules and usages. The broker not only agrees with the customer to observe all such regulations, but the latter must also necessarily agree, if he wishes the order executed on the exchange, to allow his broker to comply with all requirements imposed upon him by the exchange of which he is a member, and which he expressly agreed to observe at the time of his election to membership. Prompt execution of all orders is also understood. Execution of the order at the earliest possible moment is essential if the customer is to obtain the best possible price, and neglect of duty in this respect will subject the broker to liability for any resulting damage.

(3) "My account" means *"for me and on my behalf."*

(4) "My risk" is to be interpreted as meaning *"I (the customer) to assume the risk of any failure on your part, using due care and diligence, to perform the executory contract."* The customer, in other words, does not require the broker to guarantee that any contract to buy or sell, which he may

make in pursuance of his order, will actually be performed by the broker with whom he has contracted.

(5) *"Regular way delivery."*—When no reference is made in the order to the time when the securities which the broker is instructed to contract to buy or sell, shall be delivered, it is understood that he should contract to buy or sell for "regular way delivery," that is, for delivery on the second full business day following the day of the contract.

(6) *"200 shares of the common stock."*—The figure 200 refers to the number of shares of the particular stock that the broker is to contract to buy or sell. In law, the broker is entitled to buy or sell a smaller quantity of shares than is set forth in the order, when he is unable to buy or sell the full quantity specified.[7] So, too, on the New York Stock Exchange "All bids or offers for more than one trading unit of stocks or bonds shall be considered to be for the amount thereof or any less number of units."[8] By usage, however, it is customary not to split an order for the purchase or sale of 100 shares, or multiple thereof, into "odd lots," i.e., lots of less than 100 shares. Thus in the order under consideration the broker may contract to buy two 100-share lots from two other brokers. Should the corporation have both preferred and common stock listed on the exchange, and should the order fail to specify the kind of stock intended to be bought or sold, it is presumed, unless the stipulated price clearly indicates a different intent, that the order has reference to the common stock.

(7) *"Of the American Smelting and Refining Company at 40."*—To save time, especially in transmitting quotations, numerous abbreviations are used to represent the full names of corporations as well as the various kinds of stocks and bonds.[9] Symbolic references must be given the meaning cus-

[7] Marye *v.* Strouse (1880) 5 *Fed.* 483.
[8] *Rules,* New York Stock Exchange, Chapter I, Sec. 8 (b).
[9] *Supra,* Chapter XIII.

tomarily accepted in the market, and the broker is protected if he observes such abbreviations correctly. In our sample order, the letters "AR" stand for The American Smelting and Refining Company.

The figure 40 refers to the number of dollars per share at which the broker shall contract to buy the stock. Should the order stipulate no price, it is understood that the broker is ordered to contract to buy or sell the security at the best price, that is, "at the market price." The order, however, may expressly state that it shall be executed "at the market." In that event the broker is justified in contracting at the best possible price at the time the order is executed, even though that price may be substantially different from the one quoted at the time the order was given.

(8) *"Or Better."*—Should the order specify a fixed price, these words are presumed to be read into the agreement, but under no circumstances may the broker exceed his instructions and vary the price to the customer's detriment. Thus, our sample order instructs the broker to contract to buy American Smelting and Refining common stock at "40 or better." With respect to the price, proper service to the customer always implies that the broker must contract at the best possible price, that is, a lower price than may be stated in the order to purchase, and a higher price than that stipulated in the order to sell. The price of 40 in our sample order may have been based upon the last quotation for 100 shares. Yet, by the time the order to buy reaches the floor of the exchange, the current quotation may have changed to 39½. The customer has a right to this better price if it can be obtained, and the broker is never entitled to more than his commission and all legitimate expenses. No secret profits may be made by the broker out of any transaction entrusted to him for execution.[10]

[10] Levy *v.* Loeb (1882) 89 *N.Y.* 386; Illingworth *v.* DeMott (1899) 59 *N.J.* Eq. 8.

(9) *"This order to remain in force for this day only."*—Unless the order expressly states that it is to remain in force for a longer period, it is understood that the broker's authority to contract is limited to the day on which the order is given. Brokers are always very careful to have customers specify the time limits during which their orders are to remain in force. Very commonly orders specify some particular period of time during which they are to remain in force, or are made to read "good till countermanded." In the absence of some agreement covering the matter, when stocks sell ex-dividend all customers who have buying orders at fixed prices and stop orders to sell are notified usually that the designated price will be lowered by the amount of the dividend.

The foregoing explanation shows that legal principles and usages constitute an important part in the interpretation of an order to buy or sell through a stock broker. Rewritten with a view to including the aforementioned ideas, our sample order would read as follows:

I order you to contract to buy immediately on the exchange of which you are a member, according to all its rules and customs, for me and on my behalf (I, the customer, to assume the risk of any failure on your part, using due care and diligence, to perform the executory contract), regular way delivery, 200 shares of the common stock of The American Smelting and Refining Company at 40, or better, this order to remain in force for this day only.

Other Important Obligations of the Broker.—In addition to the foregoing, the following four important duties of the broker are also implied:

1. A broker is required to send a confirmation to his customer, reporting the execution of the order given.[11] The customer must be given full notification of every transaction setting forth "a description of the securities purchased or sold, the name of the person, firm or corporation from whom such

[11] MacDonald *v.* Wills & Company (1925) 240 *N.Y.* 144.

securities were purchased, or to which the same were sold, and the day, and the hours between which the transaction took place." [12] This is now a statutory requirement in New York, although with the exception of stating the time of execution, brokers have always followed a custom of giving the aforementioned data to their customers. Proper accounts, showing the names of all persons with whom he has dealt for his customer, must also be kept by the broker, and presumption of value against him is assumed in case of failure to comply with this requirement.

2. Correspondents or branch office managers of a stock broker are his legal agents in transactions between himself and a customer. Whether the broker is bound depends upon the agent's actual or apparent authority. The manager is usually regarded as a general agent with broad powers, and the broker is bound even if the contract is contrary to some private instruction unknown to the customer. Other employees of the broker usually have more limited authority.

3. One of the fundamental principles of the law of agency is that the agent may not have an interest in the transaction contrary to that of his principal. Accordingly a broker is legally forbidden to buy his customer's securities, or to sell his own securities to his customer, except by consent. Neither the question of fraud nor damage to the customer's interests need be

[12] *New York Penal Law,* §§ 392, 957. The latter section reads as follows: "A person engaged in the business of purchasing or selling as broker stocks, bonds and other evidences of debt of corporations, companies or associations shall deliver to each customer on whose behalf a purchase or sale of such securities is made by him a statement or memorandum of such purchase or sale, a description of the securities purchased or sold, the name of the person, firm or corporation from whom such securities were purchased, or to which the same were sold, and the day, and the hours between which the transaction took place. A broker who refuses to deliver such statement or memorandum to a customer within twenty-four hours after a written demand therefor, or who delivers a statement or memorandum which is false in any material respect, is guilty of a misdemeanor punishable by a fine of not more than five hundred dollars or imprisonment for not more than one year, or both."

considered; the transaction may be repudiated. "The principle is undeniable that an agent to sell cannot sell to himself, for the obvious reason that the two relations of agent and purchaser are inconsistent, . . ." [13] Nor may the broker represent both buyer and seller in negotiating a purchase or sale.[14] That is, he may not offset the orders of different customers by mere office records. He is permitted, however, to cross an order to buy with an order to sell, provided he does so publicly on the floor of the exchange and in accordance with its rules.[15]

4. A broker is likewise prohibited from trading against his customer's orders. That is, he cannot take a position in the market opposite to that of his customer for the purpose of neutralizing the latter's order. The execution of reverse trades for the above purpose prior to the purchase and delivery of the customer's securities is forbidden both by the New York Penal Code [16] and the New York Stock Exchange.[17]

Customs and Usages in the Stock-Brokerage Business.—Various references have been made in the preceding pages to usages prevailing in our organized exchange markets. The number of such usages, however, is so large as to preclude more than a summary of the most important ones. Although frequently disregarded or confused by courts and text writers, there is technically a difference in meaning between the words "custom" and "usage." A usage is a practice of which contracting parties have knowledge, either actual or imputed, and

[13] Porter *v.* Wormser (1884) 94 *N.Y.* 431, 447.

[14] Levy *v.* Loeb (1881) 85 *N.Y.* 365.

[15] Higgins *v.* McCrea (1886) 116 *U.S.* 671. The Rules of the New York Stock Exchange, Chapter I, Sec. 13 provide: "When a member has an order to buy and an order to sell the same security, he must offer such security, if bonds at ⅛ of 1%, and if stocks at ⅛ of one dollar, higher than his bid before making a transaction with himself."

[16] Section 954.

[17] Rules. Chapter XII, Sec. 11. The Exchange forbids any member from being directly or indirectly interested in "any organization, firm or individual engaged in purchasing or selling securities for customers and making a practice of taking the side of the market opposite to the side taken by customers."

which is incorporated into the terms of the contract. A custom is a usage that has acquired the force of law. The courts regard custom as the equivalent of law, but usage must be established by independent proof. The principle has been stated as follows: [18]

"Usage is invoked to give meaning to a contract, on the assumption that the parties contracted in reference thereto; yet, since there can be no intent without knowledge (actual or imputed) of what was intended, not only must proof be given showing that the usage relied upon exists, but the relation of the parties concerned must be shown to be such that knowledge of the usage in question may be inferred, and further that intent to be bound thereby may also be established by reasonable inference."

The rules and regulations of exchanges, when they are followed in practice, have been recognized as usages by the courts. As previously stated, subject to certain limitations, a customer who gives his broker authority to execute an order upon an exchange, is bound by the rules and usages of the exchange on which the order is executed, even though in fact the customer may be ignorant of them.[19] Since the purpose of introducing usages is to amplify or make clear the intention of the parties, and not to create a new contract, it is generally held that usages that vary or contradict the contract or change the legal relations of the parties are not binding unless the customer had actual knowledge of them.[20] If the customer, however, has knowledge he is bound unless the contract provides otherwise.

A usage that impairs the customer's legal rights is without effect unless the customer has expressly agreed, or has waived his rights. Thus, where the defendant broker offered to prove a custom that securities might be disposed of without notice when the customer's margin was exhausted the court stated: [21]

[18] Eames *v.* H. B. Claflin Co. (1917) 239 *Fed.* 631, 634.
[19] 79 *American Law Reports* 592.
[20] *Ibid.*, p. 600.
[21] Markham *v.* Jaudon (1869) 41 *N.Y.* 235, 245.

"This was an offer, not to explain the meaning of particular terms, or to prove attending circumstances to enable the court to construe the agreement, but to change the rights of the parties to a contract. By the law, as I have interpreted it, the customer did not lose the title to his stock by any process less than a sale upon reasonable notice, or by judicial proceedings. The broker had no right to sell without such a notice. A practice or custom to do otherwise, would have no more force than a custom to protest notes on the first day of grace, or a custom of brokers not to purchase the shares at all, in a case like the present, but to content themselves with a memorandum or entry in their books, of the contract made with their customer. Such practice in each case, would be in hostility to the terms of the contract, an attempt to change its obligation, and would be void. The proof could not, therefore, be legally given."

It is also generally held that a usage or rule is not binding upon the customer when it is illegal in character or when it violates any rule of law, good morals, or public policy,[22] and while a member and a non-member may in certain cases expressly contract to vary certain usages or rules, this is prohibited when such action violates the proprietary rights of the other members of the exchange.[23]

Brokers Must Exercise Due Skill and Care.—Whether acting as agent or pledgee, the broker is required to exercise due skill and care in executing his customer's orders and in taking care of pledged securities. The exercise of ordinary care and judgment is not sufficient. In the widely known case of Isham *v.* Post the degree of care required of a broker has been thus defined: [24]

"Those who dealt with him contracted for and had a right to expect a degree of care commensurate with the importance and the risks of the business to be done, and a skill and capacity adequate to its performance. That care and skill is such as should characterize

[22] Bibb *v.* Allen (1893) 149 *U.S.* 481, 490.

[23] Newman *v.* Lee (1903) 87 App. Div. (*N.Y.*) 116; Roberts *v.* Criss (1920) 266 *Fed.* 296, 300.

[24] (1894) 141 *N.Y.* 100, 105.

a banker operating for others in a financial center, and different in kind from the ordinary diligence and capacity of the ordinary citizen."

The court gave this general ruling even though the facts showed that in this instance the service to be rendered by the broker was to be gratuitous. Briefly stated, this case involved an action brought by the plaintiff, as trustee, to recover from Post, the broker, $25,000 alleged to have been placed in his hands to be loaned for the plaintiff and to be returned on demand. Post loaned the money, taking as collateral certain stock certificates that had been raised by forgery so as to represent a much larger number of shares than they had been issued for, with the result that a large loss occurred since the firm borrowing the money became insolvent. It also appears from the facts in the case that the loan was made to a firm in good repute and standing at the time, and that the original certificates were genuine and lawful, having been issued six years previously to a member of the firm. Moreover, the loan was made by Post's managing clerk, who, although having had an extensive experience in such transactions, and having handled many of the certificates of the stock in question, admitted that he took the certificates as collateral without close scrutiny.

The original trial court found that Post had been negligent in making the loan upon the security of the certificates on the following three grounds, namely, he took them (1) without presenting them for verification at the office of issue or registry, (2) without inquiry as to the solvency of the borrowing firm, and (3) without sufficiently close examination. The higher court held that the broker's duty does not extend to inquiry of the corporation whose shares were involved for the purpose of ascertaining the genuineness of the certificates. Nor must the broker inquire into the solvency of firms generally reported to be responsible. On the third point the court maintained that if the forgery was so clever that it would deceive the skill

and knowledge of an ordinary banker, the broker would not be responsible for the loss; but if a reasonable examination would have revealed the forgery, the broker would be liable. Since the evidence on this point was not conclusive, a new trial was ordered. After a retrial, the case was again considered and the court stated: [25]

"The readiness with which the fraudulent character of the certificates appears to have been detected when they were examined with real attention, indicates that ordinary diligence on the part of the person who actually accepted them as security for the loan of the plaintiff's money would have insured their rejection."

Discretionary Accounts.—A discretionary account is one in which the broker is given authority by his customer to buy and sell securities for him without specific instructions concerning what securities are to be bought and sold. This is a fiduciary relationship of extreme delicacy, particularly when the broker is dealing in like manner for other customers, as well as trading for himself. While such relationship is one "of the most delicate fiduciary character and one which no agent should have undertaken and which no principal should have intrusted to an agent," [26] yet if the customer knows all the material facts, he is responsible for his broker's transactions, since such accounts are not illegal. The broker, however, in order to bind the customer must exercise his discretion wisely.[27] The New York Stock Exchange prohibits members from giving discretionary orders to employees on the floor of the Exchange.[28] And the Committee on Quotations and Commissions has adopted the following rule: [29]

[25] Isham *v.* Post (1900) 51 App. Div. (*N.Y.*) 605. This decision was affirmed by the Court of Appeals in (1901) 167 *N.Y.* 531. The Court stated that this did not conflict with the rule of law as decided in the former case (1894) 141 *N.Y.* 100.

[26] Cohen *v.* Rothschild. (1918) 182 App. Div. (*N.Y.*) 408, 424.

[27] Hopkins *v.* Clark (1899) 158 *N.Y.* 299.

[28] *Rules*, New York Stock Exchange, Chapter XII, Sec. 9.

[29] Rule 5 of the Supplementary Rules Adopted May 7, 1930.

"Discretionary Accounts: Customers' men and all other employees are prohibited from handling discretionary accounts. Discretionary power in the handling of an account may be vested only in partners. A partner may delegate such discretionary power to a customers' man to a reasonable extent, provided the consent of the customer in writing is first obtained. Such delegation of discretionary power by a partner to a customers' man does not relieve the partner of responsibility for improper transactions."

It should be added that according to section 11, subsection (a), of the Securities Exchange Act of 1934 the Securities and Exchange Commission "shall prescribe such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors, (1) to regulate or prevent floor trading by members of national securities exchanges, directly or indirectly for their own account or for discretionary accounts."

Brokers' Communications Not Privileged.—With respect to secrets of state, communications or other information confided by a client to his legal advisers, or knowledge gained by a physician in attending a patient, wise public policy demands that certain kinds of evidence need not be furnished in case of legal controversies. Numerous attempts have been made to establish the principle that communications and transactions between broker and clients should receive similar treatment. Such consideration, however, has been refused by the courts.[30] Although communications and transactions between brokers and clients are observed as strictly confidential, they cannot, from a legal point of view, be considered as privileged in legal proceedings.

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CHAPTER XXIII

THE LEGAL NATURE OF A SPECULATIVE PURCHASE

Financial Nature of a Speculative Purchase.—A very large proportion of the total business on American exchanges consists of margin transactions, where the purchaser pays only partially for the securities, the broker holding the stock as a pledge and borrowing the balance of the purchase price. In such transactions the customer advances a certain part of the purchase price in cash, or has standing with his broker a certain balance composed either of cash, securities, or both. Since the customer's account is charged with the purchase price of the securities bought, there is normally an excess of debits over credits, which excess is commonly known as the debit balance.

The deposit that the customer has, or the part payment that he makes, is known as the margin. This subject may be viewed from two angles. It may be regarded either as the relationship existing between the customer's equity and the value of the collateral, or as the relationship existing between the customer's equity and the amount of the loan, i.e., in brokerage accounting, the debit balance. For example, if the customer purchases stock worth $100 and deposits $20 as margin, according to the first concept he has a margin of 20 per cent. In other words, the price must decline 20 per cent before his equity is exhausted. According to the second concept, which is the one prevalent in brokerage and banking circles, since the customer has an equity of $20 and since the amount of the broker's loan is $80, the margin that the latter has above his loan is $20 or 25 per cent of the amount owed him.

Margin may be figured in points, or percentage, or both. In the above example there is a margin of 20 points, i.e., the stock must decline $20 before the customer's equity disappears or before the lender has no value in excess of his loan. Whether or not a twenty-point margin is satisfactory depends entirely upon the market price of the security in question. If, for example, a stock is selling at $300 per share such a margin will be inadequate, whereas if the market price is $15 per share, it is impossible. A percentage requirement in such cases affords a much better guide. The percentage required depends upon the nature of the security under consideration, the character of the market at the time, and the individual wishes of the broker. Some securities, because of their high price, speculative character, or inactivity in the market fluctuate much more within a short time than securities having the advantages of a continuous market, and a larger margin is therefore required. The margin is for the protection of the broker in case market prices fluctuate adversely to his customer's interests. Since the broker acts in the capacity of an agent and is thereby prevented from participating in any of his customer's gains, he should also be protected against the possibility of sustaining any losses. Past experience indicates that a flat margin requirement is unsatisfactory. The requirements should be flexible and wisely administered in accord with current conditions. The New York Stock Exchange provides: [1] "The acceptance and carrying of an account for a customer, whether a member or a non-member, without proper and adequate margin, may constitute an act detrimental to the interest or welfare of the Exchange."

Usually, but not necessarily, brokers in financing margin transactions advance a certain amount of their own capital, the balance of the purchase price being advanced by the bank with which the purchased securities are hypothecated as collateral for the loan. As regards good collateral, bankers usually

[1] *Rules,* New York Stock Exchange, Chapter XII, Sec. 1.

require a margin of from 20 to 30 per cent in excess of the loan. It should be emphasized, however, that the respective amounts advanced by the three parties concerned in the financing of a speculative transaction—customer, broker and banker—vary at different times to meet general market conditions or the conditions pertaining to particular securities, the broker exercising his judgment in the matter.

Margin Requirements on Long Accounts.—In the various hearings on the Securities Exchange Act of 1934, the provisions dealing with the regulation of margins on long accounts received a great deal of attention and encountered much opposition. It was contended that margins should be flexible and not arbitrary. Section 7 of the Act imposes certain limitations on the amount of credit "that may be initially extended and subsequently maintained on any security (other than an exempted security) registered on a national securities exchange."

For the purpose of preventing the excessive use of credit for the purchase or carrying of securities, the Federal Reserve Board is given authority to "prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security) registered on a national securities exchange. For the initial extension of credit, such rules and regulations shall be based upon the following standard: An amount not greater than whichever is 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 thirty-six calendar months, but not more than 75 per centum of the current market price."

Until July 1, 1936, the lowest price at which a security has sold on or after July 1, 1933, shall be considered as the lowest price at which such security has sold during the preceding thirty-six months.

Section 7 further provides that the rules and regulations "may make appropriate provisions with respect to the carrying of undermargined accounts for limited periods and under specified conditions; the withdrawal of funds or securities; the substitution or additional purchases of securities; the transfer of accounts from one lender to another; special or different margin requirements for delayed deliveries, short sales, arbitrage transactions, and securities to which paragraph (2) of this subsection does not apply; the bases and methods to be used in calculating loans, and margins and market prices; and similar administrative adjustments and details."

In order to prevent excessive liquidation of outstanding loans on which the amount of credit extended is larger than that permitted, the Act does not apply arbitrarily to such loans until after July 1, 1937. The Federal Reserve Board may prescribe lower margins where such action is necessary or appropriate for the accommodation of commerce and industry, and it may prescribe higher margin requirements where it is deemed necessary to prevent the excessive use of credit for speculative purposes.

Rights and Duties of Brokers and Customers in a Speculative Transaction.—As previously stated, in executing an order for his customer, a broker is regarded as an agent, and the general principles of the law of agency govern the relationship. In a margin transaction, however, this is but the first step. The second involves the financing and carrying of the purchase. In providing funds for this purpose the relationship between the broker and his customer differs from that of agency and becomes one of pledgor and pledgee. The case of Markham *v.* Jaudon [2] involves a full description of the nature of a specu-

[2] (1869) 41 *N.Y.* 235. Besides the majority opinion, this case contains two dissenting opinions. It is worthy of careful study since it analyzes in detail the nature of a speculative transaction and constitutes a text on the subject. The dissenting opinions in the case are also very instructive, and were fully reported "at the request of many leading members of the profession" because, as the case states, "numerous contracts are daily

lative purchase and the respective rights and obligations of customer and broker in such a transaction. This case is important in that it constitutes an excellent text on the subject of margin transactions. With a single exception, the measure of damages in case of wrongdoing or negligence on the part of the broker, it contains the leading principles of the present law governing such transactions.

According to the facts of this case the brokers purchased for the plaintiff certain shares of stock that were to be held on margin subject to the customer's orders. The plaintiff deposited with the brokers a stipulated margin upon the purchase of the stock, and maintained that without his knowledge or consent and without due notice to him the brokers sold the stock and converted it to their own use, thereby causing a loss which he, the plaintiff, now sought to recover.

The brokers, on the other hand, alleged that they had an understanding with the plaintiff to the effect that a margin of 10 per cent of the par value of the stock should always be kept with them, and that since the plaintiff failed to maintain this margin they were at liberty to sell the stock on the exchange at the market price and in accordance with the usages and customs of the business. They further asserted that a large decline had occurred in the value of the securities, that a call for more margin was made, that the plaintiff failed to supply it, that a notice was sent to the customer that unless he supplied the additional margin the stocks would be sold, that an exhaustion of the margin had occurred, that the customer concealed himself so that notice could not be served, and that thereupon the stock was sold. After applying the margin, it was asserted by the brokers, a balance still remained due them from the plaintiff. All questions of fact involved in the transaction were referred to the jury and it was shown that

made in the City of New York, frequently involving enormous amounts, and also, because of the fact that this is the first full consideration in the court of last resort, of the legal relations of the parties in such contracts."

the plaintiff was familiar with the customs of brokers in the city of New York but that no notice had been given to him of the time and place of the sale of the stock. It should also be stated that about two months after the brokers had sold the stock the plaintiff repudiated the sale and required a sale and accounting as of that date, the stock having in the meantime advanced greatly in price. The jury, in the main, upheld the contentions of the plaintiff and awarded damages of $4,850.

In the appeal the court found it necessary to analyze the powers and obligations of the parties to the contract in question, and it is in this respect that the case is worthy of careful study. The court outlined the powers and obligations of broker and customer in a speculative transaction as follows:

The broker undertakes and agrees in such a transaction:

1. To buy for the customer the stocks as indicated in the order.
2. To advance all the money required for the purchase beyond the 10 per cent furnished by the customer.
3. To carry or hold such stocks for the benefit of the customer so long as the margin of 10 per cent is kept good, or until notice is given by either party that the transaction must be closed. Any appreciation in the value of the stock belongs to the customer and not to the broker.
4. At all times to have in his name or under his control, ready for delivery, the shares purchased, or an equal amount of other shares of the same stock.
5. To deliver such shares to the customer whenever required by him, upon receipt of the advance and commissions accruing to the broker.
6. Or to sell such shares upon the order of the customer upon payment of all advances and commissions, and to account to the customer for the proceeds of the sale.

The customer undertakes and agrees in this contract:

1. To pay the required margin.
2. To keep such margin good according to the fluctuations of the market.

3. To take the shares purchased on his order, whenever the brokers may require it, and to pay the difference between the percentage advanced by him and the amount paid therefor by the brokers.

Having stated the duties and obligations of broker and customer in a speculative transaction, the court next outlined the two-fold relation of the parties in such a transaction in the following words: [3]

"The position of the broker is two-fold. Upon the order of the customer, he purchases the shares of stocks desired by him. This is a clear act of agency. To complete the purchase, he advances from his own funds, for the benefit of the customer, ninety per cent of the purchase money. Quite as clearly, he does not in this act as an agent, but assumes a new position. He also holds, or carries the stock for the benefit of the purchaser, until a sale is made by the order of the purchaser, or upon his own action. In thus holding or carrying, he stands also upon a different ground from that of a broker or agent, whose office is simply to buy and sell. To advance money for the purchase, and to hold and carry stocks, is not the act of a broker as such."

The plaintiff insisted that the relation between the parties to the transaction is that of principal and agent so far as the execution of the order to purchase is concerned, but that in advancing the money to complete the purchase the relation of debtor and creditor is created, and that the brokers, therefore, become subjected to the law of pledgor and pledgee. The brokers, on the other hand, contended that the relationship of the parties is wholly by force of a mutual and dependent contract, that is, that the agreement to carry the stock was dependent upon the plaintiff furnishing them with the means to do so, in that in case this was not done, the obligation to hold the stock ceased and the right to sell it was complete. The majority opinion of the court held in favor of the plaintiff and stated its position in the following words: [4]

[3] Markham *v.* Jaudon (1869) 41 *N.Y.* 235, 240.

[4] Markham *v.* Jaudon (1869) 41 *N.Y.* 235, 240, 241. Massachusetts

"In the case of a pledge it is well settled, that upon default by the debtor, the property in the subject of the pledge, does not thereby become absolutely vested in the creditor, but that the general property still remains in the debtor. To cut off his claim, the creditor may resort to judicial process, or he may sell, without judicial process, upon giving notice to redeem, and giving notice of the time and place of sale."

The court concluded that, although the formality may not have been followed in detail, the effect of a speculative transaction is the same as if the stock had been delivered to the customer, and then redelivered to the broker as a pledge for the advance of the balance of the purchase price. Holding stock on margin, it was held, is essentially the same as giving collateral as a pledge for a loan. As the majority opinion states: [5]

". . . The contract between the parties to this action, was in spirit and effect, if not technically and in form, a contract of pledge. To authorize the defendants to sell the stock purchased, they were bound first to call upon the plaintiff to make good his margin; and, failing in that, he was entitled, secondly, to notice of time and place where the stock would be sold; which time and place, thirdly, must be reasonable."

The court further explained that the broker had no right to sell stock without a reasonable notice to the customer, the lower court having decided that such notice had not been given. In this respect the broker's duty is two-fold. He must demand additional margin and, if this demand is not met, he must give

seems to be the only state in which this is not true. Crehan *v.* Megargel (1920) 235 *Mass.* 279. After carefully considering both sides of the question, the United States Supreme Court repudiated the Massachusetts doctrine and upheld the view expressed in Markham *v.* Jaudon. Richardson *v.* Shaw (1908) 209 *U.S.* 365. Apparently the relationship between the broker and his customer with respect to the borrowing of securities in a short sale is that of an independent contractor rather than one of agency. Meyer, C. H., *The Law of Stock Brokers and Stock Exchanges,* Baker, Voorhis & Co., N. Y. (1931) pp. 259–262.

[5] Markham *v.* Jaudon (1869) 41 *N.Y.* 235, 243.

notice which must state the time, place, and conditions of sale. Both demand and notice, however, may be combined in a single communication. But legally the notice must actually reach the customer. And the notice must be reasonable regardless of the condition of the market.[6] Whether the notice is reasonable depends upon a number of factors and ordinarily is a question of fact for the jury to decide. Again, the broker must dispose of his customer's securities at public sale just as any other pledged article in order that the customer may protect his interests. Some of the early New York decisions hold that the New York Stock Exchange is not a place of public sale. "This view," however, "has been modified by decisions in various other jurisdictions and it is extremely probable that, in view of the development of facilities for trading on the Stock Exchange, the vast number of brokers ready and willing to act for the public, the great volume of daily transactions in most kinds of stocks and the greater opportunity thus presented for realizing fair value and protecting the pledgor, may lead to a modification of this rule by the courts of this State." [7]

Broker Lacks Protection.—The dissenting opinions in Markham *v.* Jaudon are also instructive and were purposely

[6] Small *v.* Housman (1913) 208 *N.Y.* 115, 125. In this case the right to a reasonable notice was upheld even though the court said: "In the case at bar the conditions were exceptional. It was a time of tense excitement, of sudden and violent fluctuations in prices, of veritable panic in which individual judgment was torn from its moorings by the impact of popular frenzy."

[7] Weir *v.* Dwyer (1909) 62 Misc. (*N.Y.*) 7, 11. As stated by Meyer, *op. cit.*, pp. 388, 389, footnote 3, "There is a scarcity of judicial decisions in New York directly holding that a sale on an exchange is the equivalent of a public sale for the purpose of closing out a customer's account. However, that is the way in which sales of listed securities are always made in practice by brokers in selling such securities for insufficiency of margin, and although sales made in that way have repeatedly come before the courts in cases involving the sufficiency of the sale, the broker's right to make the sale on the exchange has never been questioned." For a detailed discussion of the questions considered in connection with notice, see *ibid.*, pp. 369, 391.

reported in full. In one of these opinions it is held that the construction of the court, which vests the title in the customer as pledgor and holds that the interest of the brokers can only be that of pledgees, places the broker entirely at the mercy of the customer in respect to the performance of his agreement as to the proper maintenance of the margin. This construction was regarded as requiring the broker, although the whole margin is exhausted, to retain the stock, although rapidly depreciating, until the customer can be found and a reasonable notice of the time and place of sale be given to him with a view to affording him an opportunity to save himself from loss by redeeming the stock. In the meantime, the risk of loss from further depreciation is placed entirely upon the broker.

A study of the dissenting opinions shows two main lines of objections to the majority opinion of the court, namely, (1) that the application of the law of pledgor and pledgee leaves the broker without protection, especially in view of the hazardous undertaking connected with a margin transaction, and also because the broker ought to be released from further liability when the other party to the agreement has not complied with its provisions as regards the maintenance of the margin; and (2) that the measure of damages adopted in this particular case was excessive and wrong in principle, since the plaintiff was held to be entitled, not to the value of the stock at the time of the sale, but the highest price the stock attained between the sale and the time of the trial.

As to the first objection, the majority opinion recognized its validity and suggested a solution in the following words: [8]

"The argument of necessity is pressed. It is said that the stocks, which are the subjects of speculation, are fluctuating and uncertain in their character; that to save the broker from loss, prompt action is necessary, and that there is no time for notice to the dealer. It

[8] Markham *v.* Jaudon (1869) 41 *N.Y.* 235, 244.

is said, in the same connection, that as the broker can make nothing by the rise of the stock, his advantage being limited to his regular interest and commissions, that it is reasonable, and must have been the understanding, that he should have the power to protect himself against loss by an immediate sale, without notice. I cannot assent to this argument. If there is such necessity, the broker must secure himself by a special contract, giving him the right to sell without notice."

Form of the Order in a Speculative Transaction.— As regards the execution of the order the rights and duties involved are the same as those stated in the preceding chapter in connection with the order for an outright purchase or sale. But to protect the broker from the effects of the decision stated above, a more elaborate agreement than that already discussed is required. While the wording of orders used by different firms varies, the full form generally used may be illustrated by the following:

STANDARD CUSTOMER'S AGREEMENT

Name of Firm.
Address.

Gentlemen:

In respect of all accounts which the Undersigned now has, or may hereafter have with you, for the purchase or sale of securities or commodities, or contracts for commodities, it is understood and agreed as follows:

Only actual purchases or sales are contemplated and all orders shall be executed subject in all respects to the regulations and usages of the New York Stock Exchange or other exchange or market where executed; and you and your correspondents are hereby constituted agents of the Undersigned for the purpose of consummating all such transactions, and are authorized to make such advances and expend such moneys as may be required in respect thereof.

All securities or commodities, or contracts for commodities, now

held or hereafter purchased by you for, or now or hereafter deposited with you by, the Undersigned, are to be held by you as security for the payment of all liabilities of the Undersigned to you, however and whenever arising, and you are hereby authorized, without further notice to the Undersigned and without regard to whether you have in your possession or subject to your control at the time thereof other securities, commodities or contracts for commodities of the same kind and amount, in the usual course of business to repledge, rehypothecate (either for the amount due you from the Undersigned, or for a greater sum) and loan the same from time to time, separately or together with other securities; and you shall not be required to deliver to the Undersigned the same certificates or securities deposited or received, but only certificates or securities of the same kind and amount.

You may from time to time demand additional security or at any time demand that the account be immediately taken up and paid, and all amounts advanced and other balances due, with interest at the current rate, and all commissions fixed by the regulations and usages of the exchange or market where orders are executed shall be due and payable upon demand.

You may employ sub-brokers and shall be responsible only for reasonable care in their selection, and may settle contracts and controversies according to the regulations and customs of the exchange or market where orders are executed.

Upon failure of the undersigned to comply with any of the provisions hereof, or whenever deemed necessary for your protection, you are hereby authorized and empowered to sell, assign and deliver all or any part of the securities, commodities, or contracts for commodities pledged hereunder upon any exchange or market or at any public or private sale at your option and/or to purchase to cover short sales, and without demand for margin, and/or advertisement or notice of purchase or sale, which are expressly waived, and no specific demand or notice shall invalidate this waiver and after deducting all costs and expenses of purchase or of sale and delivery, including transfer and stamp taxes, to apply the residue of the proceeds to the payment of the liabilities of the Undersigned to you, returning the surplus, if any, to the Undersigned; and upon any such

public sale you may purchase the whole or any part thereof free from any right of redemption, and the Undersigned shall remain liable for any deficiency.

All statements of accounts current, confirmations and/or notices of transactions, or of buying and selling orders for my account as rendered me by you from time to time, shall be deemed correct unless I give you immediate oral and written notice to the contrary.

You are authorized to send by mail or otherwise all notices or other communications for me touching my account or accounts and any matter or thing connected therewith to ..... or to such other address as I may from time to time designate in writing, and I agree that all notices or other communications so sent shall be deemed to have been received by me after such time as, in the ordinary course of the mails or other service, they would have been received by me.

It is agreed that the addition of members to the present firm of ....., or the withdrawal of any present or future member or members of that firm shall not terminate the operation or effect of this instrument, and that the provisions hereof shall be binding upon and inure to the benefit of the firm of ....., and its successors without regard to any change that may be made in its membership, and it is further agreed that the provisions of this instrument shall be binding upon and inure to the benefit of the heirs, executors, administrators and assigns of the Undersigned.

If at any time my account shall be closed and reopened, this agreement is to remain in full force and effect.

It is agreed that no variance or modification of the provisions of this agreement shall be effective unless in writing and signed by the parties hereto.

I certify that I am of full age and at the present time I am not an employee of any Stock Exchange, nor of a firm registered on any Exchange, nor of a bank, trust company, insurance company, nor of any corporation, firm or individual engaged in the business of dealing either as broker or principal, in stocks, bonds, or other securities, bills of exchange, acceptances, or other forms of commercial

paper, and if at any time I become such I hereby agree to advise you in writing immediately.

Dated.....193 .

Accepted: *Name of Firm* .....(SEAL)

By..... Dated.....193 .
Partner

It will be observed that this agreement applies to all of the customer's transactions, which are to be actual purchases and sales, executed according to the regulations and usages of the exchange on which they are made. The broker reserves the right to repledge, rehypothecate and loan the customer's securities, separately or together with other securities, for the amount due from the customer or for a greater amount.[9] The broker may close the transaction at any time, and he is also protected by the agreement in that at his option he may sell the pledged securities or purchase to cover short sales upon any exchange or market or at any public or private sale, without demand for margin, and without advertisement or notice of purchase or sale. Customers sometimes believe that their liability is limited to the amount of margin deposited with the brokers. It should be emphasized therefore, that there is no obligation upon the broker's part to close out an account. If he fails to do so, he nevertheless has a right of action against the customer, independent of his right to sell the collateral. And following the sale of the collateral, if there is a deficiency, the customer is liable for the amount still due.[10]

Measure of Damages.—As regards the second objection —the measure of damages in case the broker wrongfully converts securities or otherwise acts contrary to law in transacting

[9] For a discussion of this point, see *infra,* Chapter XXIV.
[10] Meyer, *op. cit.,* pp. 401–7.

his client's business—the finding in the case of Markham *v.* Jaudon was overturned by the decision of Baker *v.* Drake.[11] As stated by the court [12] in the latter case, according to the rule established in Markham *v.* Jaudon the plaintiff "was entitled to the difference between the amount for which the stock was sold by the defendants and the highest market value which it reached at any time after such sale down to the day of trial." It was soon seen that the application of this rule would work great hardship in many cases. In fact, in Markham *v.* Jaudon the customer owed the broker money at the time he was sold out, but by the time of the trial the price of the stock in question had risen to such an extent that, in accordance with the above-mentioned rule, he was awarded nearly $5,000. In establishing the new rule to the effect that the measure of damage must be the highest intermediate value between the time of conversion and a reasonable time thereafter, the New York court decided that "the advance in the market price of the stock from the time of the sale up to a reasonable time to replace it, after the plaintiff received notice of the sale, would afford a complete indemnity." [13]

Some years later the United States Supreme Court gave its approval to the same rule, the one now prevailing, in a case the facts of which are particularly instructive.[14] A customer in Virginia City ordered the broker by telegraph to sell certain mining stocks, then being carried for him by the broker, and with the proceeds of the sale to buy certain other mining stocks. The broker received the order in time to execute it in compliance with all its terms, but no longer desired to do business with the client. Instead of executing the order, he gave notice *by letter* of his refusal to comply. Later, and without any order from the customer to do so, the broker sold the

[11] (1873) 53 *N.Y.* 211.

[12] *Ibid.*, p. 213.

[13] *Ibid.*, p. 217.

[14] Galigher *v.* Jones (1889) 129 *U.S.* 193. A few states follow other rules. Meyer, *op. cit.*, p. 557.

stock he was carrying at a price such as to net a loss of $1,200. The stock that the customer had ordered the broker to buy had, by the time of the wrongful conversion, more than doubled in value, so that if the transaction had been carried out as ordered the customer would have made $6,125. The broker was found guilty of neglect, and in awarding damages the Supreme Court decided to the following effect: [15]

"The hardship which arose from estimating the damages by the highest price up to the time of trial, which might be years after the transaction occurred, was often so great, that the Court of Appeals of New York was constrained to introduce a material modification in the form of the rule, and to hold the true and just measure of damages in these cases to be, the highest intermediate value of the stock between the time of its conversion and a reasonable time after the owner has received notice of it to enable him to replace the

[15] Galigher *v.* Jones (1889) 129 *U.S.* 193, 201, 202. Dos Passos, in his *Treatise on the Law of Stock Brokers and Stock Exchanges,* Vol. II, pp. 921–24, in reviewing the measure of damages for the conversion of securities by a broker makes the following statement:

"Formerly, in an action against the stock broker for the conversion of stocks, the same rule of damages was applied which existed in actions for the conversion of ordinary personal property—viz., the highest price of the same between the date of the conversion and the time of the trial. . . . This rule was adopted by Mr. Sedgwick in his learned treatise on the law of damages, when applied to actions for the non-performance of contracts to deliver merchandise or stocks, as being purely conjectural, and based on the highly improbable assumption that the plaintiff would have retained the property, if the contract had been complied with, till the period of its highest value, and have thus realized the latter price.

"But, despite its glaring injustice, the rule remained in full force in the State of New York until the year 1873, when it was overturned by the widely known case of Baker *v.* Drake after an elaborate and close examination of the subject and cases by Mr. Justice Rapallo.

"The theory of the old rule was, that when a broker had sold the stock of his client without notice and thus committed a conversion, the latter might, within a reasonable time after notice of the act, begin suit; and that he was entitled to avail himself of the extreme fluctuations of the stock market, and select the date, at any time between the time of the conversion and the end of the trial, at which the converted stock had reached its highest point, and that the law would fix the latter as the measure of damages to which he was entitled."

stock. This modification of the rule was very ably enforced in an opinion of the Court of Appeals delivered by Judge Rapallo, in the case of Baker *v.* Drake, 53 N.Y. 211, which was subsequently followed in the same case in 66 N.Y. 518, and in Gruman *v.* Smith, 81 N.Y. 25; Colt *v.* Owens, 90 N.Y. 368; and Wright *v.* Bank of Metropolis, 110 N.Y. 237.

"It would be a herculean task to review all the various and conflicting opinions that have been delivered on this subject. On the whole it seems to us that the New York rule, as finally settled by the Court of Appeals, has the most reasons in its favor, and we adopt it as a correct view of the law."

What constitutes "reasonable time" depends upon the circumstances of each case. According to a New York decision,[16] "it may be stated as a general rule that the customer is entitled to a reasonable opportunity to consult counsel, to employ other brokers and to watch the market for the purpose of determining whether it is advisable to purchase on a particular day or when the stock reaches a particular quotation, and to raise funds if he decides to repurchase." The period of time varies from about 15 days to about 2 months.[17]

Dividends, Assessments, and Interest.—In a margin transaction the broker merely holds the stock as a pledge subject to the orders of the client, who becomes the owner of the stock as soon as it is purchased. As a consequence of ownership, it follows that the customer is entitled to all dividends or other benefits accruing on the stock and is liable for all assessments or calls. The broker, however, is legally entitled to collect the dividends thereon on the theory that "any increase of the pledged property is likewise pledged." He also has the right to have the securities bought by him on margin transferred to him or any one of his selection. But such transfer neither deprives the client, the legal owner, of the

[16] Burhorn *v.* Lockwood (1902) 71 App. Div. (*N.Y.*) 301, 304; appeal dismissed 177 *N.Y.* 539.

[17] Meyer, *op. cit.*, p. 563.

dividends or profits, nor exempts him from assessments, although the broker may have paid the same as the stockholder of record.

Upon the funds advanced to the client in paying for the stock purchased, the broker may, unless there is an understanding to the contrary, charge the legal rate of interest, even though the money is borrowed at a lower rate. By usage he may also charge the client with any extra interest that a stringent money market may compel him to pay. This, however, is not allowed when the broker is himself the lender of the funds used to finance the transaction for his client, in which case the rate of interest that may be charged is limited to that allowed by statute. All other expenses actually incurred in the interests of the client may also be recovered by the broker.

Voting Power of the Pledgor.—The broker, as we have seen, is privileged to transfer stock bought on margin to his own name and to hypothecate it for loans. To what extent, therefore, has the client a right to vote the stock thus pledged? This matter is generally regulated by the statutes of the several states. In New York, as set forth in the general corporation law of the State, voting power is granted only to the holder of record, and the broker may, therefore, vote the stock if he has transferred it to himself. But it has been held that the pledgor may, upon showing that his rights will be prejudiced, invoke the equitable powers of the Supreme Court to grant him a proxy, and to restrain the pledgee from voting the stock.[18]

The several states, however, are not uniform in their regulation of this matter. Massachusetts provides by statute that the pledgor may vote the stock if the certificate states the fact that the stock has been issued as a pledge. Otherwise, the corporation may refuse to accept the vote of the pledgor, although, as in New York, the pledgee may be required in

[18] Dos Passos, *op. cit.*, Vol. I, pp. 247–9.

equity to give a proxy. Some states provide by statute that the pledgor has the right to vote his stock. As concluded by Dos Passos, in his review of the various statutes, "it may be stated as a general proposition that equity will intervene to protect the right of the pledgor." [19] In the absence of statutory limitation, the pledgor and pledgee may agree between themselves concerning who shall exercise the voting power.

Section 14 of the Securities Exchange Act of 1934 gives the Commission power to prescribe such rules and regulations as are necessary or appropriate in the public interest or for the protection of investors, concerning the soliciting of proxies and the giving of proxies by a broker based upon securities carried for the account of a customer.

Safekeeping of the Pledge.—Emphasis has already been placed upon the principle, laid down in Markham *v.* Jaudon,[20] that it is the duty of the broker "at all times to have in his name or under his control, ready for delivery, the shares purchased, or an equal amount of other shares of the same stock." This, however, does not mean that the broker must transfer the stock to his client's name, or even to his own. Instead, he may legally transfer the stock to any name he pleases, so long as he has the stock under his control with a view to meeting the demands of his client. The principle has been stated as follows: [21]

"As he [the broker] was to hold the shares as security for the balance of the purchase money which he had advanced, it was proper, and entirely consistent with the nature of the transaction, that he should take the title in his own name . . . and we do not see anything unlawful in his transferring it to his clerks, if it remained under his control, and if he was ready, when called on by the plaintiff, to transfer it to him upon the advance being paid."

[19] *Ibid.*, p. 249.
[20] (1869) 41 *N.Y.* 235, 239.
[21] Horton *v.* Morgan (1859) 19 *N.Y.* 170, 172, 173.

In case of loss of the securities by theft or otherwise, the broker is not liable unless such theft or loss is due to a want of ordinary diligence or care on his part, and the degree of proper care is a question for the jury. Where securities, belonging to a third party are misapplied by one of the partners, while they are in the custody of the brokerage firm, the remaining partners are liable to the client, although the wrongful conversion or misapplication of the securities was unknown to them.[22] Similar liability also attaches where the clerk of a broker wrongfully converts securities unless the wrongful act could have been prevented by ordinary care on the part of the client, provided, however, that the broker exercises due and reasonable care as to the duties of the clerk.[23]

Circumstances Under which a Broker May Close a Speculative Transaction.—Where the demand for more margin is not complied with, and where the right to sell without notice at either public or private sale has been reserved, the broker clearly has a right to terminate a margin transaction immediately. There are various other circumstances, however, under which a broker may exercise the same right. Thus, in the absence of an express agreement to the contrary the broker may, upon reasonable notice, require his client to take securities carried for him and thus close the transaction. This principle is upheld chiefly on the ground that the client has a reciprocal right to close an account. Moreover, the courts hold that the broker has earned his commission by making the transaction.

In the event of a client's bankruptcy the broker also possesses the right to sell the bankrupt's securities held on margin, and it is the broker's duty to take notice of the fact of bank-

[22] McIntyre *v.* Kavanaugh (1916) 242 *U.S.* 138, affirming Kavanaugh *v.* McIntyre (1914) 210 *N.Y.* 175.

[23] Briggs *v.* Jones (1894) 8 Misc. (*N.Y.*) 261, affirmed on opinion below 149 *N.Y.* 577; Briggs *v.* Kennett (1894) 8 Misc. (*N.Y.*) 264, affirmed on opinion below 149 *N.Y.* 577.

ruptcy. In a prominent case,[24] it was held that where a broker continued to hold the stock of a client after such bankruptcy for an unreasonable time and then sold it without application to or consent of the assignee or bankruptcy court, the bankrupt's estate was not properly chargeable with the loss. On the other hand, it should be noted that a broker is not obliged to sell in case of the exhaustion of the margin. Instead, the broker may hold the stock and rely upon the customer's liability without security, unless there is an agreement to the effect that the security should be sold when the margin is exhausted.[25]

The broker is also justified in closing an account in the event of the death of his client. In New York, however, the broker, if acting in good faith, may continue the account until the appointment of a legal representative. In a case involving a short sale the court decided that although the brokers "could not enter into fresh transactions in the purchase or sale of stocks . . . in execution of unexecuted orders or a general authority to deal in stocks," nevertheless they could maintain the speculation in *statu quo* awaiting the qualification of the executrix. The rule that the death of a principal revokes the authority of an agent has a well-settled exception when the agency is coupled with an interest.[26]

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[24] *In re* Daniels (1875) 13 National Bankruptcy Register 46.
[25] Little *v.* McClain (1909) 134 App. Div. (*N.Y.*) 197, 200.
[26] Hess *v.* Rau (1884) 95 *N.Y.* 359, 362, 363.

margins to meet the fluctuations of the market"; pp. 336–46, dealing with "The form of the notice"; pp. 902–38, dealing with the "Measure of damages."

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CHAPTER XXIV

THE BROKER'S RIGHTS AND OBLIGATIONS RELATIVE TO HIS CUSTOMER'S SECURITIES

Broker's Lien.—After the execution of an outright transaction nothing remains to be done except to deliver the securities to the customer in case of a purchase or to pay over the proceeds in the case of a sale. In a speculative transaction, however, the broker must carry the account, and this may involve the furnishing of funds, the borrowing of stock in case of a short sale, or both. But whether the transaction be outright or speculative, the broker has a lien on the securities until his claims have been satisfied.

In an outright purchase the securities are subject to a lien equal to the purchase price and the broker's commission, and the customer is not entitled to possession until he tenders payment for the full amount.[1] In a margin transaction the broker has a lien equal to his advances, interest, and commissions,[2] and this lien applies not only to the securities purchased but to any that may have been deposited as margin.[3] Whether a broker has a general lien when the customer has more than one account is an open question. However, the lien is not general when it is clearly not the intention of the parties to make it so. The standard customer's agreement usually provides that it applies to any and all accounts which the customer now has, or may hereafter have "for the purchase or sale of securities or

[1] Jacobs *v.* Moore (1921) 195 App. Div. (*N.Y.*) 452; Burnham *v.* Eyre (1908) 123 App. Div. (*N.Y.*) 777, affirmed 196 *N.Y.* 560.

[2] Small *v.* Housman (1913) 208 *N.Y.* 115, 121.

[3] Gruman *v.* Smith (1880) 81 *N.Y.* 25.

commodities or contracts for commodities." Such a provision protects the broker and will be enforced by the courts.[4] Further, the broker is within his legal rights if he transfers the stock that he has purchased for his customer to his own name or that of his clerks. As stated by the New York Court of Appeals, such procedure is proper and "entirely consistent with the nature of the transaction" and is not unlawful if the stock "remained under his control, and if he (the broker) was ready, when called on by the plaintiff, to transfer it to him upon the advance being paid." [5]

Substitution of Certificates.—Stock certificates are like grain in an elevator, when each bin contains grain of the same kind and grade. In such case the elevator owner may commingle his own grain and that of various owners. The principle has been stated by the United States Supreme Court as follows: [6]

"A certificate of the same number of shares, although printed upon different paper and bearing a different number, represents precisely the same kind and value of property as does another certificate for a like number of shares of stock in the same corporation. It is a misconception of the nature of the certificate to say that a return of a different certificate or the right to substitute one certificate for another is a material change in the property right held by the broker for the customer."

For this reason the broker in a margin transaction need not retain the specific securities that he purchased for his customer or that were deposited as margin, but may substitute others of like kind and amounts. This is subject to the general rule that he must retain their equivalent in his possession or under his control. So long as he has enough stock to satisfy his contracts, "he may buy stocks to fill several orders in a

[4] Meyer, C. H., *The Law of Stock Brokers and Stock Exchanges*, Baker, Voorhis & Co., N. Y. (1931) pp. 313–17.

[5] Horton *v.* Morgan (1859) 19 *N.Y.* 170, 172, 173.

[6] Richardson *v.* Shaw (1908) 209 *U.S.* 365, 378, 379.

lump; he may increase his single purchase by stock of the same kind that he wants for himself; he may pledge the whole block thus purchased for what sum he likes, or deliver it all in satisfaction of later orders, and he may satisfy the earlier customer with any stock that he has on hand or that he buys when the time for delivery comes." [7] The right of substitution, however, does not apply to securities that are owned outright and have been deposited with the broker for safekeeping, and even in margin transactions the right may be surrendered by agreement.[8]

Retention of Customer's Securities or Their Equivalent.—In the absence of a special agreement the broker is not permitted to dispose of his customer's securities unless he retains others of like kind and amounts either in his possession or under his control. This is based upon the principle that the customer has property rights in the securities themselves and the broker's illegal disposal of them would weaken the customer's security in that the broker would be substituting for it his own financial obligation.[9] The broker must maintain the customer's securities in such position that the latter may be able to obtain them upon tender and demand.[10] A wrongful sale and subsequent re-acquisition by the broker does not relieve him of liability. In this connection the New York Court of Appeals has commented as follows: [11]

"The subsequent acquisition by the plaintiffs (brokers), after the stock has fallen to a very low figure, of a sufficient number of shares to replace those which they had held for account of the defendant (customer), did not relieve them from liability. Such reacquired stock was never accepted by the defendant, and he was in fact ignorant of the transactions. To allow a broker to sell his customer's stock without authority, and speculate upon replacing

[7] Sexton *v.* Kessler (1912) 225 *U.S.* 90, 97, 98.
[8] Levy *v.* Loeb (1881) 85 *N.Y.* 365, 370.
[9] Katz *v.* Nast (1910) 187 Fed. 529, 536.
[10] Provost *v.* United States (1926) 269 *U.S.* 443, 455.
[11] Taussig *v.* Hart (1874) 58 *N.Y.* 425, 429, 430.

it at a lower price, would be encouraging speculations by agents, at the risk of their principals, totally inadmissible under familiar rules."

The violation of the preceding principles constitutes both a conversion of the securities and a breach of contract.[12] The unauthorized sale of a customer's securities renders the broker liable for damages even though the customer has made no demand and tender of the amount due. The wrong is committed by the sale and no demand is necessary.[13] In this respect the rule differs from that applying in case of wrongful rehypothecation.[14]

The question is sometimes presented whether a broker has converted stock when he has on hand or under his control sufficient stock to meet the demand of any one customer, but not to meet the demands of all. Apparently the rule is not definitely established. An elevator owner who depletes the common supply of grain below the quantity required to meet all outstanding receipts is guilty of conversion, and it would seem that this principle is sound and should be applied to securities as well.[15]

Broker's Right to Repledge Stock Purchased on Margin.—Were it necessary for the broker to supply from his own funds the entire deficiency existing between the value of the stocks purchased on margin and the amounts deposited as margin by his customers, there would be a great drain upon his capital and his business would necessarily be limited. He must, therefore, as a general rule borrow from third persons and he in his turn is required to deposit collateral to secure his loans. In most cases the securities that he deposits are those purchased on margin for his customers. The law is well settled that a broker may repledge stock purchased for a customer on margin, and that the broker's pledgee has a good lien thereon

[12] Meyer, *op. cit.*, p. 327.
[13] Ganley *v.* Troy City National Bank (1885) 98 *N.Y.* 487, 494.
[14] *Infra.*, this chapter.
[15] Meyer, *op. cit.*, pp. 328–31.

and is entitled to sell the stock without notice to the customer. For the protection of the customer's interest, however, in the absence of a special agreement the amount that may be borrowed is limited to the amount of the broker's own lien. The principle has been thus stated in the case of Douglas *v.* Carpenter: [16]

"It is not doubted but that the plaintiffs (brokers) might lawfully have pledged the defendant's securities, by themselves, separate and apart from others, for an amount not exceeding the indebtedness to them by the defendant thereon. In such case the defendant (customer) would have been protected, because he could have gone to the pledgees and have obtained the securities by payment or tender of the amount of his indebtedness and nothing more."

Where the broker borrows upon his customer's securities more than his own lien, he is guilty of conversion (1) unless he has similar securities in his possession or under his control, (2) unless he has borrowed upon condition that the customer's securities will be available to him upon tender of the exact amount still due,[17] or (3) unless the customer has authorized the broker to borrow in excess of the amount due.

Broker's Right to Repledge Stocks en Bloc.—While numerous questions have arisen in connection with the hypothecation of customers' securities purchased on margin, one deserves special mention, namely, the broker's right to pledge stocks *en bloc.* As has been previously stated brokers usually require credit to finance their customers' purchases. It is the general practice among them to mingle the securities of their customers, and at times, together with their own securities, to use them as collateral for a general loan. The loan thus obtained may sometimes exceed the total indebtedness of all the customers whose securities are repledged. But even if it does not, in

[16] (1897) 17 App. Div. (*N.Y.*) 329, 333.

[17] Rothschild *v.* Allen (1904) 90 App. Div. (*N.Y.*) 233, 234; affirmed in 180 *N.Y.* 561.

the great majority of cases it does exceed the indebtedness of any individual customer. In either case, in the absence of special agreement, it is illegal. The reason is similar to that which makes it unlawful to repledge the securities of a customer in a single loan for an amount in excess of his indebtedness; it deprives him of the right to obtain his securities upon payment of the balance due. In the well known case of Douglas *v.* Carpenter [18] the broker's rights and obligations were summarized under the following four principles:

"A stockbroker who is carrying securities which he has purchased for a customer 'on margin' is not required to keep on hand the identical securities purchased for the customer, but fulfills his obligation if he at all times keeps in his possession or under his control a like amount of similar securities in such situation that the customer may, by paying the amount due the broker on the securities, obtain them at any time.

"He may lawfully pledge the customer's securities, separate and apart from other securities, for an amount not exceeding the indebtedness of the customer to him, but any disposition of the securities which will deprive the customer of his right to their immediate possession upon his payment or tender of the amount of his indebtedness to the broker, amounts to a conversion.

"Accordingly, if the broker for his own benefit, mingles the customer's securities with others, and rehypothecates them for a greater amount than the customer's indebtedness to him, not having in his possession a like amount of similar securities, he is guilty of a conversion.

"It would not do to say that the plaintiffs might go into the market and buy other securities of a like kind and amount on payment or tender being made by defendant, because the plaintiffs might not have the funds to purchase the new securities, and the only reliance the defendant would have would be the personal financial responsibility and ability of the plaintiffs, whereas he had a right to rely upon the securities themselves, and if they were

[18] (1897) 17 App. Div. (*N.Y.*) 329, 332. The first three paragraphs are from the syllabus.

retained he could get them, whether the plaintiffs were financially responsible or not."

These principles were followed in two later New York cases,[19] but in 1912 in the case of Mayer *v.* Monzo,[20] the Appellate Division of the First Department altered the rule fixing the time when excessive rehypothecation of mingled securities becomes a conversion. The majority opinion in this case is brief, but a study of the comprehensive dissenting opinion will prove very enlightening. Justice Clarke, in dissenting from the majority opinion, reaffirmed the position taken in the preceding three cases, namely, that a broker who commingles a customer's margined stock with other securities for a loan exceeding the customer's indebtedness to him, and at the same time has no other like stock of equal amount in his possession or under his control, is guilty of a wrongful conversion for the reason that the customer is placed in a position where he cannot redeem the same from the broker's pledge by tendering the amount due to the broker. In other words, Justice Clarke took the position that the practice involves the loss of control of the pledged stock by the broker. The majority opinion of the court, however, takes an entirely different position, as is indicated by the following significant passage: [21]

"That it is a conversion *ipso facto* to commingle stocks belonging to different customers and to obtain a loan on all, in excess of the amount due from any one of the customers whose stocks are thus commingled, I do not concede. It is settled that a broker who buys stocks for a customer upon margin, and to whom the customer still owes a part of the purchase price, is entitled to pledge the stocks so bought for so much of the purchase price as his customer still owes. The broker's whole duty to his customer under such circumstances is either to have on hand or under his control the stocks

[19] Rothschild *v.* Allen (1904) 90 App. Div. (*N.Y.*) 233, affirmed 180 *N.Y.* 561; Strickland *v.* Magoun (1907) 119 App. Div. (*N.Y.*) 113 affirmed on opinion below 190 *N.Y.* 545.

[20] (1912) 151 App. Div. (*N.Y.*) 866.

[21] *Ibid.*, p. 868.

which he is carrying for his customer, but he is not required to do both, that is to have the amount of stocks under control and also an equal amount on hand. The customer's right to receive his securities accrues under such circumstances only when he tenders the amount he still owes and demands his stock. The refusal of such a demand constitutes the conversion."

At the present time there is a conflict in the New York decisions on this point. Subsequent to the decision in Mayer *v.* Monzo, the Court of Appeals ruled, in the case of Wood *v.* Fisk,[22] that an excessive rehypothecation "may have constituted a conversion" but in any event it was "a breach of contract." However, although the rehypothecation itself constitutes the wrong, in order to recover more than nominal damages the customer must make a tender and demand and refusal by the broker to deliver the securities at that time will determine the measure of damages. As stated by Judge Cardozo: [23]

"There are times, it is true, when a repledge, though illegal, will expose the broker to a liability for nominal damages and no more. This is so where the securities are redeemed and restored to the customer upon demand (*Donald v. Suckling, supra*). A repledge, unlike a sale, does not involve an absolute repudiation of the title of the primary pledgor; the conversion, if we view the transaction as a tort, is an assumption of partial rather than complete dominion; and the return of the subject of the pledge is, therefore, provable in mitigation of the damages (*McCormick v. Penn. Central R.R. Co.,* 80 N.Y. 353, 362; *Bigelow Co. v. Heintze,* 53 N. J. L. 69; Mayne on Damages [7th ed.], p. 429; Sutherland on Damages [3d ed.], vol. 4, section 1140.) But if, as a result of the repledge, the securities are put in a position where they cannot be returned upon demand after tender by the customer of the balance due upon them, then the value of the customer's equity in the securities is the measure of his loss. In either case, however, the repledge remains a wrongful act, whether the damages recoverable are nom-

[22] (1915) 215 *N.Y.* 233; followed in Kittredge *v.* Grannis (1926) 244 *N.Y.* 168, 173.

[23] *Ibid.,* pp. 238, 239.

inal or substantial. The tender and refusal do not constitute the wrong. They are evidence of the extent of damage resulting from the wrong. They show that the consequence of the repledge has been to disable the pledgee from restoring the thing bailed (*Matter of Neff,* 157 Fed. Rep. 57; *Matter of Pettingill Co.,* 137 Fed. Rep. 143, 147)."

A still later decision of the Appellate Division in Rogers *v.* Thomson [24] held that a conversion "does not arise until it is shown that the broker has been unable to meet his obligation to deliver the client's stock upon demand and tender of the amount due." In discussing this anomalous situation Meyer makes the following comment: [25]

"The decision of the Court of Appeals in *Wood v. Fisk* was not mentioned by the Appellate Division in its later decision of *Rogers v. Thomson,* and apparently was not called to its attention. If it had been, it seems reasonable to assume that it would have been followed. The question was considered by Judge (now Chief Judge) Cardozo with considerable care, and the logic of his reasoning seems unanswerable. The repledge for an excessive amount is an act of dominion over the customer's property inconsistent with his rights of ownership, and therefore is in itself a wrong. Were that not so, the legal restrictions on rehypothecation of customer's securities would be of little practical significance."

Justification for Commingling Stocks en Bloc.—It is contended by many that enforcement of the legal principles stated above would make it exceedingly difficult, if not impossible, for brokers to conduct their business along modern lines.

[24] (1926) 215 App. Div. (*N.Y.*) 541, 546.

[25] Meyer, *op. cit.,* pp. 341, 342. For a comprehensive discussion on whether excessive rehypothecation *ipso facto* constitutes conversion, see *In re* Salmon Weed & Co. (C. C. A.$_2$; 1931) 53 *Fed.* (2) 335, 337-39. In this case the court states that the question "is one over which legal battles have been fought for many years," and points out the confusion that exists in the New York courts, and the fact that "the Court of Appeals has not yet spoken on this precise question." However, it reaches the conclusion that such rehypothecation is conversion *ipso facto.*

As a matter of fact, the customer's agreement, signed when he opens a speculative account contains some such provisions as the following:

"All securities or commodities, or contracts for commodities, now held or hereafter purchased by you for, or now or hereafter deposited with you by, the Undersigned, are to be held by you as security for the payment of all liabilities of the Undersigned to you, however and whenever arising, and you are hereby authorized, without further notice to the Undersigned and without regard to whether you have in your possession or subject to your control at the time thereof other securities, commodities or contracts for commodities of the same kind and amount, in the usual course of business to repledge, rehypothecate (either for the amount due you from the Undersigned, or for a greater sum) and loan the same from time to time, separately or together with other securities; and you shall not be required to deliver to the Undersigned the same certificates or securities deposited or received, but only certificates or securities of the same kind and amount."

Such broad authorization by the customer is susceptible to abuse by the broker. Accordingly, the New York Stock Exchange has provided that such an agreement "does not justify the member in pledging or loaning more of such securities than is fair and reasonable in view of the indebtedness" of the customer.[26]

Hypothecating a client's margined securities for more than he actually owes to the broker at the time has also received considerable attention from legislative bodies. In 1913 the State of New York enacted a law making such hypothecation a felony, punishable by a fine of not more than $5,000 or by imprisonment for not more than two years, or both. When the broker without the customer's consent pledges or disposes of securities in his possession on which he has no lien he is guilty even though the customer has sustained no loss. The broker is also guilty of a criminal offense when he has in his

[26] *Rules*, New York Stock Exchange, Chapter XII, Section 4.

possession the securities of a customer "on which he has a lien for indebtedness due to him by the customer, (and) pledges the same for more than the amount due to him thereon, or otherwise disposes thereof for his own benefit, without the customer's consent, and without having in his possession or subject to his control, stocks, bonds or other evidences of debt of the kind and amount to which the customer is then entitled, for delivery to him upon his demand therefor and tender of amount due thereon, and thereby causes the customer to lose, in whole or in part, such stocks, bonds or other evidences of debt, or the value thereof." [27]

Substantially the same limitations are imposed by the Securities Exchange Act of 1934. Section 8 provides that "it shall be unlawful for any member of a national securities exchange, or any broker or dealer who transacts a business in securities through the medium of any such member, directly or indirectly —"(c) In contravention of such rules and regulations as the Commission shall prescribe for the protection of investors to hypothecate or arrange for the hypothecation of any securities carried for the account of any customer under circumstances (1) that will permit the commingling of his securities without his written consent with the securities of any other customer, (2) that will permit such securities to be commingled with the securities of any person other than a bona fide customer, or (3) that will permit such securities to be hypothecated, or subjected to any lien or claim of the pledgee, for a sum in excess of the aggregate indebtedness of such customers in respect of such securities.

"(d) To lend or arrange for the lending of any securities carried for the account of any customer without the written consent of such customer."

Section E of the Senate bill to regulate stock exchanges [28] provided that members of exchanges coming within the scope

[27] *Penal Law*, § 956.

[28] *Senate Bill 3895, 63d Congress, Second Session*, 1914.

of the proposed legislation should be forbidden under penalty of expulsion from hypothecating any securities belonging to their customers or others for any amount in excess of the sum at the time owing by such members thereon. But instead of using the words "without the customer's consent," the bill contained the far-reaching provision that brokers should be forbidden from "entering into any arrangement or agreement with such customer or others for such use of their securities."

The necessity for, and practicability of, legislation like that proposed in the Senate Bill has been seriously questioned in many quarters. On the one hand it is asserted that the matter of hypothecating margined securities should be one of arrangement between broker and customer, and that the customer should have the right to give or refuse his consent. The customer who refuses, it is argued, can easily find a bank in any city willing to accept delivery of good securities, and to loan directly to the customer 80 per cent of their market value. Having arranged with the bank for the requisite loan, the customer can direct his broker to purchase the securities and to deliver the certificates directly to the bank. In this way all danger of rehypothecation is avoided, with the difference, however, as pointed out in the testimony of H. H. Boyesen: [29] that "the only consequence to the man who objects to having his securities rehypothecated is that probably the banker will not allow him as big an equity, which is the equivalent of a margin in the broker's language, as the broker would. In other words, the bank will, to use the broker's term, require a 20-point margin, where the broker will, to use the bank's term, require only a 10 per cent equity."

Since the above mentioned method is open to customers who object to the rehypothecation of their securities by brokers, it is argued that it is an "invasion of private rights" to prohibit by law the other class of transactions. It is asserted

[29] *Testimony in the Hearings before the Senate Committee on Banking and Currency on S. 3895,* p. 258.

that it is impracticable for brokers to comply with a law that absolutely prohibits the rehypothecation of securities for an amount in excess of what is actually due on them. Brokers having 50 or 100 accounts would be compelled, according to the argument, to make arrangements with the banks whereby each customer's securities would have to be kept in a particular envelope, each stating the amount owing by the customer. Moreover, many of the accounts may be very active; and assuming one of the accounts to involve 100 different stocks, many of them being held for a considerable period, it would follow, as testified [30] by Boyesen, that:

"Every time the customer wants to withdraw a part of the margin, or deposit, which he has made the broker will arbitrarily have to alter on those envelopes the statement of the amount due from the customer. Every time those corporations pay a quarterly dividend he will have to rush to the bank, or send some one to the bank, and mark down the amount of the loan due. On 100 stocks he would have 400 trips a year to the bank to alter the amount due by reason of the receipt of dividends.

"Every time his customer desires to draw a check on his account, or to come in and say, 'I want $100,' the broker would have to rush to the bank and readjust his loan. It would make business altogether too burdensome and cumbersome to make it practicable.

"Then, too, take this case: I say to a broker, 'Here is $10,000. I think the market is going up. You can buy me 100 Steel today, and I will let you know what else I want afterwards.' My broker could not in that case, I having paid him $10,000, and the Steel being worth perhaps $6,500, borrow on it at all. Then I order the broker to buy another 100 shares of Steel, and he then can take both certificates to the bank, assuming they are worth $13,000, and marks my name and the amount of $3,000 owing on them on the envelope containing them. Then I go out of town, and telegraph him to buy me 100 Northern Pacific. How is the broker to know how much is due on the Northern Pacific, and how much on each of the two lots of 100 shares of Steel? I go on transacting business that

[30] *Hearings before the Senate Committee on Banking and Currency on S. 3895*, p. 259.

way, buying and selling. The broker has no legal right, arbitrarily, to apportion the amount between the loan on each security. I do not see how he could possibly do it, and I have discussed this provision with bankers, who tell me that they would not be willing to do a stock exchange loaning business on any such basis."

Rights of a Bona Fide Pledgee from a Broker.—The rule is well established that a *bona fide* second pledgee acquires rights superior to those of the first pledgee, and may enforce his lien by sale without notice to the owner of the securities.[31] The principle has been thus stated in McNeil *v.* The Tenth National Bank: [32]

"It must be conceded, that as a general rule, applicable to property other than negotiable securities, the vendor or pledgor can convey no greater right or title than he has. But this is a truism, predicable of a simple transfer from one party to another where no other element intervenes. It does not interfere with the well-established principle, that where the true owner holds out another, or allows him to appear, as the owner of, or as having full power of disposition over the property, and innocent third parties are thus led into dealing with such apparent owner, they will be protected. Their rights in such cases do not depend upon the actual title or authority of the party with whom they deal directly, but are derived from the act of the real owner, which precludes him from disputing, as against them, the existence of the title or power which, through negligence or mistaken confidence he caused or allowed to appear to be vested in the party making the conveyance."

In order that the broker's pledgee obtain good title, however, it "must be founded upon a present and valuable consideration, and the pledgee must have acted in good faith, and without knowledge of the claims of the true owner." [33] Even

[31] Rothschild *v.* Allen (1904) 90 App. Div. (*N.Y.*) 233, affirmed 180 *N.Y.* 561; Thompson *v.* St. Nicholas National Bank (1889) 113 *N.Y.* 325, affirmed (1892) 146 *U.S.* 240.

[32] (1871) 46 *N.Y.* 325, 329.

[33] Strickland *v.* Magoun (1907) 119 App. Div. (*N.Y.*) 113, 116, affirmed on opinion below 190 *N.Y.* 545.

where the rightful owner has been deprived of his securities by fraud, the second pledgee is protected. The case of Fisher *v.* Mechanics and Metals National Bank [34] involved the right of a customer to recover securities from a bank that, it was alleged, were procured by a broker through false representation and were then pledged with a bank as security for a loan. According to the plaintiff the broker had induced him, through fraudulent representations in the form of a false accounting, to deposit an unnecessarily large amount of marginal securities, consisting of certificates of stock endorsed in blank and unregistered bonds, and had in turn pledged these securities as collateral for a bank loan. The court decided in favor of the bank, and against the customer, on three main grounds. In the first place the court made use of the principle that where one of two innocent parties must suffer through the act of a third party, that one must bear the loss whose act made possible the conversion. In this case the customer had assigned the stock in blank, that is, had made possible the wrongful conversion. Therefore the bank, an innocent pledgee, should be protected.

The plaintiff contended that obtaining property by false representation is larceny under the statute and should constitute an exception to the ruling of the court. The court, however, held that: "This argument ignores the reason for the exception in the case of common-law larceny, which involves the taking against the will of the owner. Obviously there can be no estoppel by virtue of an act that is done unintentionally against one's will." [35] Lastly, the court held that the bank was not put on inquiry and notice by virtue of the fact that the pledged certificates of stock stood in the name of the customer and not in the name of the broker.

[34] (1915) 89 Misc. Reps. (*N.Y.*) 587.
[35] *Ibid.*, p. 594.

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CHAPTER XXV

RIGHTS OF CUSTOMERS IN CASE OF BROKERAGE INSOLVENCY

General Principles.—The respective claims of various classes of customers against an insolvent broker's estate present an interesting study and have been the subject of numerous court decisions. The subject is complicated because of the different positions of various customers. Some have delivered money to the insolvent broker, and others securities; some are interested in margin transactions while others have purchased or sold securities outright without having received the securities or money at the time of insolvency; and some have entrusted securities to the broker for safekeeping. In case of a broker's insolvency, the burden of deciding the manner of distributing the moneys in bank or elsewhere, and the securities actually held by the broker or hypothecated by him with the banks, rests with the courts. In unraveling the many conflicting claims that usually arise it should be noted that while creditors generally share equally in the bankrupt broker's estate, special circumstances may exist that give certain customers a prior claim over others. To be taken out of the group of general creditors, it is necessary for a customer to trace his money or securities and thus to identify his particular property. Further, it should be borne in mind that of those claimants that are able to trace, some will have equities superior to others for the reason that they have been wrongfully treated by the broker. The principles applying to the tracing of money differ somewhat from those applying to the tracing of securities.

When a member or the firm of a member holding a seat upon

the New York Stock Exchange becomes insolvent this fact is announced [1] and all other members having contracts with him are required according to the rules to close out their contracts without unnecessary delay.[2] Claims arising between the parties in the ordinary course of business become a lien against the proceeds derived from the sale of the member's seat.[3] The courts have held that such lien is neither a violation of the bankrupt law nor in contravention of any principle of morals.[4]

Before stating the general principles applicable to the settlement of a bankrupt broker's estate, certain salient facts should be kept in mind. Very probably the broker will have in greater or less volume some of his customer's securities in his possession, i.e., "in the box." Generally, they are securities (1) that he has purchased for customers but not yet delivered, (2) that have been placed with him for sale, (3) that have been bought on margin, or deposited as margin, and (4) that have been deposited with him for safekeeping. If, as very rarely occurs, he had in the box all the securities thus held, the settlement would be relatively simple. Each claimant could get his own securities, subject to the qualification that he pay any balance owing to the broker. As a matter of fact, however, the broker has without doubt pledged some of the securities as collateral for loans with various third parties. As stated in the preceding chapter, such third parties have good title to securities thus pledged, to the extent of their indebtedness, and they may dispose of as many as is necessary to repay their claims against the broker. This principle applies even though some of the securities on the loan were wrongfully repledged by the broker. Thus it may happen that the securities that have been disposed of by the sub-pledgee may have belonged to the customers that were wrongfully treated. Finally, in addition

[1] *Constitution,* New York Stock Exchange, Article XVI, Section 2.
[2] *Rules,* New York Stock Exchange, Chapter IV, Section 1.
[3] *Constitution,* New York Stock Exchange, Article XIV.
[4] *Supra,* p. 137.

to repledging certain securities wrongfully, the broker may have converted some to his own use, or may have reported as executed, certain transactions that in fact were not. In applying the general principles that have been established to secure substantial equity among the various claimants, it is important to note whether the securities are in the box or in pledge, and whether they were owned outright or on margin.

Reclamation of Securities.—As a general rule a customer, whether an outright owner or a margin purchaser, has the right to reclaim securities held for him by a broker, provided he is able to find them in the broker's box or in his pledge. The principle has been thus stated by the United States Supreme Court: [5]

"In view of our former opinions it must be taken as settled: That bankrupts and their customer stood in the relation of pledgee and pledgor. That in their dealings stock certificates issued by same corporation lacked individuality and, like fac-simile storage receipts for gold coin, could properly be treated as indistinguishable tokens of identical values. That as between themselves, after paying amount due brokers, the customer had a right to demand delivery of stocks purchased for his account; and such delivery might have been made during insolvency without creating a preference. [citations].

"Summing up the doctrine of Richardson *v.* Shaw concerning legal relationship between customer and broker in buying and holding shares, we said in Gorman *v.* Littlefield (pp. 23–24): 'It was held that the certificates of stock were not the property itself, but merely the evidence of it, and that a certificate for the same number of shares represented precisely the same kind and value of property as another certificate for a like number of shares in the same corporation; that the return of a different certificate or the substitution of one certificate for another made no material change in the property right of the customer; that such shares were unlike distinct articles of personal property, differing in kind or value, as a horse, wagon or harness, and that stock has no earmark which distinguishes

[5] Duel *v.* Hollins (1916) 241 *U.S.* 523, 527, 528. See also Gorman *v.* Littlefield (1913) 229 *U.S.* 19.

one share from another, but is like grain of a uniform quality in an elevator, one bushel being of the same kind and value as another. It was therefore concluded that the turning over of the certificates for the shares of stock belonging to the customer and held by the broker for him did not amount to a preferential transfer of the bankrupt's property.' "

In Skiff *v.* Stoddard,[6] a leading case and one that established rules frequently applied in the identification of securities, the reasoning behind this principle has been explained as follows:

"We are of the opinion that both reason and authority support the proposition that the relation of pledgeor and pledgee existed between the plaintiffs (customers) and Bunnell & Scranton (brokers) at the time of the latter's insolvency as respects the stocks and securities which they were then carrying for the former in the execution of their orders.

"From this proposition it follows that the plaintiffs, as pledgeors of the stocks and securities so carried, are entitled to redeem them. The assignment of Bunnell & Scranton does not interfere with the exercise of this right. The title to the pledged property was never in the insolvents. The plaintiffs have from the first been its general owners. The insolvent firm had only a special property in it. The assignment and appointment of the defendant as trustee in insolvency have never operated to deprive the plaintiffs of their ownership, nor to convert Bunnell & Scranton's interest into an absolute title in the trustee. The defendant trustee is not in the position of a *bona fide* purchaser for value. The creditors of the insolvents did not prior to the assignment have the right to appropriate the plaintiffs' stocks and securities to the satisfaction of their claims. The transfer of the stocks into the name of Bunnell & Scranton upon the books of the several corporations did not confer such right.

"The trustee, in his capacity as a representative of the creditors, cannot therefore have acquired it. By the plaintiffs' exercise of their privilege of redeeming the property the creditors of the pledgees are not deprived of any right or advantage they ever enjoyed.

[6] (1893) 63 *Conn.* 198, 224.

Redemption involves payment of the plaintiffs' several indebtednesses. From these payments the creditors obtain every benefit it was ever theirs to hope for."

Tracing Securities.—Before a customer may avail himself of the above-stated principle he must be able to trace his securities. In other words he must find them either in the possession of the broker or of the broker's pledgee. As expressed in a frequently cited case,[7] "the ultimate result is that the claimant must find physically in existence either the precise certificate or a stock in kind, or the earmarked proceeds where there is a liquidation,—" This rule is applied no matter how grievous the wrong that the customer has suffered. To quote from another case: [8]

"To get any standing, except as general creditors, they must identify the original assets, or trace them into other specific funds which came into the trustee's hands. It is not enough to show that they were converted by the bankrupts, or indeed that they may have generally enriched their estate. . . . The claimant has the burden of identification in such cases, and the appellants at bar have made no effort to discharge it. To the extent that the bankrupts' books acknowledge the identity they can prevail, but no further; the balance of their claim is a general credit against the trustee, and we are not here concerned with its liquidation."

A claimant has traced his securities if he is able to identify them *specifically* by certificate number, or if he is able to identify them *generally* by showing that similar securities are in the possession of the broker or of the broker's pledgee.[9] Gen-

[7] *In re* J. C. Wilson & Co., (Dist. Ct., S.D. N.Y.; 1917) 252 *Fed.* 631, 652, 653.

[8] *In re* Byrne (C.C.A.$_2$; 1929) 32 *Fed.* (2d) 189, 190.

[9] Gorman *v.* Littlefield (1913) 229 *U.S.* 19, 24. "It is therefore unnecessary for a customer, where shares of stock of the same kind are in the hands of a broker, being held to satisfy his claims, to be able to put his finger upon the identical certificates of stock purchased for him. It is enough that the broker has shares of the same kind which are legally subject to the demand of the customer."

erally, it may be said that in the former case the claimant's position is more favorable.

Securities in the Broker's Possession.—The general rule that claimants who have been wrongfully treated have prior claims does not apply to securities in the broker's possession. All such claimants have equal rights since such securities have not been pledged.[10] If the specific securities are in the box they may be reclaimed, whether owned outright or on margin, subject, of course, in the latter case to the repayment of the existing indebtedness. When the broker's box contains securities all of which are *specifically* identified, they may be reclaimed only by those so identifying. If in addition to such securities, others are found which have been identified only *generally,* these are distributed to those who have succeeded in making such general identification. When the securities in the broker's possession are insufficient to supply the demands of all the customers that have traced, those tracing specifically are entitled to reclaim in full, and those tracing generally, share *pro rata.*[11] Thus, assume that A, specifically, and eight other 100-share claimants of a particular stock have succeeded in tracing their stocks, generally, to the broker's box and that 900 shares are found there. Each claimant has succeeded in tracing his stock, and is entitled to reclaim in full. If, on the contrary, only 500 shares had been found, A would have been entitled to reclaim 100 shares, and each of the others, 50 shares.

Securities in Possession of the Broker's Pledgee.—As stated in the preceding chapter, a sub-pledgee, who is a *bona fide* holder for value, has a prior claim upon the securities pledged with him and may sell them to reimburse himself to the extent of his loan, even though the broker had no right to pledge any or all of them. Such securities may be sold after

[10] *In re* J. C. Wilson & Co. (Dist. Ct. S.D. N.Y.; 1917) 252 *Fed.* 631, 651.

[11] Duel *v.* Hollins (1916) 241 *U.S.* 523, 529.

the filing of the petition in bankruptcy. As stated by the United States Supreme Court: [12]

"The position that the pledgees could not sell the pledge after the adjudication in bankruptcy, is quite untenable. It is sustained by nothing in the Bankrupt Act. The bonds were negotiable instruments. They passed by delivery, and even were there no expressed stipulation in the contracts of pledge, that the pledgee might sell on default of the pledgor, such a right is presumable from the nature of the transaction. Certainly the Bankrupt Act has taken away no right from a pledgee secured to him by his contract."

When the broker pledges his customers' securities, some wrongfully and some rightfully, in a general loan, after the sub-pledgee has reimbursed himself for the amount of the loan, the balance of the securities or money or both is available to the customers that have traced their securities to the repledge. It is in the distribution of this balance that many of the perplexing problems pertaining to brokerage insolvency are found.

Sharing the Burden of the Loan.—Reclaiming customers who have traced their securities to a general loan are forced to share the burden of the loan.[13] That is, they must contribute with other claimants in the same class. Thus, where the securities of different customers are pledged *en bloc* and some of them have been sold by the sub-pledgee to satisfy his claim, the owners of the remaining securities must contribute *pro rata* to the loss of those whose securities have been sold. It would be unfair to deprive a claimant of his entire interest in the pledge merely because his particular securities had been disposed of either by chance or through the deliberate action of the pledgee. This right to contribution "is based on principles of fundamental justice and equity. And of these principles no one is

[12] Jerome *v.* McCarter (1876) 94 *U.S.* 734, 739.

[13] Meyer, C. H., *The Law of Stock Brokers and Stock Exchanges,* Baker, Voorhis & Co., N. Y. (1931) p. 631. "This doctrine is, however, by no means unanimously accepted by the courts, although it represents the very preponderating weight of authority."

more explicit and outstanding than the one that where the situation of parties is equal and one has borne more than his just share of the common burden he is entitled to contribution from others who have been dealt with more fortunately." [14] On this same point Judge Mayer comments as follows: [15]

"The case is quite different from one where a pledgee rightly sells collateral prior to a bankruptcy. In the absence of fraud or collusive arrangements, the result of such a sale is one of the hazards which may befall persons in a business of this character. If, however, it be held that, after a petition in bankruptcy has been filed, the pledgee, by selecting for sale some stocks and not others, can thereby save some stocks intact for the owners without the burden of contribution, and not others, it can readily be seen that the door will be opened for the most indefensible kind of favoritism, and possibly for corrupt bargains between the owners of securities and the pledgee. Indeed, a pledgee of his own motion, without any agreement with owners of securities, could easily safeguard his friends to the detriment of others who were strangers to him."

Priority.—It frequently happens that certain of the securities in the general loan have been wrongfully pledged by the broker. The owners of such securities who have traced them have equities superior to those of customers whose securities have been rightfully pledged. Courts have generally designated as class A those claimants having superior equities, and as class B those having inferior equities. After the claim of the pledgee is satisfied, the balance is available to class A claimants. Any remaining balance goes to satisfy the claims of those in class B. The general creditors share what is left.

The division of claimants into the two aforementioned classes is well illustrated in Matter of Mills,[16] where a customer, Beach,

[14] Asylum of St. Vincent de Paul *v.* McGuire (1925) 239 *N.Y.* 375, 382.

[15] *In re* J. C. Wilson & Co. (Dist. Ct. S.D. N.Y.; 1917) 252 *Fed.* 631, 639, 640. The measure of contribution is usually based upon the value of the surviving securities at the date of bankruptcy. *Ibid.*, p. 654.

[16] (1908) 125 App. Div. (*N.Y.*) 730, affirmed 193 *N.Y.* 626.

left for safekeeping with her broker 300 shares of United States Steel common stock, owned outright and endorsed in blank. The broker also had in his possession the securities of two other customers, named Henck and Townsend, which, however, had been bought on margin and were being held by the broker as security for the unpaid balance of the purchase price. Subsequently, he used the securities of all three customers as collateral for a loan of $35,000 from the Colonial Bank of New York. Following the assignment of the brokerage firm, the Colonial Bank, without notice of the claims of Beach, Henck, or Townsend, sold a sufficient amount of the deposited collateral to pay the indebtedness, and after the sale had in its possession a balance of $560, in addition to certain securities that it had been found unnecessary to sell in order to satisfy the loan. The Bank had sold all of the securities belonging to Beach and a part of those belonging to Henck, Townsend, and other margin creditors. Beach thereupon demanded that the assignee sell the securities that the bank had not sold, and that the entire proceeds derived from the sale, including the cash turned over by the bank to the assignee, be delivered to her. Henck and Townsend, however, opposed this contention and demanded that the assignee return to them their respective securities held by him. Justice McLaughlin held: [17]

"I am of the opinion that the appellant Beach is entitled to the entire proceeds, or so much thereof as may be necessary to make good her loss in the sale of her stock. She does not stand, either legally or equitably, in the same position as the appellants Henck and Townsend. She had simply deposited her certificate of stock with Mills Brothers & Co. for safe keeping. She owed them no money and had never had any other dealings with them, and their use of this stock was a larceny. No title to it, as against her, could be acquired by any one except a person who had, in good faith, purchased the stock or loaned money upon it, relying upon the apparent title that she had conferred upon the insolvent firm."

[17] *Ibid.*, p. 732.

The conclusion of the court was, therefore, to the effect that: [18]

"When after the insolvency of the depositories their creditor sells the stock wrongfully pledged, together with other stock originally held by the insolvents as security for purchases on margin and thus rightfully pledged, the owner of the converted stock is entitled to have her claims first satisfied in full out of any surplus remaining after the sale by the creditor, and is not remitted to share *pro rata* with those whose stock was pledged for margins. This, although prior to the insolvency, the owners of the stock pledged for margins tendered payment and demanded its return."

In determining priority, only two classes are established and all members of the same class are treated equally, regardless of the degree of wrong that each has suffered.[19] The right to contribution exists among members of the same class, but not between a member of class A in favor of a member of class B.[20] In placing claimants in class A or class B the determining factor is whether their securities have been wrongfully or rightfully pledged. Although there are conflicts in the decisions, the general rule is that those customers whose securities have been wrongfully pledged are assigned to class A, and those whose securities have been rightfully pledged, to class B. A margin purchaser is not by that fact alone restricted to class B. Where the broker has converted enough of the securities of a particu-

[18] *Ibid.*, from the syllabus.

[19] Asylum of St. Vincent de Paul *v.* McGuire (1925) 239 *N.Y.* 375, 380.

[20] *In re* Toole (C.C.A.2; 1921) 274 *Fed.* 337, 344, 345. "So that if the stock of A, B, and C is lawfully pledged for the payment of the debt of X, the stock of each is under the common burden, and if X sells the stock of A and B, and leaves unsold the stock of C, the latter must contribute to A and B the excess they have paid above their share. But if, on the other hand, the stock of A is lawfully pledged, while that of B and C is unlawfully pledged, there is no obligation on the part of B and C to contribute, for there is no common burden as between A, on the one side, and B and C, on the other. The principle applies only in cases where the situations of the parties are equal as equality among persons whose situations are not equal is not equitable. The situations are equal when the parties are under a common burden."

lar margin customer to extinguish the latter's indebtedness, he may be a class A claimant insofar as his remaining securities are concerned.[21] So too if the broker has failed to execute a customer's orders, the latter is placed in class A with respect to securities deposited as margin.[22] Formerly the courts were more liberal in their treatment of marginal customers, but recent decisions are inclined to recognize the superior equities of outright owners.[23] The reasoning underlying such transition has been explained in *In re* Kardos: [24]

"It may not at first be easy to see why outright owners should have been treated so much better by the courts than margin traders having valuable equities in securities, since the broker who without special authority repledged the securities of margin customers beyond the amount of his own lien was as guilty of a conversion as though he had pledged the securities of customers who had paid in full. Yet it must have been realized that there was scarcely an active brokerage house, however honest, where the stocks of margin traders were not customarily carried in the blanket loans of the house, and that any other method of conducting business was widely regarded as impracticable. These considerations doubtless subconsciously affected the courts, and moved them to regard margin traders as having in fact accepted the almost inevitable hazards of a rehypothecation of their securities beyond the amount of their own indebtedness, and as having assumed the same status which traders in recent years have commonly agreed to in writing.

"But, whatever be the reason, it is settled that securities on which there is no indebtedness are in a broad sense to be given a priority over the securities of margin traders."

Tracing and Priority.—As stated in a preceding paragraph, before a customer is able to reclaim any securities, he must

[21] *In re* J. C. Wilson & Co. (Dist. Ct., S.D. N.Y.; 1917) 252 *Fed.* 631, 650.

[22] Leonard *v.* Hunt (C.C.A.1; 1929) 36 *Fed.* (2d) 13, 14.

[23] Meyer, *op. cit.*, p. 642. For a comprehensive discussion of priority see *ibid.*, pp. 637–50.

[24] (C.C.A.2; 1928) 27 *Fed.* (2d) 690, 694, 695.

trace them. If he traces them to the broker's box he may reclaim them in full if he identifies *specifically,* or he may reclaim them in full or *pro rata* (depending on whether or not there is sufficient quantity) if he identifies *generally.* Where, however, the securities have been traced to the broker's pledgee, they may only be reclaimed subject to the burden of the loan and the rights of claimants of a superior class. This is true whether securities are identified specifically or generally. Specific identification, however, is more likely to result in the customer's ability to trace in full, or to a larger extent than would be the case if he could identify only generally. It should be emphasized that it does not necessarily follow from the fact that a claimant has traced his securities in full to the broker's pledgee that he will be able to reclaim in full. Since he may be a class B claimant it might happen that the priority of class A claims will reduce the amount available for class B to little or nothing. On the other hand, it is obvious that the greater the extent to which a customer has been able to trace, the better his position. So much so, in fact, that a class B claimant who has traced in full or nearly so may receive a larger proportion of the fund than a class A claimant who has traced only to a limited extent.[25] In tracing securities no distinction is made between class A and class B claimants.[26] It is only "after the proper *pro rata*

[25] For examples illustrative of this point, see Meyer, *op. cit.,* pp. 651–53.

[26] *In re* J. C. Wilson & Co. (Dist. Ct., S.D. N.Y.; 1917) 252 *Fed.* 631, 651. The special master, acting on the presumption that the broker converted first the securities of margin customers, permitted class A claimants to trace in full and class B claimants to trace only in proportion to the balance remaining. As stated by the court: "The difficulty with this theory is that the stockbroker had no more right to convert the stock of a margin customer than he had to convert the stock of a cash customer; for, although the broker had the right to pledge or lend the margin customer's stock under the terms and within the limits of his agreement with the margin customer, he was not thereby authorized to convert it. The conclusion of the special master in this regard can be sustained only by invoking the purest kind of legal fiction, not in my opinion justified by anything said in Gorman v. Littlefield, supra, or Duel v. Hollins, supra, or to be inferred therefrom." This case contains a full discussion of the distinction between tracing and priority at pp. 650–54.

has been assigned to each claimant who has successfully traced," that "the equities of the claimant will be considered, in order to determine whether the claim falls under class A or class B." [27]

Reclamation of Money.—In order to identify money, it is necessary to trace it into some specific fund or property.[28] Where the broker has converted the securities of a customer and sold them, the latter can reclaim the proceeds if he is able to trace.[29] So too, the proceeds of securities that have been rightfully pledged can be obtained by the customer after the claim of the sub-pledgee has been satisfied.[30] And the customer, provided he is able to trace, can claim money given to a broker for the purpose of buying securities, which securities have not been purchased.[31] But the proceeds of securities that have been sold according to the customer's order, cannot be reclaimed.[32] Furthermore, if the broker's client can trace his money into a fund and can show that it was used to buy securities which can be traced and identified, he can reclaim such securities.[33]

The rules applying to the reclamation of money are somewhat different from those applying to the reclamation of securities. If a broker converts securities and later acquires securities of the same kind, they are considered to be in replacement of the converted securities.[34] But "where one has deposited trust funds in his individual bank account and the mingled fund is at any time wholly depleted the trust fund is thereby dissipated, and cannot be treated as reappearing in sums subsequently deposited to the credit of the same account." [35] When a broker mingles moneys impressed with a

[27] *Ibid.*, p. 654.
[28] *In re* A. Bolognesi & Co. (C.C.A.$_2$; 1918) 254 *Fed.* 770, 773.
[29] Thomas *v.* Taggart (1908) 209 *U.S.* 385, 389, 390.
[30] *In re* Codman, Fletcher & Co. (C.C.A.$_1$; 1923) 287 *Fed.* 806.
[31] *In re* Shapiro (C.C.A.$_2$; 1924) 298 *Fed.* 1021.
[32] Schuyler *v.* Littlefield (1914) 232 *U.S.* 707.
[33] *Ibid.*; National Bank *v.* Insurance Co. (1881) 104 *U.S.* 54, 67.
[34] Duel *v.* Hollins (1916) 241 *U.S.* 523.
[35] Schuyler *v.* Littlefield (1914) 232 *U.S.* 707, 710.

trust with his own funds, and subsequently withdraws part of the fund, he is presumed to have withdrawn his own money, and any balance will be presumed to include the trust money. But the most that can be reclaimed is "the smallest amount the fund contained subsequent to the commingling." [36] This is in accordance with the rule that a trust fund, depleted by withdrawals, is not replenished by subsequent deposits. Where there are several claimants and the account is not sufficiently large to permit recovery in full by all claimants, the latter are permitted to recover in the inverse order in which their money was added to the fund.[37] That is, the claimant whose money was deposited last is entitled to recover in full before any other claimants can recover anything, the assumption being that the money first withdrawn was that which was first deposited. It will be noted that this rule is different from the one applying to securities which in case of insufficiency permits recovery *pro rata* by all the claimants who have succeeded in tracing securities of a specific kind.

Liability of Broker When Cooperating with an Insolvent Broker.—Where a broker continues to cooperate with another broker, known by him to be insolvent and not to be acting in good faith with his clients, he is liable for his acts to the customers of the insolvent broker. Such liability was imposed in the highly interesting case of Austin *v.* Hayden.[38] According to the facts of the case a Detroit firm continued, following its insolvency, to accept orders for speculative transactions, and used its New York correspondent to make the purchases and sales and to finance them. In protecting its correspondent, the Detroit firm committed many gross irregularities and wrongly pledged the securities of some of its customers. Having grounds for suspicion, the New York correspondent saw fit to audit the affairs of the Detroit firm. But despite the in-

[36] *In re* A. Bolognesi & Co. (C.C.A.₂; 1918) 254 *Fed.* 770, 773.
[37] *Ibid.*, p. 773.
[38] (1916) 190 *Mich.* 528.

solvent condition revealed by this audit, the correspondent continued to do business with the Detroit firm on the theory, no doubt, that it could do so legally and that its only care need be in securing sufficient collateral for its advances. The court, however, held that the correspondent was liable, equally with the Detroit firm, to the customers of the insolvent broker, since it knew of the insolvency and still continued to coöperate with the insolvent firm in buying stocks on margin and in accepting as security stocks that it knew belonged to the clients of the insolvent firm.

Prohibition of Transactions by Brokers after Insolvency.—With respect to the transaction of business after insolvency is known to exist, the position of the broker is analogous to that of the banker who continues to receive deposits after he knows his bank to be insolvent. It is clear that huge losses might be incurred unnecessarily by customers who are ignorant of the insolvency of the firm with which they continue to deal. Innocent customers should certainly be protected against such a contingency. It is for this reason that New York has enacted a statute prohibiting any broker, under a heavy penalty, from accepting money or securities from customers, after he knows of his insolvency, except for purposes of liquidating the customer's existing indebtedness. The statute referred to provides: [89]

"A person engaged in the business of purchasing and selling as broker, stocks, bonds, or other evidences of debt of corporations, companies, or associations who, knowing that he is insolvent, accepts or receives from a customer ignorant of such broker's insolvency, money, stocks, bonds, or other evidences of debt belonging to the customer otherwise than in liquidation of, or as security for, an existing indebtedness, and who thereby causes the customer to lose in whole or in part such money, stocks, bonds, or other evidences of debt, is guilty of a felony punishable by fine of not more than five thousand dollars, or by imprisonment for not more than

[89] *N. Y. Laws* (1913) Chapter 500; Penal Law, § 955.

two years, or by both. A person shall be deemed insolvent within the meaning of this section whenever the aggregate of his property shall not, at a fair valuation, be sufficient in amount to pay his debts."

Brokerage insolvencies will no doubt continue to occur from time to time, but there is no question that every effort should be made to reduce the number to an absolute minimum. Section 8 of the Securities Exchange Act of 1934 attempts to accomplish this purpose by prohibiting exchange members or brokers or dealers transacting business through them from incurring indebtedness, in the ordinary course of business as a broker, which will exceed twenty times the net capital (exclusive of fixed assets and value of exchange membership) employed in the business. The Commission may by rules and regulations further limit this amount. It may be pointed out that even without any Federal regulation, the record of the members of the New York Stock Exchange, relative to insolvency, has been exceedingly good.

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APPENDICES

APPENDIX I

CLASSIFICATION AND DESCRIPTION OF STOCK CERTIFICATES [1]

I. Classification According to Par Value.

1. *Par value ranging from $1,000 per share, in the case of certain bank and trust-company stocks, to one cent per share in the case of certain oil or mining shares.* In the majority of instances the par value of listed stocks is $100 a share, but many important corporations have issued stock with a par value of $50 or $25. With many important mining corporations the par value of stocks is $10, $5, or $1. Where several kinds of stock have been issued by the same corporation, the par value is usually the same. Numerous instances, however, exist where the preferred stock is either one-half or double that of the common stock.

2. *Stocks without any par value.*—The issuance of no par value shares seems to be on the increase. Here each certificate simply represents its designated share of the total issue. Dividends take the form of a designated number of dollars per share.

II. Classification of Stock Certificates with Reference to Their Issue.

1. *Unissued stock.*—Such stock may be defined as "that which has been authorized but not yet disposed of, that is, it merely

[1] [Summary based on "Stocks and Their Features—A Division and Classification," by John Adams, Jr., published in "Stocks and the Stock Market," *Annals of the American Academy of Political and Social Science,* May, 1910, pp. 42–62. This analysis by Adams is based mainly on an examination of stock issues listed on the New York Stock Exchange at the time of the preparation of the article. The article gives examples of various corporations with a view to illustrating the various types of described stocks.]

represents the right to admit new stockholders and has no value in itself. It has no active stock rights and is not an asset of the corporation. It usually is reserved for various corporate purposes, such as the conversion of bonds or the purchase of new lines or plants."

2. *Issued and outstanding stock.*—Such stock has not merely been authorized but has actually been issued. It has passed into the ownership of some holder other than the issuing corporation.

3. *Treasury stock.*—Such stock has been issued, but is not outstanding. It has been defined as stock "issued and outstanding which has come into possession of the corporation which received it by purchase, donation, or in liquidation of a debt. If it has been issued full paid, it remains so, even if sold again below par, and it is considered an asset of the corporation for bookkeeping purposes. But such stock, so long as it is held by the corporation or its representatives as treasury stock, neither participates in dividends nor in the meetings of the corporation as treasury stock; though it still represents a paid-for interest in the property of the corporation."

III. Classification of Stock Certificates According to Whether They Are Full Paid or Assessable.

1. *Full paid stock* is "stock which has been fully paid for as required by law in money, property, or labor. Such stocks indicate the fact on their face that they are 'full paid and non-assessable,' and in the absence of any special statute on the subject carry with them no legal liability."

2. *Assessable stock* is "stock which has not yet been fully paid for by its subscriber. The legal status of assessable stock is such that creditors of the corporation can hold the owners of the shares liable for the difference between the amount actually paid in and the par value of the stock. The laws of certain states are such as to make stockholders liable for assessments for certain debts, even though the certificates are marked 'full paid and non-assessable.' Moreover, by law, certain stocks, such as national-bank stock, for example, are liable to creditors for double the par value of the shares."

IV. Classification of Stock Certificates According to the Rights and Limitations Attaching Thereto.

1. *Common stock.*—"This term refers to the junior issue, when there is preferred stock, or stock analogous to preferred. Sometimes it has a real preference in regard to voting, for there are instances where the preferred gives up the right to vote as a consideration for its receiving regular dividends. The usual provision is that if such disbursements are discontinued for a certain period, varying with the individual corporation, the preferred stock shall resume its voting power. Common stock generally has the right to receive all the surplus remaining for dividends after the preferred has been paid its stipulated percentage. It is evidently, therefore, not an advantage to the common stock to have any preferred stock ahead of it."

2. *Deferred stock.*—"Such stock refers to certain issues commonly, in England, but only infrequently met with in the United States. The name itself is largely explanatory of its nature. It is an issue on which dividends are deferred until dividends on some other variety of stock, or interest on some particular bonds, have been paid. The common stock of companies possessing this issue is usually divided into two parts—one, the 'B', or ordinary stock, and the deferred, or 'A' stock, which receives no dividends until a certain fixed rate has been paid upon the 'B' stock. Both of these issues are junior, of course, to the 'preference' stock, as it is called in England. The corporations which possess this class of stock are usually English either in their inception, location, or management."

3. *Preferred stock.*—"This stock may have a preference in any one, any two, or all three, of three particulars, i.e., dividends always; assets, generally; and voting power at times. It may also be 'callable,' 'convertible,' or 'participating.'" Preferred stock may have preference as regards:

(1) *Dividends.*—"Such stock always has a preference over the common as regards dividends, which may be either 'cumulative' or 'non-cumulative.'"

(a) *Cumulative dividends* are "in the nature of a fixed charge, because if the corporation is unable to pay the dividend in one year, it must be paid in succeeding years,

together with the dividends for those years, before the common stock can receive anything. No such duty attaches to non-cumulative stock."

(b) *Non-cumulative dividend* implies that "if the dividend cannot be paid this year, the rights of the common stock to share in next year's earnings are in no wise impaired. Sometimes dividends do not become cumulative for a few years, in order to give the corporation an opportunity to become firmly established before it must meet the fixed cumulative dividend obligation."

(2) *Assets.*—As compared with the common stock, preferred stock often enjoys preference as to assets upon a dissolution of the corporation. "Practically every large industrial concern has its preferred stock protected by giving it this preference should it ever become necessary to distribute the corporate assets. The practice, however, is not so common in the case of railroads, as among industrials. Various plans of preference are provided for. Thus the arrangement may be to the effect that the preferred stock has the first claim on all assets up to $100 a share, and then shares the balance with the common after that issue has received $100 or some other stipulated amount per share. In a few instances, the preferred stock is given a preference to an amount over par, like $115 a share. In most cases, too, unpaid cumulative dividends must be settled for out of assets before the common stock can receive anything."

(3) *Voting power.*—"Often the common stock possesses a superior voting right. In some instances, however, though not so often as the common stock, the preferred stock carries the entire voting power. On the other hand, the preferred stock often has a voting preference in regard to special matters—usually in case of the creation or increase of funded debt or the enlargement of the preferred issue itself. More than a majority of the issue, usually two-thirds to three-fourths, is required to sanction such changes."

(4) *Creation of dividend funds.*—"Various corporations safeguard the dividends of their various classes of preferred stock by creating special so-called dividend funds. The dif-

ference between a first and second preferred stock is this: that while both are senior to the common stock, the first preferred ranks ahead of the second in regard to receiving dividends, and in some cases priority as regards assets also. There are instances where corporations have as many as three classes of preferred stock. Moreover, a few corporations have made provision for the accumulation of a certain fund out of which dividends on the preferred shall be paid during times of business depression, when earnings are not sufficient to meet such payments. Thus the corporation may provide a separate fund of, say $2,000,000 of prior lien bonds, the proceeds of which may be drawn upon to the extent that net profits shall not be sufficient to insure the dividend payments on the preferred stock for a designated period, like three years. Or, the corporation may promise the preferred stockholders that a surplus of, say $1,000,000 shall be accumulated out of earnings before any dividend shall be paid on the common stock. Such dividend funds serve as a protection to the preferred stockholders, for if there were no surplus when net earnings are little above the amount needed for preferred dividends, it might not be deemed advisable to declare such dividends unless there were such a surplus fund to fall back upon for working capital."

(5) *Special features.*—Preferred stocks may possess any one or more of three special features, that is, may be "callable," "convertible," or "participating."

(*a*) *Callable feature.*—"Corporations may have hopes that in time their business will so improve that by issuing bonds at a low interest rate or by selling additional common stock they can retire the preferred stock, probably yielding a higher rate of dividend, and thus leave the common stock in a much better position. Hence, the callable feature may be inserted. This is never obligatory on the corporation but merely optional with the directors. It is the opposite of the convertible feature which depends on the stockholder's option." The callable feature presents a great variety. Thus the stock may be called at par, or at a premium like 105, 110, or 125.

Often the callable feature may be exercised only "if and when allowed by law," or if some other preferred issue has first been redeemed or converted, or "only by vote of two-thirds of the directors," or "subject to conversion for thirty days after notice." "It is generally considered a disadvantage to have a stock callable as the holder must then seek new fields for his capital usually just when the investment begins to look attractive."

(*b*) *Convertible feature.*—Unlike the callable feature, it is usually advantageous for a stock to possess the convertible feature. Here the stockholder possesses the option, and not the company. The stockholder, in other words, is given the right, under certain definitely stated conditions, to convert his preferred stock into common stock, or into some other issue of preferred stock, or partly in common stock and partly in some other issue of preferred stock, or possibly into some bond issue.

(c) *Participating feature.*—"This feature is of the utmost importance, for it is practically only in this class of preferred stocks that the holder has an income unlimited except by the company's earning power. In cumulative preferred stocks he is nearly always limited to his fixed percentage, but here he shares with the common stock the surplus remaining after a certain amount has been paid on that class." The participating feature presents a great variety. Sometimes the feature provides that after the common stock has received the same dividend paid to the preferred stock, both types of stock shall share *pro rata* in any surplus. Another variation is to the effect that following the receipt of a certain dividend by the common stock the preferred shall receive three per cent, then the common three per cent, then both stocks to share equally. Sometimes the preferred is given merely an extra one or two per cent after the common stock has been given a certain dividend, while under still other instances, the preferred stock is to receive, say, "one-half per cent for each one per cent paid on the common stock over seven per cent."

2. Stock Analogous to Preferred.

(1) *Interest bearing stock.*—"This is really only another name for preferred stock, because interest (instead of dividends) must be paid upon it before there can be any disbursement on the common stock. Such issues are obsolete to-day and no examples are found in the various manuals."

(2) *Special stock.*—"Under certain Massachusetts statutes, especially the Acts of 1855 and 1882, manufacturing and other corporations by vote of three-fourths of their stockholders at a meeting called especially for this purpose, may authorize the special stock which must never exceed two-thirds of the actual capital, bearing semi-annual dividends not exceeding four per cent, and subject to redemption at par after a fixed date, which must be expressed on the certificate. The holder of such stock is in no case liable for the debts of the corporation. Instances of such stock are rare and crop out now and then because of law suits over the rights of the stockholders. The nearest modern analogy is the callable preferred stock, but it also resembles in some ways a short-term note, for the obligation to pay dividends is absolute, not as in interest bearing or ordinary preferred stock, contingent on there being sufficient profits so to do, and it is also usually redeemable in a short time."

(3) *Guaranteed stock.*—"This term is properly applied to the stock of a company, the dividends on which are guaranteed by another corporation, provided there are sufficient earnings to meet them, but not otherwise. It is sometimes erroneously employed as describing preferred stock, that is, the corporation guaranteeing the dividends on its own stock. Guaranteed stocks usually arise from a consolidation or lease of one road, or industrial corporation, with or to another." The terms of the guarantee may vary greatly. Usually a definite percentage of dividend is guaranteed, but frequently the guarantee is limited to the payment of "net earnings."

(4) *Founders' stock.*—"Such stock is practically unknown in this country, though it may exist in certain small corporations. It may be defined as stock ranking ahead of preferred stock,

entitled to a certain fixed dividend and then to a certain proportion of the surplus after dividends on all classes of stock have been paid. Assume a corporation with $100,000 six per cent Founders' stock, $4,900,000 six per cent preferred, and $5,000,000 common stock, and a balance for dividends for the year of $1,000,000. The Founders' stock will receive $6,000, the preferred $294,000, and the common, say, $250,000. The surplus for the year would then be $450,000. The Founders' stock is entitled to a certain proportion of this—fixed by the articles of incorporation—usually one-fourth to one-half. This type of stock was formerly common in England but is now looked upon with disfavor. Such stock was usually given to promoters, or to persons of influence in consideration of their lending the weight of their names to new corporations, and is naturally, highly valued by its fortunate possessors."

(5) *Debenture stock.*—"This class of stock may be said to be on the margin between mortgage bond issues and regular stock issues. To the ordinary person a debenture signifies a 'non-mortgage bond.' But it is also used to describe a stock. It differs from other stock in that the company promises, generally in the form of a covenant, to pay interest on specified dates. This interest has priority over dividends on any class of stock whatever, whether guaranteed or not. Such issues are common in England and Canada, but rare in the United States, though debenture bonds are well known here. Such stocks may be issued on the irredeemable plan, or provision may be made for their redemption after a certain date."

APPENDIX II

SAMPLE FORM OF COMMON STOCK CERTIFICATE

COMMON CAPITAL STOCK

NUMBER
K273,420

SHARES
100

Incorporated Under the Laws Of the State of New Jersey

UNITED STATES STEEL CORPORATION

This is to certify that_____is the owner of ONE HUNDRED fully paid and non-assessable shares of the par value of One Hundred Dollars each, in the COMMON CAPITAL STOCK of United States Steel Corporation, transferable only in person or by attorney upon the books of said corporation, upon surrender of this certificate. The holders of the preferred stock shall be entitled to receive, when and as declared from the surplus or net profits of the Corporation, yearly dividends at the rate of seven percentum per annum, and no more, payable quarterly on dates to be fixed by the By-Laws. The dividends on the preferred stock shall be cumulative and shall be payable before any dividends on the common stock, shall be paid or set apart, so that if in

any year dividends amounting to seven per cent shall not have been paid thereon, the deficiency shall be payable before any dividends shall be paid or set apart for the common stock. Whenever all cumulative dividends on the preferred stock for all previous years shall have been declared and shall have become payable, and the accrued quarterly installments for the current year shall have been declared, and the Company shall have paid such cumulative dividends for previous years and such accrued quarterly installments, or shall have set aside from its surplus or net profits a sum sufficient for the payment thereof, the Board of Directors may declare dividends on the common stock, payable then or thereafter, out of any remaining surplus or net profits. In the event of any liquidation or dissolution or winding up (whether voluntary or involuntary) of the Corporation, the holders of the preferred stock shall be entitled to be paid in full both the par amount of their shares and the unpaid dividends accruing thereon, before any amount shall be paid to the holders of the common stock, and after the payment to the holders of the preferred stock of its par value, and the unpaid accruing dividends thereon, the remaining assets and funds shall be divided and paid to the holders of the common stock according to their respective shares. The preferred stock and the common stock may be increased as provided in the CERTIFICATE OF INCORPORATION.

This Certificate is not valid without the signatures of the Transfer Agent and Registrar of Transfers.

Witness the signatures of the President or of a Vice-President, and of the Treasurer or of an Assistant Treasurer, of said Corporation.

Treasurer

President

Shares $100 each

American Bank Note Company

Countersigned

Transfer Agent

Registered

Guaranty Trust Company of New York

Registrar

by

Authorized Officer

(ON REVERSE SIDE OF CERTIFICATE)

For value received_____hereby sell, assign and transfer unto

Please print or type name and address of assignee

_____

_____

_____shares
of the capital stock represented by the within Certificate, and do hereby irrevocably constitute and appoint

_____Attorney
to transfer the said stock on the books of the within named Corporation with full power of substitution in the premises.

Dated_____19.

In Presence of

_____

NOTICE AND SIGNATURE OF THIS ASSIGNMENT MUST CORRESPOND WITH THE NAME AS WRITTEN UPON THE FACE OF THE CERTIFICATE, IN EVERY PARTICULAR, WITHOUT OMISSION OR ENLARGEMENT, OR ANY CHANGE WHATEVER.

APPENDIX III

SAMPLE FORM OF PREFERRED STOCK CERTIFICATE

SEVEN PER CENT CUMULATIVE PREFERRED STOCK

NUMBER	SHARES
C672,052	100

Incorporated Under the Laws Of the State of New Jersey

UNITED STATES STEEL CORPORATION

This is to certify that _____ is the owner of ONE HUNDRED fully paid and non-assessable shares of the par value of One Hundred Dollars each, in the PREFERRED CAPITAL STOCK of United States Steel Corporation, transferable only in person or by attorney upon the books of said Corporation, upon surrender of this certificate. The holders of the preferred stock shall be entitled to receive, when and as declared, from the surplus or net profits of the Corporation, yearly dividends at the rate of seven percentum per annum, and no more, payable quarterly on dates to be fixed by the By-Laws. The dividends on the preferred stock shall be cumulative, and shall be payable before any dividend on the common stock shall be paid or set apart, so that, if in any year dividends amounting to seven per cent shall not have been paid thereon, the deficiency

shall be payable before dividends shall be paid or set apart for the common stock. Whenever all cumulative dividends on the preferred stock for all previous years shall have been declared and shall have become payable, and the accruing quarterly installments for the current year shall have been declared, and the Company shall have paid such cumulative dividends for previous years and such accrued quarterly installments, or shall have set aside from its surplus or net profits a sum sufficient for the payment thereof, the Board of Directors may declare dividends on the common stock, payable then or thereafter, out of any remaining surplus or net profits. In the event of any liquidation or dissolution or winding up (whether voluntary or involuntary) of the Corporation, the holders of the preferred stock shall be entitled to be paid in full both the par amount of their shares and the unpaid dividends accruing thereon, before any amount shall be paid to the holders of the common stock, and after the payment to the holders of the preferred stock of its par value, and the unpaid accruing dividends thereon, the remaining assets and funds shall be divided and paid to the holders of the common stock according to their respective shares. The preferred stock and the common stock may be increased as provided in the CERTIFICATE OF INCORPORATION. This Certificate is not valid without the signature of the Tranfer Agent and Registrar of Transfers.

Witness the signatures of the President or of a Vice-President, and of the Treasurer or of an Assistant Treasurer, of said Corporation.

Treasurer

President

Shares $100 each

American Bank Note Company

Countersigned

Transfer Agent

Registered

The New York Trust Company

by

Registrar

Assistant Secretary

APPENDIX IV

SAMPLE FORM OF BOND CERTIFICATE

No.

D2184

SOUTHERN PACIFIC COMPANY

$500., or MARKS 2,100, or
£102.15s.6d., or GUILDERS
1240., or FRANCS 2592.50.

SAN FRANCISCO TERMINAL

First Mortgage
Four Per Cent Bond
Principal Due April 1st
1950

Interest Payable
April 1st and October 1st

Principal and interest payable in the city of New York or at Holder's Option, at the places in Europe named in the within Bond and Attached coupons.

TRUSTEE'S CERTIFICATE

This bond is one of the bonds described in the within-mentioned mortgage and deed of trust.

UNITED STATES MORTGAGE AND TRUST COMPANY
Trustee,

BY

Vice-President.

SOUTHERN PACIFIC

Company

No. D2184 No. D2184

SAN FRANCISCO TERMINAL FIRST MORTGAGE FOUR PER CENT BOND

SOUTHERN PACIFIC COMPANY (hereinafter called "Company") for value received, hereby promises to pay to the bearer or, if registered, to the registered owner of this bond, on the first day of April, 1950 (unless before that time this bond shall have been redeemed), the sum of FIVE HUNDRED DOLLARS, in gold coin of the United States of America, of or equal to the present standard of weight and fineness, at the office or agency of the company, in the Borough of Manhattan, in the City of New York, or, at the option of the holder, Two Thousand One Hundred Marks in Germany, at the office in Berlin of Direction de Disconto-Gesellschaft, Berliner Handels-Gesellschaft or Nationalbank fur Deutschland or at the office in Hamburg of Norddeutsche Bank in Hamburg or M. M. Warburg & Company or at the office in Frankfort of Direction der Disconto-Gesellschaft, or One Hundred and Two Pounds Fifteen Shillings Six pence, sterling money of Great Britain, in England, at the office in London of J. Henry Schroder & Co., or One Thousand Two Hundred and Forty Guilders in Holland, at the office in Amsterdam of Hope & Co., or Two Thousand Five Hundred and Ninety-two Francs Fifty Centimes in Switzerland, at the office in Basel, Zurich or Geneva of Schweizerischer Bankvoreim, or at such other agency in any of the aforesaid European cities as the Company shall determine; and to pay interest thereon at the rate of four per cent per annum, from the first day of April, 1910, payable semi-annually on the first day of April and the first day of October in each year, in like gold coin at the said office or agency in the Borough of Manhattan, or, at the option of the holder, in marks at any of said offices in Germany, or in sterling at said office in London, or in guilders at said office in Amsterdam, or in francs at any of said offices in Switzerland, or at such other agency in any

of the aforesaid European cities as the Company shall determine, but only upon presentation and surrender, as they severally mature of the coupons therefor annexed hereto. Both the principal and the interest of this bond shall be paid without deduction for any tax or taxes which the Company may be required to pay thereon, or to retain therefrom, under any present or future law of the United States of America, or of any state, territory, county, municipality or other taxing authority therein. This bond is one of a duly authorized issue of San Francisco Terminal First Mortgage Bonds (Coupon and registered) of the Company, limited to the aggregate principal amount, in United States gold coin, of Fifty Million Dollars ($50,000,000) at any one time outstanding, issued and to be issued under and in pursuance of, and all equally secured by, a mortgage and deed of trust dated the first day of April, 1910, executed by the Company to United States Mortgage and Trust Company, as Trustee, to which mortgage reference is hereby made for a statement of the property and franchises mortgaged, the nature and extent of the security, the rights of the holders of bonds under the same, and the terms and conditions upon which said bonds are issued and secured. All the bonds issued under said mortgage at any time outstanding (but not part thereof) may be redeemed, at the option of the Company or its successors, at 105 per cent of the face value thereof, and accrued interest thereon, on the first day of April, 1915, or on any semi-annual interest day thereafter, upon previous notice published at least once a week for a period of at least ninety days next preceding the date of redemption specified in such notice in one newspaper in each of the following cities: New York, San Francisco, Berlin, Hamburg, Frankfort, London, Amsterdam, Basel, Zurich and Geneva, as provided in said mortgage and deed of trust. In the event of certain defaults as specified in said mortgage and deed of lease, the principal of the bonds issued thereunder may become or be declared due and payable in the manner and with the effect provided in said mortgage and deed of trust. This bond shall pass by delivery, unless registered in the owner's name on the books of the Company at its office or agency in the City of New York, such registration being noted on the bond by the Company. After such registration no transfer shall be valid unless made on the Company's books by the registered owner in person, or by his duly

authorized attorney, and similarly noted on the bond; but the same may be discharged from registration by being in like manner transferred to bearer, and thereupon transferability by delivery shall be restored; but this bond may again, from time to time, be registered or transferred to bearer, as before. Such registration, however, shall not affect the negotiability of the coupons, which shall continue to be transferable by delivery merely. The holder of this bond, at his option, may surrender the same, with all unmatured coupons thereto appertaining, for cancellation and in exchange for a registered bond without coupons, as provided in said mortgage and deed of trust, and on payment, if the Company shall require it, of the transfer charges therein provided for. This bond shall not become valid or obligatory for any purpose until it shall have been authenticated by the certificate, hereon endorsed, of the Trustee under said mortgage and deed of trust.

IN WITNESS WHEREOF, Southern Pacific Company has caused these presents to be signed by its President or one of its Vice-Presidents, and its corporate seal to be hereunto affixed and to be attested by its Secretary or one of its Assistant Secretaries, and coupons for said interest, bearing the engraved facsimile signature of its Treasurer, to be attached hereto, as of the first day of April, 1910.

Southern Pacific Company,

Attest: By

Seal

Assistant Secretary Vice-President

APPENDIX V

SAMPLE FORM OF STOCK ALLOTMENT WARRANT

FULL SHARE WARRANT

No. 264

RIGHT TO SUBSCRIBE EXPIRES JULY 15, 1930

This Warrant Entitles the Holder to Subscribe for —35—SHARE(S) It represents—1050—Rights

If not used for subscription on or before said date, this warrant will be void and of no value.

E. I. DU PONT DE NEMOURS & COMPANY

Wilmington, Delaware

FULL SHARE STOCK SUBSCRIPTION WARRANT

Dated June 5, 1930.

This is to Certify that
J. FRANK AYARS********
1033 CLAYTON ST.
WILMINGTON, DELAWARE

or assigns, upon surrender of this warrant to the Transfer Agent, E. I. du Pont de Nemours & Co., Broadway at 57th St., New York City on or before July 15, 1930, is entitled to subscribe at $88.00 per share plus dividend, with interest adjustment on partial payments in form below for the number of full shares indicated herein, upon the terms and conditions specified in circular letter of Company addressed to its stockholders dated May 19, 1930, which is summarized in part on the back of this warrant.

J. B. Eliason
Treasurer

J. S. Dean
Assistant Treasurer. Transfer Agent

The above right of subscription may be sold and transferred by assignment endorsed hereon.

SUBSCRIPTION AGREEMENT

E. I. du Pont de Nemours & Co., Broadway at 57th St., New York, N. Y. Date_____ 1930.

The undersigned hereby subscribes for stock covered by this Warrant and agrees to pay therefor in_____ (insert "Full" or "Installment") as provided in the circular letter of the Company referred to in this Warrant.

PAYMENT MUST ACCOMPANY THIS SUBSCRIPTION AGREEMENT

Subscriber's Signature_____

Give first or middle name in full. If a woman, indicate whether "Miss" or "Mrs."

Subscriber's Mailing Address_____

Street and Number City or Town State

Mailing Address for Stock Certificate if not to be sent to Subscriber_____

PLEASE DO NOT WRITE IN SPACE BELOW. RESERVED FOR USE OF COMPANY

Full	Instal.	Date	Register No.	Shares	Payment	Description of Remittance	Main Warrant
							Supporting Warrants
Classification							

Accepted by	Verified by	Memoranda

American Bank Note Co., Litho.

Payment of the subscription must be made as set forth in the circular letter of the Company to its stockholders dated May 19, 1930, as follows:

Payment in three installments		Option 1—Full payment anticipating both deferred installments		Option 2—Payment anticipating installment	
	Per Share		*Per Share*		*Per Share*
July 15, 1930	$20.00	July 15, 1930	$80.33 *	July 15, 1930	$20.00
September 30, 1930	$30.00			September 20, 1930	$59.87 *
December 20, 1930	$29.25 *				
* $30 less interest credit of 80¢ plus dividend adjustment of 5¢.		* Including 33¢ dividend adjustment.		* $60 less interest credit of 18¢ plus dividend adjustment of 5¢.	

The privilege of subscribing under this warrant will expire at the close of business on July 15, 1930 and if this warrant is not utilized for such purpose on or before said date, it will be void and of no value.

Warrants may be transferred or divided into warrants of smaller denominations on surrender, properly endorsed to A. B. Hull, Transfer Agent, E. I. du Pont de Nemours & Co., Broadway at 57th St., New York, N. Y.

Stock certificates will be issued as soon as practicable against fully paid Subscriptions made on or before July 15, 1930, however in no event previous to July 1, 1930.

ASSIGNMENT

Do not execute this Assignment if you execute the Subscription Agreement on the face of this Warrant.

Date_____ 1930.

For value received, the rights described in this Warrant, together with all right, title and interest therein are hereby assigned to

Please print or type name and address

Name	Address	( )
Name	Address	( )

Signature of registered owner_____

Witness: _____

If assigned attach Federal Revenue Tax stamps amounting to 2¢ for each five shares or fraction thereof in this space.

NOTE: The signature to this assignment must correspond with the name as written upon the face of this Warrant, in every particular, without alteration or enlargement or any change whatever. When assignments are executed by Administrators, Executors, Trustees, Guardians, Attorneys, etc., proper evidence of their authority so to act must be on file with the Company.

APPENDIX VI

SAMPLE FORM OF STOCK PURCHASE WARRANT SECOND SERIES

Right to Purchase
5* share(s)
of common stock

UNITED AIRCRAFT & TRANSPORT CORPORATION
No.

$\frac{BW}{A}$ 1083

Bearer Stock Purchase Warrant,
Second Series
Void after November 1, 1938.

THIS CERTIFIES that the bearer hereof has the right to purchase at any time on or before November 1, 1938, but not thereafter, all or any part of FIVE*** shares, without par value, full paid and non-assessable, of the *common stock* of the *United Aircraft & Transport Corporation,* a corporation of the State of Delaware (hereinafter referred to as the "corporation"), as such stock shall be constituted at the time of purchase, at the price of thirty dollars a share, subject to the following terms and provisions, and not otherwise:

(A) The said right may be exercised only upon surrender of this warrant at the head office of the trustee hereinafter named, in the Borough of Manhattan, in the City of New York, State of New York.

(B) Payment in full for the stock purchased in the exercise of the said right shall be made in cash or in New York City funds at the time of the surrender of this warrant, as aforesaid.

(C) No fractional share will be issued; but, in case this warrant evidences the right to purchase a fraction of a share of common stock (either alone or in addition to one or more whole shares of common stock), the purchaser will be entitled to receive, as and to the extent provided in the stock purchase warrant agreement hereinafter referred to, a script certificate with respect to the fraction of a share purchased in the exercise of such right, which script certificate may be combined with other similar script certificates so as to aggregate one or more whole shares of common stock, and, as so combined, may be surrendered on or before a date to be specified therein (which date shall not be less than six months from the date of issue thereof), but not thereafter, in exchange for a stock certificate or certificates representing the number of whole shares of common stock so aggregated and a new script certificate for the remaining fraction of a share (if any). Holders of script certificates, as such, will not be entitled to receive dividends or to exercise any of the rights of stockholders.

This warrant is issued under and subject to the terms and provisions of a stock purchase warrant agreement, dated as of February 5, 1929, between the corporation and the National City Bank of New York, Trustee, to all of which terms and provisions the holder hereof assents by accepting this warrant. Anything herein or in the said stock purchase warrant agreement contained to the contrary notwithstanding, in case of consolidation or merger of the corporation with or into any other corporation, or in case of sale by the corporation of all or substantially all its assets, as more particularly set forth in the said stock purchase warrant agreement, or in case of issue by the corporation of additional shares of common stock at a lower price than the price at which shares of common stock might have been purchased hereunder immediately prior to the issue of such additional shares, the number and character of the shares of stock or other securities or assets which the holder hereof shall thereafter have the right to purchase, and the price to be paid therefor, shall be adjusted and determined as provided in the said stock purchase warrant agreement; but in no case shall any such adjusted price be greater than thirty dollars a share. The holder of this warrant, as such, shall have none of the preemptive or other rights of a holder of common stock. This warrant is issued subject, also, to the

following terms and conditions, to all of which each and every holder hereof assents by accepting this warrant: All rights under and by virtue of this warrant shall pass and be transferred by the delivery hereof; and the delivery of this warrant shall vest title thereto in the transferee to the same extent, for all intents and purposes, as in the case of the delivery under similar circumstances of a negotiable instrument payable to bearer. The corporation and the trustee shall be entitled to treat the bearer of this warrant as the absolute owner hereof for all purposes and shall not be affected by any notice to the contrary. This warrant shall be wholly void and of no effect after November 1, 1938.

IN WITNESS WHEREOF, the corporation has caused this warrant to be signed by its president or one of its vice-presidents, and the trustee, for the purpose of identification only, has countersigned this warrant, this Jan. 2, 1934.

UNITED AIRCRAFT & TRANSPORT CORPORATION,

by _____
Vice President.

Countersigned:
THE NATIONAL CITY BANK OF NEW YORK,
As Trustee,

By _____
Authorized Officer.

APPENDIX VII

COMMISSIONS CHARGED BY THE NEW YORK STOCK EXCHANGE

CONSTITUTION AND RULES OF THE NEW YORK STOCK EXCHANGE

ARTICLE XIX

Sec. 1. Commissions shall be charged and collected upon the execution of all orders for the purchase or sale for account of others, of securities admitted to dealings upon the Exchange and these commissions shall be at rates not less than the rates in this Article prescribed; and shall be net and free from any rebate, return discount or allowance made in any shape or manner, or by any method or arrangement direct or indirect. No bonus or percentage or portion of a commission, whether such commission be at or above the rates herein established, or any portion of a profit except as may be specifically permitted by the Constitution or a Rule adopted by the Governing Committee, shall be given, paid or allowed, directly or indirectly, or as a salary or portion of a salary, to a clerk or person for business sought or procured for any member of the Exchange or firm registered thereon.

Sec. 2. Commissions shall be as follows:

(a) *On business for parties not members of the Exchange, including joint account transactions in which a non-member is interested; and on transactions for partners not members of the Exchange:*

ON STOCKS:

(except as to Ten-share-unit Stocks, as stated below)

Price	Rate per Share
Selling under 50 cents	As mutually agreed
Selling at 50 cents and above, but under $1	Not less than 3 cents

Price	Rate per Share
Selling at $1 and above, but under $10	Not less than 7½ cents
Selling at $10 and above, but under $25	Not less than 12½ cents
Selling at $25 and above, but under $50	Not less than 15 cents
Selling at $50 and above, but under $75	Not less than 17½ cents
Selling at $75 and above, but under $100	Not less than 20 cents
Selling at $100 and above, but under $200	Not less than 25 cents
Selling at $200 and above, but under $250	Not less than 30 cents
For each additional $50 in price	5 cents additional

provided, however, that on every transaction which involves an amount of $15 or more, the minimum commission shall be not less than $1.00.

ON TEN-SHARE-UNIT STOCKS:

(as designated by the Committee of Arrangements)

Price	Rate per Share
Selling at less than $1 per share	As mutually agreed
Selling at $1 per share and above but under $5	Not less than 5 cents
Selling at $5 per share and above but under $10	Not less than 10 cents
Selling at $10 per share and above but under $100	Not less than 20 cents
Selling at $100 per share and above	The same rates as provided for other stocks

ON BONDS:

Price per $1,000 of Principal	Rate per $1,000 of Principal
Selling at less than $10	Not less than 75 cents
Selling at $10 and above but under $100	Not less than $1.25
Selling at $100 and above	Not less than $2.50

ON SUBSCRIPTION RIGHTS:

Price	Rate per Right
Selling under 50 cents	As mutually agreed
Selling at 50 cents and above, but under $1	Not less than 3 cents
Selling at $1 and above, but under $5	Not less than 5 cents
Selling at $5 and above, but under $10	Not less than 7½ cents
Selling at $10 and above	Not less than 15 cents

(b) *On business for members of the Exchange when a principal is not given up:*

ON STOCKS:

(except as to Ten-share-unit Stocks as stated below)

Price	Rate per Share
Selling under 50 cents	As mutually agreed
Selling at 50 cents and above, but under $1	Not less than ¾ cent
Selling at $1 and above, but under $10	Not less than 1¾ cents
Selling at $10 and above, but under $125	Not less than 3¾ cents
Selling at $125 and above	Not less than 5 cents

ON TEN-SHARE-UNIT STOCKS:

(As designated by the Committee of Arrangements)

Price	Rate per Share
Selling at less than $1 per share	As mutually agreed
Selling at $1 per share and above but under $5	Not less than 2 cents
Selling at $5 per share and above but under $10	Not less than 4 cents
Selling at $10 per share and above	Not less than 8 cents

ON BONDS:

Price per $1,000 of Principal	Rate per $1,000 of Principal
Selling at less than $10	Not less than 50 cents
Selling at $10 and above, but under $100	Not less than 62½ cents
Selling at $100 and above	Not less than $1.25

ON SUBSCRIPTION RIGHTS:

Price	Rate per Right
Selling under 50 cents	As mutually agreed
Selling at 50 cents and above, but under $1	Not less than ¾ cent
Selling at $1 and above, but under $5	Not less than 1¼ cents
Selling at $5 and above, but under $10	Not less than 1¾ cents
Selling at $10 and above	Not less than 3¾ cents

(c) *On business for members of the Exchange when a principal is given up:*

ON STOCKS:

(except as to Ten-share-unit Stocks, as stated below)

Price	Rate per Share
Selling under 50 cents	As mutually agreed
Selling at 50 cents and above, but under $1	Not less than ½ cent
Selling at $1 and above, but under $10	Not less than 1¼ cents
Selling at $10 and above, but under $125	Not less than 2½ cents
Selling at $125 and above	Not less than 3 cents

Except that when the amount dealt in is less than 100 shares of stock the commission shall be not less than 1 cent per share on stocks selling below $10 per share and 2 cents per share on stocks selling at $10 per share and over.

ON TEN-SHARE-UNIT STOCKS:

(as designated by the Committee of Arrangements)

Price	Rate per Share
Selling at less than $1 per share	As mutually agreed
Selling at $1 per share and above but under $5	Not less than 1 cent
Selling at $5 per share and above but under $10	Not less than 2 cents
Selling at $10 per share and above	Not less than 4 cents

ON BONDS:

Price per $1,000 of Principal	Rate per $1,000 of Principal
Selling at less than $10	Not less than 25 cents
Selling at $10 and above, but under $100	Not less than 37½ cents
Selling at $100 and above	Not less than 75 cents

ON SUBSCRIPTION RIGHTS:

Price	Rate per Right
Selling under 50 cents	As mutually agreed
Selling at 50 cents and above, but under $1	Not less than ½ cent
Selling at $1 and above, but under $5	Not less than ¾ cent
Selling at $5 and above, but under $10	Not less than 1¼ cents
Selling at $10 and above	Not less than 2½ cents

(d) *On obligations of the United States, Porto Rico, Philippine Islands, and States, Territories and Municipalities therein; Bonds or Notes having five years or less to run; Securities which, pursuant to call or otherwise, are to be redeemed within twelve months:*

Such rates to members or non-members as may be mutually agreed upon; provided, however, that the Committee on Quotations and Commissions may determine special rates on any or all of the

above-mentioned securities, reporting the same to the Governing Committee.

Sec. 3. If a member of the Exchange, or firm registered thereon engages in transactions in which the member or firm is acting as a dealer in securities of original issue, the rates of commission prescribed in this Article shall not apply to such transactions if not made on the Exchange; provided, however, that such transactions shall be subject to such regulations as the Committee on Quotations and Commissions may from time to time prescribe.

Sec. 4. No member shall make a proposition for the transaction of business at less than the minimum rates of commission prescribed in this Article.

APPENDIX VIII

ABBREVIATIONS [1]

NEW YORK STOCK EXCHANGE, STOCK AND BOND QUOTATIONS

GENERAL ARRANGEMENTS USED TO DENOTE SALES BIDS AND OFFERS

Bonds of Companies that have no abbreviation on the card will be abbreviated as plainly as possible, and all will be printed with the bond denomination added, per "Words and Phrases" list. A single price after the name of a bond indicates a sale of $1,000 principal amount at that price.

One price following the name of a stock signifies a sale of 100 shares at that price; thus X43⅞ means 100 shares of United States Steel at 43⅞; 200 shares will be printed thus: X2.43⅞; 300 shares will be printed X3.43⅞, and so on up to 1,000 shares, which will be printed X10.43⅞; 1,500 shares will be printed X15.43⅞; 2,000 shares X20.43⅞, and so on.

In order that no confusion shall occur where the number of shares is near the price of a stock the letter S will be printed between the figures denoting shares and price, thus: PGM.28.S.28¼ will mean Procter & Gamble 2,800 shares at $28¼ per share; SB.12.S.12¼ will mean 1,200 shares of Standard Brands, Inc. at $12¼ per share; B.2.S.3 will mean 200 shares of Baldwin Locomotive Works at $3 per share, and so on.

Sales of inactive stocks dealt in at the ten share unit post will be designated by the letters SS, thus: VX.10.SS.28½.20.29.100.29¼ will mean, respectively, 10, 20 and 100 shares of Vulcan Detinning.

Odd lots of stocks dealt in on a 100 share unit basis will be desig-

[1] The Western Union Telegraph Company, corrected to Aug. 1, 1933.

nated by the letters SHRS, thus: X.10SHRS.43¾ will mean 10 shares of United States Steel at $43¾ per share.

In times of extraordinary market activity it may be necessary to print only the final full figure and fraction of the price of stocks, after the opening, except in cases where confusion is likely to occur. For example, after the opening price printed in full, X.6.3¾ will mean 600 shares of United States Steel at $43¾ per share, and X.4.S.3¾ will mean 400 shares at $43¾ per share.

An offer alone, without a bid is preceded by an 0 and a dot, thus: LT.0.66.

A sale and offer, thus: LT.66.0.66.

A bid alone, without an offer, is followed by the letter B, thus: LT.66.B.

When a sale is not recorded in its proper place the price will be preceded by the abbreviation SLD., thus: LT.SLD.66.

When an error has been made by the reporter, or in printing, the last letter or figure is repeated several times, indicating that the quotation is to be thrown out, thus: LT.66½ ½ ½.

Three-day contracts in stocks which have been placed in the Clearing House will be printed thus: LT.2.66. 3 days.

At fourteen minutes after two P. M., the words *Delivery time* will be printed on the tape, and shortly after the lever of the instrument will give fifteen distinct beats.

At the end of the fifteen beats it is 2h. 15m. P. M., and the close of the recognized settlement time for transactions of the Exchange.

ABBREVIATIONS	NAMES OF CORPORATIONS
A	Atchison, Topeka & Santa Fe Ry.
AAC	Auburn Automobile Co.
AB	N. Y. Air Brake Co.
ABI	Abitibi Power & Paper Co., Ltd.
ABK	American Brake Shoe & Foundry Co.
ABM	Atlanta and Birmingham
ABN	American Bank Note Co.
ABP	Albany Perforated Wrapping Paper Co., Inc.
ABS	American Beet Sugar Co.
ABY	Byers Co., A. M.
AC	American Can Co.

ABBREVIATIONS	NAMES OF CORPORATIONS
ACD	Allied Chemical & Dye Corp.
ACF	American Commercial Alcohol Corp.
ACJ	American Chicle Co.
ACK	Armstrong Cork Co.
ACL	American Coal Co. of Allegany
ACN	American Chain Co., Inc.
ACS	American Ship & Commerce Corp.
ACT	Arnold Constable & Co., Inc.
ADD	Archer Daniels Midland Co.
ADE	Andes Copper Mining Co.
ADN	Air Reduction Co.
ADO	Associated Oil Co.
ADT	American Radiator & Standard Sanitary Corp.
AE	Adams Express
AEG	German General Electric Co. (Allgemeine Elektricitäts Gesellschaft)
AEN	American Encaustic Tiling Co., Ltd.
AF	American Car & Foundry Co.
AFG	American LaFrance & Foamite Corp.
AFI	Atlantic Refining Co.
AFP	Affiliated Products Inc.
AFW	American & Foreign Power Co., Inc.
AFX	American Machine & Foundry Co.
AG	Atlantic Gulf & West Indies S.S. Lines
AGL	Alleghany Steel Co.
AGM	American Rolling Mill Co.
AGO	Anglo Chilean Consolidated Nitrate Corporation
AGR	Agricultural Mortgage Bank Republic of Colombia
AGS	Spalding (A. G.) & Bros.
AGT	Alabama Great Southern R.R. Co.
AH	Allis Chalmers Mfg. Co.
AHC	American Agricultural Chem. Co. Connecticut
AHD	American Agricultural Chem. Co. Delaware
AHP	Alpha Portland Cement Co.
AHS	American Hawaiian Steamship Co.
AIG	American I. G. Chemical Corp.

ABBREVIATIONS	NAMES OF CORPORATIONS
AIN	Addressograph, Multigraph Corp.
AJS	Atchison, T. & S. Fe Adjustment
AKL	Mathieson Alkali Works
AKN	Atlanta, Knoxville & Cin.
AKO	Atlas Tack Corp.
AL	American International Corp.
ALL	Adams Millis Corp.
ALM	Alabama & Vicksburg Ry. Co. (The)
ALO	American Locomotive Co.
ALR	Amalgamated Leather Co's Inc.
ALT	Chicago & Alton R.R. Co.
AM	Armour & Co. of Illinois
AMD	Armour & Co. of Delaware
AME	American Machine & Metals, Inc.
AMM	American Metal Co., Ltd.
AMS	American Sumatra Tobacco Co.
AMU	American European Securities Co.
AMX	American Express
AMZ	American Seating Co.
AN	Ann Arbor R.R. Co.
ANC	American News Co., Inc.
ANO	Austin Nichols & Co., Inc.
AOW	American Power & Light Co.
AOY	American Colortype Co.
APP	Associated Apparel Industries, Inc.
APW	Atlas Powder Co.
AQS	Albany & Susquehanna R.R. Co.
AR	American Smelting & Refining Co.
ARC	Amerada Corp.
ARG	Argentine Republic
ARH	Anchor Cap Corp.
ARR	Artloom Corpn.
ART	Art Metal Construction Co.
ARZ	American Safety Razor Corp.
AS	General Asphalt Co.
ASC	American Stores Co.

ABBREVIATIONS	NAMES OF CORPORATIONS
ASL	Atchison Transcontinental Short Line
ASR	American Sugar Refining Co.
AST	Abraham & Straus, Inc.
ASU	American Shipbuilding Co.
AT	American Tobacco Co.
ATB	American Tobacco Co. Com. "B"
AUS	Austrian Govt., Bonds
AUT	Commonwealth of Australia
AV	Allegheny Valley R.R.
AVC	Aviation Corp. (The)
AW	American Writing Paper Co.
AWC	Anaconda Wire & Cable Co.
AWW	American Water Works & Electric Co.
AWY	Air Way Electric Appliance Corp.
AX	Atlantic Coast Line R.R.
AY	Allegheny & Western Ry.
AYY	Alleghany Corp.
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X	United States Steel Corp.
XA	Crucible Steel Co. of Amer.
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YA	Yale & Towne Mfg. Co., (The)
YB	Youngstown Sheet & Tube Co., (The)
YC	Yellow Truck & Coach Mfg. Co.
YG	L. A. Young Spring & Wire Corp.
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ABBREVIATIONS	NAMES OF CORPORATIONS
Z	F. W. Woolworth Co.
ZA	American Zinc, Lead & Smelting Co.
ZE	Zenith Radio Corp.
ZP	Zonite Products Corp.

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GOVERNMENTS

U. S. Gov. Securities

L	Liberty Loan Bonds
PAN	Panama Canal Bonds
PHI	Philippine Islands Bonds
US	U. S. 2s Con., 3s Con. Bonds
US	U. S. Treasury Bonds

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WORDS AND PHRASES

A	Assented, Class A
AJ	Adjustment
B	Bonds, Class B, or (in fig.) Bid or Buyer
BNK	Bank
C	Bonds, Class C (in fig.) Coupon or following a sale, cash. In closing prices signifies odd lot.
CLT	Collateral Trust
CN	Consolidated or Consols
CT	Certificates
CV	Convertible

ABBREVIATIONS	WORDS AND PHRASES
D	Debenture or Division
DD	Delayed Delivery
EXT	Extended or Extension
FD	Funding
FLT	Flat, without interest
FPD	Full Paid
GM	General Mortgage
GNT	Land Grant
GTD	Guaranteed
I	First
II	Second
III	Third
IMP	Improvement
IN	Income
LL	Leased Lines
MG	Modified Guaranteed
MTG	Mortgage
N	New or North
ND	Next Day Delivery
NN	Non Voting
O	(In figures) Offered
OB	Opening of Books
P	Prior or Participating
PR	Preferred
RCT	Receipts
RE	Real Estate
REG	Registered
RT	Rights
S	South, Southern, Stock, Series or (in figures) Seller, or Shares
SB	Small Bonds
SF	Sinking Fund
SHRS	Odd lots (100 share basis)
SS	Odd lots (10 share basis)
Stmpd	Stamped
T	Terminal

ABBREVIATIONS	WORDS AND PHRASES
TE	Tax Exempt
UN	Unified
UR	Under the Rule
WI	When Issued
WW	With Warrants
X	Ex-coupon, Interest, etc.
XD	Ex-Dividend
XW	Without Warrants

NAMES OF CORPORATIONS	ABBREVIATIONS
Abitibi Power & Paper Co. Ltd.	ABI
Abraham & Straus, Inc.	AST
Adams Express	AE
Adams, Millis Corp.	ALL
Addressograph Multigraph Corp.	AIN
Advance Rumely Co.	RX
Affiliated Products Inc.	AFP
Agricultural Mortgage Bank Republic of Colombia	AGR
Air Reduction Co.	ADN
Airway Electric Appliance Corp.	AWY
Alabama Great Southern R.R. Co.	AGT
Alabama & Vicksburg Ry. Co. (The)	ALM
Alaska-Juneau Gold Mining Co.	JU
Albany Perforated Wrapping Paper Co., Inc.	ABP
Albany & Susquehanna R.R. Co.	AQS
Alleghany Corp.	AYY
Alleghany Steel Corp.	AGL
Allegheny Valley R.R.	AV
Allegheny & Western Ry.	AY
Allied Chemical & Dye Corp.	ACD
Allis Chalmers Mfg. Co.	AH
Alpha Portland Cement	AHP
Amalgamated Leather Co's Inc.	ALR
Amerada Corp.	ARC
American Agricultural Chemical Co., Connecticut	AHC
American Agricultural Chemical Co., Delaware	AHD

NAMES OF CORPORATIONS	ABBREVIATIONS
American Bank Note Co.	ABN
American Beet Sugar Co.	ABS
American Brake Shoe & Foundry Co.	ABK
American Can Co.	AC
American Car & Foundry Co.	AF
American Chain Co., Inc.	ACN
American Chicle Co.	ACJ
American Coal Co. of Allegany	ACL
American Colortype Co.	AOY
American Commercial Alcohol Corp.	ACF
American Encaustic Tiling Co., Ltd.	AEN
American European Secs. Co.	AMU
American Express	AMX
American Hawaiian Steamship Corp.	AHS
American Hide & Leather Co.	HI
American Home Products Corp.	HPT
American I. G. Chemical Corp.	AIG
American Ice Co.	IS
American International Corp.	AL
American LaFrance & Foamite Corp.	AFG
American Locomotive Co.	ALO
American Machine & Foundry Co.	AFX
American Machine & Metals, Inc.	AME
American Metal Co., Ltd.	AMM
American News Co., Inc.	ANC
American Power & Light Co.	AOW
American Radiator & Standard Sanitary Corp.	ADT
American Rolling Mill Co.	AGM
American Safety Razor Corp.	ARZ
American Seating Co.	AMZ
American Ship & Com. Corp.	ACS
American Shipbuilding Co.	ASU
American Smelting & Refining Co.	AR
American Snuff Co.	SNU
American Steel Foundries Co.	FJ
American Stores Corp.	ASC

NAMES OF CORPORATIONS	ABBREVIATIONS
American Sugar Refining Co.	ASR
American Sumatra Tobacco Co.	AMS
American Telephone & Telegraph Co.	T
American Tobacco Co.	AT
American Tobacco Co. common 'B'	ATB
American Type Founders Co.	TY
American Water Works & Electric Co.	AWW
American Woolen Co.	WY
American Writing Paper Co.	AW
American Zinc, Lead & Smelting Co.	ZA
American & Foreign Power Co., Inc.	AFW
Anaconda Copper Mining Co.	C
Anaconda Wire & Cable Co.	AWC
Anchor Cap Corp.	ARH
Andes Copper Mining Co.	ADE
Anglo Chilean Consolidated Nitrate Corpn. (Bonds)	AGO
Ann Arbor R.R. Co.	AN
Archer Daniels Midland Co.	ADD
Argentine Republic	ARG
Armour & Co. of Delaware	AMD
Armour & Co. of Illinois	AM
Armstrong Cork Co.	ACK
Arnold Constable & Co., Inc.	ACT
Artloom Corpn.	ARR
Art Metal Construction Co.	ART
Associated Apparel Industries Inc.	APP
Associated Dry Goods Corp.	DG
Associated Oil Co.	ADO
Atchison, Topeka & Santa Fe Ry.	A
Atchison, T. & Santa Fe Adjustment	AJS
Atchison, T. Tr'scontin'tal Short Line	ASL
Atlanta & Birmingham	ABM
Atlanta, Knoxville & Cin.	AKN
Atlantic Coast Line R.R.	AX
Atlantic, Gulf & W. Indies S.S. Line	AG
Atlantic Refining Co.	AFI

NAMES OF CORPORATIONS	ABBREVIATIONS
Atlas Power Co.	APW
Atlas Tack Corp.	AKO
Auburn Automobile Co.	AAC
Austin Nichols & Co., Inc.	ANO
Austrian Govt., Bonds	AUS
Aviation Corp. (The)	AVC
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Wabash R.R. Co.	WA
Waldorf System, Inc.	WXY
Walgreen Co.	WAG
Walworth Co.	WAL
Ward Baking Corp.	WD
Warner Bros. Pictures, Inc.	WB
Warner Quinlan Co.	QW
Warner Sugar Refining Co.	WSU
Warren Brothers Co.	WAR
Warren Foundry & Pipe Corp.	WFP
Washington Central Ry.	WCN
Webster Eisenlohr Inc.	WBS
Wells Fargo Express Co.	WF
Wesson Oil & Snowdrift Co. Inc.	WNO
Western Dairy Products Co.	WYY
Western Electric Co.	WN
Western Maryland Ry. Co.	WM
Western New York & Penn. R.R.	WNY
Western Pacific R.R. Corporation	WR
Western Pacific R.R. Co.	WRS
Western Union Telegraph Co.	W
West Penn Electric Co. (The)	WEP
West Penn Power	WPP
West Shore R.R.	WS
Westchester Lighting Co.	WH

NAMES OF CORPORATIONS	ABBREVIATIONS
Westinghouse Air Brake Co.	WKM
Westinghouse Electric & Mfg. Co.	WX
Weston Electrical Instrument Corp.	WZ
Westphalia United Elec. Power Corp.	WEW
Westvaco Chlorine Products	WCO
Wheeling Steel Corp.	WHX
Wheeling & Lake Erie Ry.	WL
White Motor Car Co.	WHI
White Rock Mineral Springs Co.	WHR
White Sewing Machine Corp.	WSW
Wickwire Spencer Steel Corp.	WIK
Wilcox (H. F.) Oil & Gas Co.	WXC
Wilcox Rich Corp.	WLX
Wilkes-Barre & Eastern	WE
Willys-Overland Co. (Bonds)	WO
Wilson & Co. Inc.	WIL
Wisconsin Central Ry.	WC
Wis. Cen. Sup. & Dul. Div. Term.	WCS
Woolworth, F. W., & Co.	Z
Worthington Pump & Mach. Corp.	WPU
Wright Aeronautical Corp.	WAC
Wrigley, Wm., Jr., & Co.	WWY
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Yale & Towne Mfg. Co. (The)	YA
Yellow Truck & Coach Mfg. Co.	YC
Young (L. A.) Spring & Wire Corp.	YG
Youngstown Sheet & Tube Co. (The)	YB
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Zenith Radio Corp.	ZE
Zonite Products Corp.	ZP

APPENDIX IX

SECURITIES EXCHANGE ACT OF 1934

AN ACT

To provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE I—REGULATION OF SECURITIES EXCHANGES

SHORT TITLE

SECTION 1. This Act may be cited as the "Securities Exchange Act of 1934."

NECESSITY FOR REGULATION AS PROVIDED IN THIS TITLE

SEC. 2. For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System,

and to insure the maintenance of fair and honest markets in such transactions:

(1) Such transactions (a) are carried on in large volume by the public generally and in large part originate outside the States in which the exchanges and over-the-counter markets are located and/or are affected by means of the mails and instrumentalities of interstate commerce; (b) constitute an important part of the current of interstate commerce; (c) involve in large part the securities of issuers engaged in interstate commerce; (d) involve the use of credit, directly affect the financing of trade, industry, and transportation in interstate commerce, and directly affect and influence the volume of interstate commerce; and affect the national credit.

(2) The prices established and offered in such transactions are generally disseminated and quoted throughout the United States and foreign countries and constitute a basis for determining and establishing the prices at which securities are bought and sold, the amount of certain taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and the value of collateral for bank loans.

(3) Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities which (a) cause alternately unreasonable expansion and unreasonable contraction of the volume of credit available for trade, transportation, and industry in interstate commerce, (b) hinder the proper appraisal of the value of securities and thus prevent a fair calculation of taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and (c) prevent the fair valuation of collateral for bank loans and/or obstruct the effective operation of the national banking system and Federal Reserve System.

(4) National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security

prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit.

DEFINITIONS AND APPLICATION OF TITLE

SEC. 3. (a) When used in this title, unless the context otherwise requires—

(1) The term "exchange" means any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.

(2) The term "facility" when used with respect to an exchange includes its premises, tangible or intangible property whether on the premises or not, any right to the use of such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service.

(3) The term "member" when used with respect to an exchange means any person who is permitted either to effect transactions on the exchange without the services of another person acting as broker, or to make use of the facilities of an exchange for transactions thereon without payment of a commission or fee or with the payment of a commission or fee which is less than that charged the general public, and includes any firm transacting a business as broker or dealer of which a member is a partner, and any partner of any such firm.

(4) The term "broker" means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank.

(5) The term "dealer" means any person engaged in the business

of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business.

(6) The term "bank" means (A) a banking institution organized under the laws of the United States, (B) a member bank of the Federal Reserve System, (C) any other banking institution, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under section 11 (k) of the Federal Reserve Act, as amended, and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this title, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

(7) The term "director" means any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated.

(8) The term "issuer" means any person who issues or proposes to issue any security; except that with respect to certificates of deposit for securities, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors or of the fixed, restricted management, or unit type, the term "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; and except that with respect to equipment-trust certificates or like securities, the term "issuer" means the person by whom the equipment or property is, or is to be, used.

(9) The term "person" means an individual, a corporation, a partnership, an association, a joint-stock company, a business trust, or an unincorporated organization.

(10) The term "security" means any note, stock, treasury stock,

bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

(11) 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.

(12) 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."

(13) The terms "buy" and "purchase" each include any contract to buy, purchase, or otherwise acquire.

(14) The terms "sale" and "sell" each include any contract to sell or otherwise dispose of.

(15) The term "Commission" means the Securities and Exchange Commission established by section 4 of this title.

(16) The term "State" means any State of the United States, the District of Columbia, Alaska, Hawaii, Puerto Rico, the Philippine Islands, the Canal Zone, the Virgin Islands, or any other possession of the United States.

(17) The term "interstate commerce" means trade, commerce, transportation, or communication among the several States, or between any foreign country and any State, or between any State and any place or ship outside thereof.

(b) The Commission and the Federal Reserve Board, as to matters within their respective jurisdictions, shall have power by rules and regulations to define technical, trade, and accounting terms used in this title insofar as such definitions are not inconsistent with the provisions of this title.

(c) No provision of this title shall apply to, or be deemed to include, any executive department or independent establishment of the United States, or any lending agency which is wholly owned, directly or indirectly, by the United States, or any officer, agent, or employee of any such department, establishment, or agency, acting in the course of his official duty as such, unless such provision makes specific reference to such department, establishment, or agency.

SECURITIES AND EXCHANGE COMMISSION

SEC. 4. (a) There is hereby established a Securities and Exchange Commission (hereinafter referred to as the "Commission") to be composed of five commissioners to be appointed by the President by and with the advice and consent of the Senate. Not more than three of such commissioners shall be members of the same political party, and in making appointments members of different political

parties shall be appointed alternately as nearly as may be practicable. No commissioner shall engage in any other business, vocation, or employment than that of serving as commissioner, nor shall any commissioner participate, directly or indirectly, in any stock-market operations or transactions of a character subject to regulation by the Commission pursuant to this title. Each commissioner shall receive a salary at the rate of $10,000 a year and shall hold office for a term of five years, except that (1) any commissioner appointed to fill a vacancy occurring prior to the expiration of the term for which his predecessor was appointed, shall be appointed for the remainder of such term, and (2) the terms of office of the commissioners first taking office after the date of enactment of this title shall expire, as designated by the President at the time of nomination, one at the end of one year, one at the end of two years, one at the end of three years, one at the end of four years, and one at the end of five years, after the date of enactment of this title.

(b) The Commission is authorized to appoint and fix the compensation of such officers, attorneys, examiners, and other experts as may be necessary for carrying out its functions under this Act, without regard to the provisions of other laws applicable to the employment and compensation of officers and employees of the United States, and the Commission may, subject to the civil-service laws, appoint such other officers and employees as are necessary in the execution of its functions and fix their salaries in accordance with the Classification Act of 1923, as amended.

TRANSACTIONS ON UNREGISTERED EXCHANGES

SEC. 5. It shall be unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange within or subject to the jurisdiction of the United States to effect any transaction in a security, or to report any such transaction, unless such exchange (1) is registered as a national securities exchange under section 6 of this title, or (2) is exempted from such registration upon application by the exchange because, in the opinion of the Commission, by reason of

the limited volume of transactions effected on such exchange, it is not practicable and not necessary or appropriate in the public interest or for the protection of investors to require such registration.

REGISTRATION OF NATIONAL SECURITIES EXCHANGES

SEC. 6. (a) Any exchange may be registered with the Commission as a national securities exchange under the terms and conditions hereinafter provided in this section, by filing a registration statement in such form as the Commission may prescribe, containing the agreements, setting forth the information, and accompanied by the documents, below specified:

(1) An agreement (which shall not be construed as a waiver of any constitutional right or any right to contest the validity of any rule or regulation) to comply, and to enforce so far as is within its powers compliance by its members, with the provisions of this title, and any amendment thereto and any rule or regulation made or to be made thereunder;

(2) Such data as to its organization, rules of procedure, and membership, and such other information as the Commission may by rules and regulations require as being necessary or appropriate in the public interest or for the protection of investors;

(3) Copies of its constitution, articles of incorporation with all amendments thereto, and of its existing bylaws or rules or instruments corresponding thereto, whatever the name, which are hereinafter collectively referred to as the "rules of the exchange"; and

(4) An agreement to furnish to the Commission copies of any amendments to the rules of the exchange forthwith upon their adoption.

(b) No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this title or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.

(c) Nothing in this title shall be construed to prevent any exchange from adopting and enforcing any rule not inconsistent with

this title and the rules and regulations thereunder and the applicable laws of the State in which it is located.

(d) If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with the provisions of this title and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange.

(e) Within thirty days after the filing of the application, the Commission shall enter an order either granting or, after appropriate notice and opportunity for hearing, denying registration as a national securities exchange, unless the exchange applying for registration shall withdraw its application or consent to the Commission's deferring action on its application for a stated longer period after the date of filing. The filing with the Commission of an application for registration by an exchange shall be deemed to have taken place upon the receipt thereof. Amendments to an application may be made upon such terms as the Commission may prescribe.

(f) An exchange may, upon appropriate application in accordance with the rules and regulations of the Commission, and upon such terms as the Commission may deem necessary for the protection of investors, withdraw its registration.

MARGIN REQUIREMENTS

SEC. 7. (a) For the purpose of preventing the excessive use of credit for the purchase or carrying of securities, the Federal Reserve Board shall, prior to the effective date of this section and from time to time thereafter, prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security) registered on a national securities exchange. For the initial extension of credit, such rules and regulations shall be based upon the following standard: 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 thirty-six calendar months, but not more than 75 per centum of the current market price.

Such rules and regulations may make appropriate provision with respect to the carrying of undermargined accounts for limited periods and under specified conditions: the withdrawal of funds or securities; the substitution or additional purchases of securities; the transfer of accounts from one lender to another; special or different margin requirements for delayed deliveries, short sales, arbitrage transactions, and securities to which paragraph (2) of this subsection does not apply; the bases and the methods to be used in calculating loans, and margins and market prices; and similar administrative adjustments and details. For the purposes of paragraph (2) of this subsection, until July 1, 1936, the lowest price at which a security has sold on or after July 1, 1933, shall be considered as the lowest price at which such security has sold during the preceding thirty-six calendar months.

(b) Notwithstanding the provisions of subsection (a) of this section, the Federal Reserve Board, may, from time to time, with respect to all or specified securities or transactions, or classes of securities, or classes of transactions, by such rules and regulations (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.

(c) It shall be unlawful for any member of a national securities exchange or any broker or dealer who transacts a business in securities through the medium of any such member, directly or indirectly to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer—

(1) On any security (other than an exempted security) registered on a national securities exchange, in contravention of the rules and regulations which the Federal Reserve Board shall prescribe under subsections (a) and (b) of this section.

(2) Without collateral or on any collateral other than exempted

securities and/or securities registered upon a national securities exchange, except in accordance with such rules and regulations as the Federal Reserve Board may prescribe (A) to permit under specified conditions and for a limited period any such member, broker, or dealer to maintain a credit initially extended in conformity with the rules and regulations of the Federal Reserve Board, and (B) to permit the extension or maintenance of credit in cases where the extension or maintenance of credit is not for the purpose of purchasing or carrying securities or of evading or circumventing the provisions of paragraph (1) of this subsection.

(d) It shall be unlawful for any person not subject to subsection (c) to extend or maintain credit or to arrange for the extension or maintenance of credit for the purpose of purchasing or carrying any security registered on a national securities exchange, in contravention of such rules and regulations as the Federal Reserve Board shall prescribe to prevent the excessive use of credit for the purchasing or carrying of or trading in securities in circumvention of the other provisions of this section. Such rules and regulations may impose upon all loans made for the purpose of purchasing or carrying securities registered on national securities exchanges limitations similar to those imposed upon members, brokers, or dealers by subsection (c) of this section and the rules and regulations thereunder. This subsection and the rules and regulations thereunder shall not apply (A) to a loan made by a person not in the ordinary course of his business, (B) to a loan on an exempted security, (C) to a loan to a dealer to aid in the financing of the distribution of securities to customers not through the medium of a national securities exchange, (D) to a loan by a bank on a security other than an equity security, or (E) to such other loans as the Federal Reserve Board shall, by such rules and regulations as it may deem necessary or appropriate in the public interest or for the protection of investors, exempt, either unconditionally or upon specified terms and conditions or for stated periods, from the operation of this subsection and the rules and regulations thereunder.

(e) The provisions of this section or the rules and regulations thereunder shall not apply on or before July 1, 1937, to any loan or extension of credit made prior to the enactment of this title or to the maintenance, renewal, or extension of any such loan or

credit, except to the extent that the Federal Reserve Board may by rules and regulations prescribe as necessary to prevent the circumvention of the provisions of this section or the rules and regulations thereunder by means of withdrawals of funds or securities, substitutions of securities, or additional purchases or by any other device.

RESTRICTIONS ON BORROWING BY MEMBERS, BROKERS, AND DEALERS

SEC. 8. It shall be unlawful for any member of a national securities exchange, or any broker or dealer who transacts a business in securities through the medium of any such member, directly or indirectly—

(a) To borrow in the ordinary course of business as a broker or dealer on any security (other than an exempted security) registered on a national securities exchange except (1) from or through a member bank of the Federal Reserve System, (2) from any nonmember bank which shall have filed with the Federal Reserve Board an agreement, which is still in force and which is in the form prescribed by the Board, undertaking to comply with all provisions of this Act, the Federal Reserve Act, as amended, and the Banking Act of 1933, which are applicable to member banks and which relate to the use of credit to finance transactions in securities, and with such rules and regulations as may be prescribed pursuant to such provisions of law or for the purpose of preventing evasions thereof, or (3) in accordance with such rules and regulations as the Federal Reserve Board may prescribe to permit loans between such members and/or brokers and/or dealers, or to permit loans to meet emergency needs. Any such agreement filed with the Federal Reserve Board shall be subject to termination at any time by order of the Board, after appropriate notice and opportunity for hearing, because of any failure by such bank to comply with the provisions thereof or with such provisions of law or rules or regulations; and, for any willful violation of such agreement, such bank shall be subject to the penalties provided for violations of rules and regulations prescribed under this title. The provisions of sections 21 and 25 of this title shall apply in the case of any such proceeding or order of the Federal Reserve Board in the same manner as such

provisions apply in the case of proceedings and orders of the Commission.

(b) To permit in the ordinary course of business as a broker his aggregate indebtedness to all other persons, including customers' credit balances (but excluding indebtedness secured by exempted securities), to exceed such percentage of the net capital (exclusive of fixed assets and value of exchange membership) employed in the business, but not exceeding in any case 2,000 per centum, as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors.

(c) In contravention of such rules and regulations as the Commission shall prescribe for the protection of investors to hypothecate or arrange for the hypothecation of any securities carried for the account of any customer under circumstances (1) that will permit the commingling of his securities without his written consent with the securities of any other customer, (2) that will permit such securities to be commingled with the securities of any person other than a bona fide customer, or (3) that will permit such securities to be hypothecated, or subjected to any lien or claim of the pledgee, for a sum in excess of the aggregate indebtedness of such customers in respect of such securities.

(d) To lend or arrange for the lending of any securities carried for the account of any customer without the written consent of such customer.

PROHIBITION AGAINST MANIPULATION OF SECURITY PRICES

SEC. 9. (a) It shall be unlawful for any person, directly or indirectly, by the use of the mails or any means or instrumentality of interstate commerce, or of any facility of any national securities exchange, or for any member of a national securities exchange—

(1) For the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security, (A) to effect any transaction in such security which involves no change in the beneficial ownership thereof, or (B) to enter an order or orders for the purchase of

such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the sale of any such security, has been or will be entered by or for the same or different parties, or (C) to enter any order or orders for the sale of any such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the purchase of such security, has been or will be entered by or for the same or different parties.

(2) To effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.

(3) If a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security, to induce the purchase or sale of any security registered on a national securities exchange by the circulation or dissemination in the ordinary course of business of information to the effect that the price of any such security will or is likely to rise or fall because of market operations of any one or more persons conducted for the purpose of raising or depressing the price of such security.

(4) If a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security, to make, regarding any security registered on a national securities exchange, for the purpose of inducing the purchase or sale of such security, any statement which was at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, and which he knew or had reasonable ground to believe was so false or misleading.

(5) For a consideration, received directly or indirectly from a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security, to induce the purchase or sale of any security registered on a national securities exchange by the circulation or dissemination of information to the effect that the price of any such security will or is likely to rise or fall because of the market operations of any one or more per-

sons conducted for the purpose of raising or depressing the price of such security.

(6) To effect either alone or with one or more other persons any series of transactions for the purchase and/or sale of any security registered on a national securities exchange for the purpose of pegging, fixing, or stabilizing the price of such security in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) It shall be unlawful for any person to effect, by use of any facility of a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors—

(1) any transaction in connection with any security whereby any party to such transaction acquires any put, call, straddle, or other option or privilege of buying the security from or selling the security to another without being bound to do so; or

(2) any transaction in connection with any security with relation to which he has, directly or indirectly, any interest in any such put, call, straddle, option, or privilege; or

(3) any transaction in any security for the account of any person who he has reason to believe has, and who actually has, directly or indirectly, any interest in any such put, call, straddle, option, or privilege with relation to such security.

(c) It shall be unlawful for any member of a national securities exchange directly or indirectly to endorse or guarantee the performance of any put, call, straddle, option, or privilege in relation to any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(d) The terms "put," "call," "straddle," "option," or "privilege" as used in this section shall not include any registered warrant, right, or convertible security.

(e) Any person who willfully participates in any act or transaction in violation of subsection (a), (b), or (c) of this section,

shall be liable to any person who shall purchase or sell any security at a price which was affected by such act or transaction, and the person so injured may sue in law or in equity in any court of competent jurisdiction to recover the damages sustained as a result of any such act or transaction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant. Every person who becomes liable to make any payment under this subsection may recover contribution as in cases of contract from any person who, if joined in the original suit, would have been liable to make the same payment. No action shall be maintained to enforce any liability created under this section, unless brought within one year after the discovery of the facts constituting the violation and within three years after such violation.

(f) The provisions of this section shall not apply to an exempted security.

REGULATION OF THE USE OF MANIPULATIVE AND DECEPTIVE DEVICES

SEC. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

SEGREGATION AND LIMITATION OF FUNCTIONS OF MEMBERS, BROKERS, AND DEALERS

SEC. 11. (a) The Commission shall prescribe such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors, (1) to regulate or prevent floor trading by members of national securities exchanges, directly or indirectly for their own account or for discretionary accounts, and (2) to prevent such excessive trading on the exchange but off the floor by members, directly or indirectly for their own account, as the Commission may deem detrimental to the maintenance of a fair and orderly market. It shall be unlawful for a member to effect any transaction in a security in contravention of such rules and regulations, but such rules and regulations may make such exemptions for arbitrage transactions, for transactions in exempted securities, and, within the limitations of subsection (b) of this section, for transactions by odd-lot dealers and specialists, as the Commission may deem necessary or appropriate in the public interest or for the protection of investors.

(b) When not in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, the rules of a national securities exchange may permit (1) a member to be registered as an odd-lot dealer and as such to buy and sell for his own account so far as may be reasonably necessary to carry on such odd-lot transactions, and/or (2) a member to be registered as a specialist. If under the rules and regulations of the Commission a specialist is permitted to act as a dealer, or is limited to acting as a dealer, such rules and regulations shall restrict his dealings so far as practicable to those reasonably necessary to permit him to maintain a fair and orderly market, and/or to those necessary to permit him to act as an odd-lot dealer if the rules of the exchange permit him to act as an odd-lot dealer. It shall be unlawful for a specialist or an official of the exchange to disclose information in regard to orders placed with such specialist which is not available to all members of the exchange, to any person other than an official of the exchange, a representative of the Commission, or a specialist who may be acting for such specialist; but the Commission shall

have power to require disclosure to all members of the exchange of all orders placed with specialists, under such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. It shall also be unlawful for a specialist acting as a broker to effect on the exchange any transaction except upon a market or limited price order.

(c) If because of the limited volume of transactions effected on an exchange, it is in the opinion of the Commission impracticable and not necessary or appropriate in the public interest or for the protection of investors to apply any of the foregoing provisions of this section or the rules and regulations thereunder, the Commission shall have power, upon application of the exchange and on a showing that the rules of such exchange are otherwise adequate for the protection of investors, to exempt such exchange and its members from any such provision or rules and regulations.

(d) It shall be unlawful for a member of a national securities exchange who is both a dealer and a broker, or for any person who both as a broker and a dealer transacts a business in securities through the medium of a member or otherwise, to effect through the use of any facility of a national securities exchange or of the mails or of any means or instrumentality of interstate commerce, or otherwise in the case of a member, (1) any transaction in connection with which, directly or indirectly, he extends or maintains or arranges for the extension or maintenance of credit to or for a customer on any security (other than an exempted security) which was a part of a new issue in the distribution of which he participated as a member of a selling syndicate or group within six months prior to such transaction: Provided, That credit shall not be deemed extended by reason of a bona fide delayed delivery of any such security against full payment of the entire purchase price thereof upon such delivery within thirty-five days after such purchase, or (2) any transaction with respect to any security (other than an exempted security) unless, if the transaction is with a customer, he discloses to such customer in writing at or before the completion of the transaction whether he is acting as a dealer for his own account, as a broker for such customer, or as a broker for some other person.

(e) The Commission is directed to make a study of the feasibility and advisability of the complete segregation of the functions of dealer and broker, and to report the results of its study and its recommendations to the Congress on or before January 3, 1936.

REGISTRATION REQUIREMENTS FOR SECURITIES

SEC. 12. (a) It shall be unlawful for any member, broker, or dealer to effect any transaction in any security (other than an exempted security) on a national securities exchange unless a registration is effective as to such security for such exchange in accordance with the provisions of this title and the rules and regulations thereunder.

(b) A security may be registered on a national securities exchange by the issuer filing an application with the exchange (and filing with the Commission such duplicate originals thereof as the Commission may require), which application shall contain—

(1) Such information, in such detail, as to the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, the issuer, and any guarantor of the security as to principal or interest or both, as the Commission may by rules and regulations require, as necessary or appropriate in the public interest or for the protection of investors, in respect of the following:

(A) the organization, financial structure and nature of the business;

(B) the terms, position, rights, and privileges of the different classes of securities outstanding;

(C) the terms on which their securities are to be, and during the preceding three years have been, offered to the public or otherwise;

(D) the directors, officers, and underwriters, and each security holder of record holding more than 10 per centum of any class of any equity security of the issuer (other than an exempted security), their remuneration and their interests in the securities of, and their material contracts with, the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, the issuer;

(E) remuneration to others than directors and officers exceeding $20,000 per annum;

(F) bonus and profit-sharing arrangements;

(G) management and service contracts;

(H) options existing or to be created in respect of their securities;

(I) balance sheets for not more than the three preceding fiscal years, certified if required by the rules and regulations of the Commission by independent public accountants;

(J) profit and loss statements for not more than the three preceding fiscal years, certified if required by the rules and regulations of the Commission by independent public accountants; and

(K) any further financial statements which the Commission may deem necessary or appropriate for the protection of investors.

(2) Such copies of articles of incorporation, bylaws, trust indentures, or corresponding documents by whatever name known, underwriting arrangements, and other similar documents of, and voting trust agreements with respect to, the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, the issuer as the Commission may require as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security.

(c) If in the judgment of the Commission any information required under subsection (b) is inapplicable to any specified class or classes of issuers, the Commission shall require in lieu thereof the submission of such other information of comparable character as it may deem applicable to such class of issuers.

(d) If the exchange authorities certify to the Commission that the security has been approved by the exchange for listing and registration, the registration shall become effective thirty days after the receipt of such certification by the Commission or within such shorter period of time as the Commission may determine. A security registered with a national securities exchange may be withdrawn or stricken from listing and registration in accordance with the rules of the exchange and, upon such terms as the Commission may deem necessary to impose for the protection of investors, upon

application by the issuer or the exchange to the Commission; whereupon the issuer shall be relieved from further compliance with the provisions of this section and section 13 of this title and any rules or regulations under such sections as to the securities so withdrawn or stricken.

An unissued security may be registered only in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. Such rules and regulations shall limit the registration of an unissued security to cases where such security is a right or the subject of a right to subscribe or otherwise acquire such security granted to holders of a previously registered security and where the primary purpose of such registration is to distribute such unissued security to such holders.

(e) Notwithstanding the foregoing provisions of this section, the Commission may by such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors permit securities listed on any exchange at the time the registration of such exchange as a national securities exchange becomes effective, to be registered for a period ending not later than July 1, 1935, without complying with the provisions of this section.

(f) The Commission is directed to make a study of trading in unlisted securities upon exchanges and to report the results of its study and its recommendations to Congress on or before January 3, 1936. Notwithstanding the foregoing provisions of this section, the Commission may, by such rules and regulations as it deems necessary or appropriate for the protection of investors, prescribe terms and conditions under which, upon the application of any national securities exchange, such exchange (1) may continue until June 1, 1936, unlisted trading privileges to which a security had been admitted on such exchange prior to March 1, 1934, and for such purpose exempt such security and the issuer thereof from the provisions of this section and sections 13 and 16, or (2) may extend until July 1, 1935, unlisted trading privilege to any security registered on any other national securities exchange which security was listed on such other exchange on March 1, 1934.

A security for which unlisted trading privileges are so continued

shall be considered a "security registered on a national securities exchange" within the meaning of this title. The rules and regulations of the Commission relating to such unlisted trading privileges for securities shall require that quotations of transactions upon any national securities exchange shall clearly indicate the difference between fully listed securities and securities admitted to unlisted trading privileges only.

PERIODICAL AND OTHER REPORTS

SEC. 13. (a) Every issuer of a security registered on a national securities exchange shall file the information, documents, and reports below specified with the exchange (and shall file with the Commission such duplicate originals thereof as the Commission may require), in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security—

(1) Such information and documents as the Commission may require to keep reasonably current the information and documents filed pursuant to section 12.

(2) Such annual reports, certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports, as the Commission may prescribe.

(b) The Commission may prescribe, in regard to reports made pursuant to this title, the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earning statement, and the methods to be followed in the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of separate and/or consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer; but in the case of the reports of

any person whose methods of accounting are prescribed under the provisions of any law of the United States, or any rule or regulation thereunder, the rules and regulations of the Commission with respect to reports shall not be inconsistent with the requirements imposed by such law or rule or regulation in respect of the same subject matter, and, in the case of carriers subject to the provisions of section 20 of the Interstate Commerce Act, as amended, or carriers required pursuant to any other Act of Congress to make reports of the same general character as those required under such section 20, shall permit such carriers to file with the Commission and the exchange duplicate copies of the reports and other documents filed with the Interstate Commerce Commission, or with the governmental authority administering such other Act of Congress, in lieu of the reports, information and documents required under this section and section 12 in respect of the same subject matter.

(c) If in the judgment of the Commission any report required under subsection (a) is inapplicable to any specified class or classes of issuers, the Commission shall require in lieu thereof the submission of such reports of comparable character as it may deem applicable to such class or classes of issuers.

PROXIES

SEC. 14. (a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of any national securities exchange or otherwise to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered on any national securities exchange in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) It shall be unlawful for any member of a national securities exchange or any broker or dealer who transacts a business in securities through the medium of any such member to give a proxy, consent, or authorization in respect of any security registered on a national securities exchange and carried for the account of a cus-

tomer in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

OVER-THE-COUNTER MARKETS

SEC. 15. It shall be unlawful, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest and to insure to investors protection comparable to that provided by and under authority of this title in the case of national securities exchanges, (1) for any broker or dealer, singly or with any other person or persons, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of making or creating, or enabling another to make or create, a market, otherwise than on a national securities exchange, for both the purchase and sale of any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills, or unregistered securities the market in which is predominantly intrastate and which have not previously been registered or listed), or (2) for any broker or dealer to use any facility of any such market. Such rules and regulations may provide for the regulation of all transactions by brokers and dealers on any such market, for the registration with the Commission of dealers and/or brokers making or creating such a market, and for the registration of the securities for which they make or create a market and may make special provision with respect to securities or specified classes thereof listed, or entitled to unlisted trading privileges, upon any exchange on the date of the enactment of this title, which securities are not registered under the provisions of section 12 of this title.

DIRECTORS, OFFICERS, AND PRINCIPAL STOCKHOLDERS

SEC. 16. (a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered on a national securities exchange, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security or within ten days after he becomes

such beneficial owner, director, or officer, a statement with the exchange (and a duplicate original thereof with the Commission) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been any change in such ownership during such month, shall file with the exchange a statement (and a duplicate original thereof with the Commission) indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issue in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

(c) It shall be unlawful for any such beneficial owner, director, or officer, directly or indirectly, to sell any equity security of such issuer (other than an exempted security), if the person selling the security or his principal (1) does not own the security sold, or (2)

if owning the security, does not deliver it against such sale within twenty days thereafter, or does not within five days after such sale deposit it in the mails or other usual channels of transportation; but no person shall be deemed to have violated this subsection if he proves that notwithstanding the exercise of good faith he was unable to make such delivery or deposit within such time, or that to do so would cause undue inconvenience or expense.

(d) The provisions of this section shall not apply to foreign or domestic arbitrage transactions unless made in contravention of such rules and regulations as the Commission may adopt in order to carry out the purposes of this section.

ACCOUNTS AND RECORDS, REPORTS, EXAMINATIONS OF EXCHANGES, MEMBERS, AND OTHERS

SEC. 17. (a) Every national securities exchange, every member thereof, every broker or dealer who transacts a business in securities through the medium of any such member, and every broker or dealer making or creating a market for both the purchase and sale of securities through the use of the mails or of any means or instrumentality of interstate commerce, shall make, keep, and preserve for such periods, such accounts, correspondence, memoranda, papers, books, and other records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors. Such accounts, correspondence, memoranda, papers, books, and other records shall be subject at any time or from time to time to such reasonable periodic, special, or other examinations by examiners or other representatives of the Commission as the Commission may deem necessary or appropriate in the public interest or for the protection of investors.

(b) Any broker, dealer, or other person extending credit who is subject to the rules and regulations prescribed by the Federal Reserve Board pursuant to this title shall make such reports to the Board as it may require as necessary or appropriate to enable it to perform the functions conferred upon it by this title. If any such broker, dealer, or other person shall fail to make any such report or fail to furnish full information therein, or, if in the judgment

of the Board it is otherwise necessary, such broker, dealer, or other person shall permit such inspections to be made by the Board with respect to the business operations of such broker, dealer, or other person as the Board may deem necessary to enable it to obtain the required information.

LIABILITY FOR MISLEADING STATEMENTS

SEC. 18. (a) Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this title or any rule or regulation thereunder, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant.

(b) Every person who becomes liable to make payment under this section may recover contribution as in cases of contract from any person who, if joined in the original suit, would have been liable to make the same payment.

(c) No action shall be maintained to enforce any liability created under this section unless brought within one year after the discovery of the facts constituting the cause of action and within three years after such cause of action accrued.

POWERS WITH RESPECT TO EXCHANGES AND SECURITIES

SEC. 19. (a) The Commission is authorized, if in its opinion such action is necessary or appropriate for the protection of investors—

(1) After appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to withdraw the registration of a national securities exchange if the Commission finds that such exchange has violated any provision of this title or of the rules and regulations thereunder or has failed to enforce, so far as is within its power, compliance therewith by a member or by an issuer of a security registered thereon.

(2) After appropriate notice and opportunity for hearing, by order to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to withdraw, the registration of a security if the Commission finds that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder.

(3) After appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to expel from a national securities exchange any member or officer thereof whom the Commission finds has violated any provision of this title or the rules and regulations thereunder, or has effected any transaction for any other person who, he has reason to believe, is violating in respect of such transaction any provision of this title or the rules and regulations thereunder.

(4) And if in its opinion the public interest so requires, summarily to suspend trading in any registered security on any national securities exchange for a period not exceeding ten days, or with the approval of the President, summarily to suspend all trading on any national securities exchange for a period not exceeding ninety days.

(b) The Commission is further authorized, if after making appropriate request in writing to a national securities exchange that such exchange effect on its own behalf specified changes in its rules and practices, and after appropriate notice and opportunity for hearing, the Commission determines that such exchange has not made the changes so requested, and that such changes are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange, by rules or regulations or by order to alter or supplement the rules of such exchange (insofar as necessary or appropriate to effect such changes) in respect of

such matters as (1) safeguards in respect of the financial responsibility of members and adequate provision against the evasion of financial responsibility through the use of corporate forms or special partnerships; (2) the limitation or prohibition of the registration or trading in any security within a specified period after the issuance or primary distribution thereof; (3) the listing or striking from listing of any security; (4) hours of trading; (5) the manner, method, and place of soliciting business; (6) fictitious or numbered accounts; (7) the time and method of making settlements, payments, and deliveries and of closing accounts; (8) the reporting of transactions on the exchange and upon tickers maintained by or with the consent of the exchange, including the method of reporting short sales, stopped sales, sales of securities of issuers in default, bankruptcy or receivership, and sales involving other special circumstances; (9) the fixing of reasonable rates of commission, interest, listing, and other charges; (10) minimum units of trading; (11) odd-lot purchases and sales; (12) minimum deposits on margin accounts; and (13) similar matters.

(c) The Commission is authorized and directed to make a study and investigation of the rules of national securities exchanges with respect to the classification of members, the methods of election of officers and committees to insure a fair representation of the membership, and the suspension, expulsion, and disciplining of members of such exchanges. The Commission shall report to the Congress on or before January 3, 1935, the results of its investigation, together with its recommendations.

LIABILITIES OF CONTROLLING PERSONS

SEC. 20. (a) Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

(b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person

to do under the provisions of this title or any rule or regulation thereunder through or by means of any other person.

(c) It shall be unlawful for any director or officer of, or any owner of any of the securities issued by, any issuer of any security registered on a national securities exchange, without just cause to hinder, delay, or obstruct the making or filing of any document, report, or information, required to be filed under this title or any rule or regulation thereunder.

INVESTIGATIONS; INJUNCTIONS AND PROSECUTION OF OFFENSES

SEC. 21. (a) The Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated or is about to violate any provision of this title or any rule or regulation thereunder, and may require or permit any person to file with it a statement in writing, under oath or otherwise as the Commission shall determine, as to all the facts and circumstances concerning the matter to be investigated. The Commission is authorized, in its discretion, to publish information concerning any such violations, and to investigate any facts, conditions, practices, or matters which it may deem necessary or proper to aid in the enforcement of the provisions of this title, in the prescribing of rules and regulations thereunder, or in securing information to serve as a basis for recommending further legislation concerning the matters to which this title relates.

(b) For the purpose of any such investigation, or any other proceeding under this title, any member of the Commission or any officer designated by it is empowered to administer oaths and affirmations, subpena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records which the Commission deems relevant or material to the inquiry. Such attendance of witnesses and the production of any such records may be required from any place in the United States or any State at any designated place of hearing.

(c) In case of contumacy by, or refusal to obey a subpena issued to, any person, the Commission may invoke the aid of any court of the United States within the jurisdiction of which such

investigation or proceeding is carried on, or where such person resides or carries on business, in requiring the attendance and testimony of witnesses and the production of books, papers, correspondence, memoranda, and other records. And such court may issue an order requiring such person to appear before the Commission or member or officer designated by the Commission, there to produce records, if so ordered, or to give testimony touching the matter under investigation or in question; and any failure to obey such order of the court may be punished by such court as a contempt thereof. All process in any such case may be served in the judicial district whereof such person is an inhabitant or wherever he may be found. Any person who shall, without just cause, fail or refuse to attend and testify or to answer any lawful inquiry or to produce books, papers, correspondence, memoranda, and other records, if in his power so to do, in obedience to the subpena of the Commission, shall be guilty of a misdemeanor and, upon conviction, shall be subject to a fine of not more than $1,000 or to imprisonment for a term of not more than one year, or both.

(d) No persons shall be excused from attending and testifying or from producing books, papers, contracts, agreements, and other records and documents before the Commission, or in obedience to the subpena of the Commission or any member thereof or any officer designated by it, or in any cause or proceeding instituted by the Commission, on the ground that the testimony or evidence, documentary or otherwise, required of him may tend to incriminate him or subject him to a penalty or forfeiture; but no individual shall be prosecuted or subject to any penalty or forfeiture for or on account of any transaction, matter, or thing concerning which he is compelled, after having claimed his privilege against self-incrimination, to testify or produce evidence, documentary or otherwise, except that such individual so testifying shall not be exempt from prosecution and punishment for perjury committed in so testifying.

(e) Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this title, or of any rule or regulation thereunder, it may in its discretion bring an action in the proper district court of the United States,

the Supreme Court of the District of Columbia, or the United States courts of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this title.

(f) Upon application of the Commission the district courts of the United States, the Supreme Court of the District of Columbia, and the United States courts of any Territory or other place subject to the jurisdiction of the United States, shall also have jurisdiction to issue writs of mandamus commanding any person to comply with the provisions of this title or any order of the Commission made in pursuance thereof.

HEARINGS BY COMMISSION

SEC. 22. Hearings may be public and may be held before the Commission, any member or members thereof, or any officer or officers of the Commission designated by it, and appropriate records thereof shall be kept.

RULES AND REGULATIONS; ANNUAL REPORTS

SEC. 23. (a) The Commission and the Federal Reserve Board shall each have power to make such rules and regulations as may be necessary for the execution of the functions rested in them by this title, and may for such purpose classify issuers, securities, exchanges, and other persons or matters within their respective jurisdictions.

(b) The Commission and the Federal Reserve Board, respectively, shall include in their annual reports to Congress such information, data, and recommendation for further legislation as they may deem advisable with regard to matters within their respective jurisdictions under this title.

INFORMATION FILED WITH THE COMMISSION

SEC. 24. (a) Nothing in this title shall be construed to require, or to authorize the Commission to require, the revealing of trade

secrets or processes in any application, report, or document filed with the Commission under this title.

(b) Any person filing any such application, report, or document may make written objection to the public disclosure of information contained therein, stating the grounds for such objection, and the Commission is authorized to hear objections in any such case where it deems it advisable. The Commission may, in such cases, make available to the public the information contained in any such application, report, or document only when in its judgment a disclosure of such information is in the public interest; and copies of information so made available may be furnished to any person at such reasonable charge and under such reasonable limitations as the Commission may prescribe.

(c) It shall be unlawful for any member, officer, or employee of the Commission to disclose to any person other than a member, officer, or employee of the Commission, or to use for personal benefit, any information contained in any application, report, or document filed with the Commission which is not made available to the public pursuant to subsection (b) of this section: Provided, That the Commission may make available to the Federal Reserve Board any information requested by the Board for the purpose of enabling it to perform its duties under this title.

COURT REVIEW OF ORDERS

SEC. 25. (a) Any person aggrieved by an order issued by the Commission in a proceeding under this title to which such person is a party may obtain a review of such order in the Circuit Court of Appeals of the United States, within any circuit wherein such person resides or has his principal place of business, or in the Court of Appeals of the District of Columbia, by filing in such court, within sixty days after the entry of such order, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall be forthwith served upon any member of the Commission, and thereupon the Commission shall certify and file in the court a transcript of the record upon which the order complained of was entered. Upon the filing of such transcript such court shall have exclusive jurisdic-

tion to affirm, modify, and enforce or set aside such order, in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If either party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the hearing before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts, by reason of the additional evidence so taken, and it shall file such modified or new findings, which, if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, and enforcing or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in sections 239 and 240 of the Judicial Code, as amended (U. S. C., title 28, secs. 346 and 347).

(b) The commencement of proceedings under subsection (a) shall not, unless specifically ordered by the court, operate as a stay of the Commission's order.

UNLAWFUL REPRESENTATIONS

SEC. 26. No action or failure to act by the Commission or the Federal Reserve Board, in the administration of this title shall be construed to mean that the particular authority has in any way passed upon the merits of, or given approval to, any security or any transaction or transactions therein, nor shall such action or failure to act with regard to any statement or report filed with or examined by such authority pursuant to this title or rules and regulations thereunder, be deemed a finding by such authority that such statement or report is true and accurate on its face or that it is not

false or misleading. It shall be unlawful to make, or cause to be made, to any prospective purchaser or seller of a security any representation that any such action or failure to act by any such authority is to be so construed or has such effect.

JURISDICTION OF OFFENSES AND SUITS

SEC. 27. The district courts of the United States, the Supreme Court of the District of Columbia, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this title or rules and regulations thereunder, or to enjoin any violation of such title or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 128 and 240 of the Judicial Code, as amended (U. S. C., title 28, secs. 225 and 347). No costs shall be assessed for or against the Commission in any proceeding under this title brought by or against it in the Supreme Court or such other courts.

EFFECT ON EXISTING LAW

SEC. 28. (a) The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. Nothing in this title shall affect the jurisdiction of the

securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder.

(b) Nothing in this title shall be construed to modify existing law (1) with regard to the binding effect on any member of any exchange of any action taken by the authorities of such exchange to settle disputes between its members, or (2) with regard to the binding effect of such action on any person who has agreed to be bound thereby, or (3) with regard to the binding effect on any such member of any disciplinary action taken by the authorities of the exchange as a result of violation of any rule of the exchange, insofar as the action taken is not inconsistent with the provisions of this title or the rules and regulations thereunder.

VALIDITY OF CONTRACTS

SEC. 29. (a) Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void.

(b) Every contract made in violation of any provision of this title or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule or regulation.

(c) Nothing in this title shall be construed (1) to affect the validity of any loan or extension of credit (or any extension or renewal thereof) made or of any lien created prior or subsequent to the enactment of this title, unless at the time of the making of

such loan or extension of credit (or extension or renewal thereof) or the creating of such lien, the person making such loan or extension of credit (or extension or renewal thereof) or acquiring such lien shall have actual knowledge of facts by reason of which the making of such loan or extension of credit (or extension or renewal thereof) or the acquisition of such lien is a violation of the provisions of this title or any rule or regulation thereunder, or (2) to afford a defense to the collection of any debt or obligation or the enforcement of any lien by any person who shall have acquired such debt, obligation, or lien in good faith for value and without actual knowledge of the violation of any provision of this title or any rule or regulation thereunder affecting the legality of such debt, obligation, or lien.

FOREIGN SECURITIES EXCHANGES

SEC. 30. (a) It shall be unlawful for any broker or dealer, directly or indirectly, to make use of the mails or of any means or instrumentality of interstate commerce for the purpose of effecting on an exchange not within or subject to the jurisdiction of the United States, any transaction in any security the issuer of which is a resident of, or is organized under the laws of, or has its principal place of business in, a place within or subject to the jurisdiction of the United States, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors or to prevent the evasion of this title.

(b) The provisions of this title or of any rule or regulation thereunder shall not apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of this title.

REGISTRATION FEES

SEC. 31. Every national securities exchange shall pay to the Commission on or before March 15 of each calendar year a registration fee for the privilege of doing business as a national securities exchange during the preceding calendar year or any part thereof.

Such fee shall be in an amount equal to one five-hundredths of 1 per centum of the aggregate dollar amount of the sales of securities transacted on such national securities exchange during the preceding calendar year and subsequent to its registration as a national securities exchange.

PENALTIES

SEC. 32. Any person who willfully violates any provision of this title, or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this title, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this title or any rule or regulation thereunder, which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than $10,000, or imprisoned not more than two years, or both, except that when such person is an exchange, a fine not exceeding $500,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

SEPARABILITY OF PROVISIONS

SEC. 33. If any provision of this Act, or the application of such provision to any person or circumstances, shall be held invalid, the remainder of the Act, and the application of such provision to persons or circumstances other than those as to which it is held invalid, shall not be affected thereby.

EFFECTIVE DATE

SEC. 34. This Act shall become effective on July 1, 1934, except that sections 6 and 12(b), (c), (d), and (e) shall become effective on September 1, 1934; and sections 5, 7, 8, 9(a), (6), 10, 11, 12(a), 13, 14, 15, 16, 17, 18, 19, and 30 shall become effective on October 1, 1934.

TITLE II—AMENDMENT TO SECURITIES ACT OF 1933

(Text omitted)

APPENDIX X

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