Memorandum in regard to draft of Regulation T

Submitted by

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MEMORANDUM OF PRINCIPAL POINTS IN DRAFT REGULATION T
TO WHICH THERE IS OBJECTION BY THE NEW YORK STOCK EXCHANGE

Through the courtesy of Mr. Parry, representatives of the New York Stock Exchange have had an opportunity to consider the various drafts of Regulation T, dealing with extensions of credit by members of national securities exchanges and other brokers and dealers. While I am advised certain additional changes may be made, I understand that the draft dated September 5th is the document which the Federal Reserve Board has considered.

This draft proceeds, as I see it, on three fundamental principles. (1) It attempts to control all extensions of credit made by members of national securities exchanges or by brokers or dealers transacting a business in securities through such members; (2) It adopts the standard which is contained in Section 7 (a) of the Securities Exchange Act of 1934 as the formula to be used in determining the maximum amount of credit that may be initially extended by such members, brokers and dealers, and (3) It adopts a similar standard for the determination of what credit may be maintained by such members, brokers and dealers and restricts accounts which at any given time do not meet this standard.
In the interest of clarity I shall discuss these three points seriatim, and shall, for the sake of brevity use the term "brokers" to describe all members of national securities exchanges and other dealers and brokers who are subject to the rules and regulations adopted by the Federal Reserve Board.

II.

Under the Act, the Federal Reserve Board is given full power to control all extensions of credit made by brokers. The history of the Act, however, shows very clearly that this all inclusive power was granted only to make effective the primary purpose of the Congress which was to permit the Federal Reserve Board to regulate the amount of speculative credit used in margin accounts. Throughout the hearings on the bill, both before the House and the Senate Committees, constant references were made to the number and excessive size of margin accounts during the boom years. One of the avowed purposes of the bill was to prevent, by controlling the amount of credit used in margin accounts, another inflation of security prices. In these hearings it was pointed out that brokers might extend credit in other directions for the purpose of evading the restrictions imposed on margin accounts. To prevent such evasions, the
Congress vested in the Federal Reserve Board broad powers to regulate every form of credit extended by brokers. However looking at the whole history of the Act, and I approach this problem as a layman and not as a lawyer, it is apparent that the Congress intended the power to regulate all forms of brokers' credit to be used primarily for the purpose of preventing the excessive use of credit in margin accounts.

In view of the history of the Act, the Federal Reserve Board might, in my opinion, undertake to regulate margin accounts and leave unregulated other forms of credit until experience demonstrates that additional regulations are necessary in order to prevent evasions of the restrictions placed upon margin accounts. I recognize, of course, that the Board, even before the necessity for such action is actually demonstrated, can regulate all extensions of credit made by brokers, if it should conclude that its regulation of margin accounts could not otherwise be made effective. As I see it, the draft regulation proceeds upon the theory that the Board must necessarily reach this conclusion.

This view of the scope of the proposed regulation entails many difficulties. It necessitates an immediate definition of what constitutes an extension of credit. The
term credit is not defined by the Securities Exchange Act nor does the draft regulation contain any specific definition of this term. Both the Act and the draft regulation are silent as to what constitutes an extension of credit. It is clear, however, from many of the provisions of the draft regulation, that mere brokerage contracts which may not involve the present payment of money, are nevertheless treated as extensions of credit. Furthermore the sections dealing with cash transactions imply that contracts for the purchase or sale of securities involve extensions of credit. The doubt created by these provisions will profoundly disturb business. I find it hard to believe that the Board will take the position that a contract by a broker to purchase securities for a customer involves an extension of credit to the customer, unless, of course, the broker should pay for the securities without receiving reimbursement from his customer. In like manner, I find it hard to believe that a contract by a dealer to sell securities can be considered an extension of credit to the purchaser unless the seller makes delivery before the purchaser pays the purchase price. Certainly, on points as important as these, the regulation should be clear and definite.
Another difficulty inherent in any attempt to regulate all forms of brokers' credit lies in the fact that exceptions must be made for various types of transactions, which, are not connected in any way with speculation in securities, but which might, in view of the all inclusive manner in which the term is used elsewhere in the draft regulation, be deemed to involve extensions of credit. This is apparent from even a cursory examination of the draft regulation. For instance, in Section 3 (c), exception is made for credit used for commercial and industrial purposes; in Section 3 (d) extensions of credit between brokers are in part exempted from the general rule; in Section 3 (e) arbitrage accounts are excepted; in Section 8 cash transactions are made the subject of separate and very special rules; in Section 14 (b) exception is made for credit which is not used for the purchasing or carrying of securities; in Section 14 (c) exception is made for credit on acceptances, commercial paper, etc., and in Section 14 (e) for loans on commodities. In other places, commitments in commodity futures, foreign exchange and other similar transactions, are likewise excluded from the regulation.

This method of including all forms of brokerage
credit and then making exceptions for particular transactions results in a long and complicated regulation. In spite of the time and thought devoted by all concerned in preparing this draft to make it clear, even experienced persons studying it would hesitate to give an immediate answer as to whether a certain type of transactions is or is not permitted. We must remember that this regulation will be used, not by experts but by thousands of ordinary businessmen. It affects the two or three thousand members of national securities exchanges, and also the much larger number of persons who are dealers and brokers in securities transacting a business through members of national securities exchanges. These people will have to rely upon their employees and primarily upon their margin clerks who have no special training in the interpretation of complicated regulations. It is almost certain that many of them will misunderstand or misconstrue any regulation as lengthy and complex as the present draft.

While the members of the staff of the Federal Reserve Board have spent weeks in the study of our security markets and have earnestly tried to make an exception for every type of transaction which did not involve an ex-
tension of credit for the purchase or carrying of securities. I nevertheless doubt whether the numerous exceptions in the draft regulation are sufficiently comprehensive. A simple example will illustrate the type of question which is certain to arise. Under Section 8 a security can be sold for cash if the purchaser pays the entire purchase price upon delivery. Under Section 14 a broker may purchase acceptances or commercial paper. There is nothing in the regulation, however, that clearly shows that these two transactions may be combined in one and that a broker may sell securities and take acceptances or commercial paper in payment for them. In like manner, while Section 8 permits cash transactions, it does not specifically cover the very common practice, particularly in bond transactions, of exchanging securities for other securities and settling the difference in market value by check. I am convinced that no matter how many exceptions are made, the regulation cannot cover specifically all the possible types of non-speculative transactions which form a part of the usual and ordinary business of brokers.

Since the first draft of the regulation was submitted to the Exchange in the latter part of last month, it has been under constant consideration by the members of the Law Committee of the Exchange. It is their unanimous opinion that any attempt to regulate, at this time, all forms of brokers'
credit will create doubt and hesitation which will seriously interfere with security business. They are convinced that the direct consequence of such an attempt will be a further reduction in the activity of our security and capital markets and the liquidation of many accounts. They are fearful that this in turn may disturb business and tend to retard national recovery.

III.

The second principle on which the draft regulation is founded is the adoption of the statutory standard as the formula to be used in determining the maximum amount of credit that may be initially extended by brokers. This formula is a complicated one which involves the use of varying percentages of the current market price and of the lowest price reached by a security within three years or since July 1, 1933.

The staff of the Federal Reserve Board, in an effort to make this complicated formula as workable as possible, have provided that the lowest price reached down to the end of any particular month may be used as the lowest price throughout the next succeeding month. They have likewise adopted a formula for determining current market value which in effect makes the closing price of the preceding business day the current market value during the next succeeding business day. Even on this basis, the formula
is still an extremely complicated one which involves mathematical computations in which errors are certain to occur. Actual tests have indicated that the statutory formula will at least double the time required to compute the margin in a simple account and treble it in more complicated cases. This is a matter of grave concern to stock brokers. It will increase substantially the cost of operation. More important still, it will delay the sending out of margin calls. At times like the present when the market is inactive, margins can be computed within a few hours after the close of the market. In times of greater activity, however, margin clerks work late into the night and in emergency periods, it frequently happens that margin calls cannot be sent out until early the following morning. For their own protection, therefore, brokers will hesitate to accept accounts unless the margin substantially exceeds the statutory standard.

It is primarily the delay caused by the difficulty of computing margins under the statutory formula that makes it objectionable from the point of view of members of the Exchange. At the present time, as an examination of the current prices will readily indicate, the statutory standard of margin is only fractionally above the minimum margin required by the New York Stock Exchange on accounts having debit balances of more than $5,000 and is substantially less than the amount of margin which the exchange requires on
smaller accounts. Brokers do not fear, therefore, that the statutory standard will restrict their business by requiring excessive margin. They honestly believe that the statutory standard is too complicated for practical application.

We urge the Federal Reserve Board to exercise its discretion and to adopt a percentage of current market value as the method to be used for the determination of the amount of credit that may be initially extended by brokers. This method of determining margins is the one which has regularly been employed, not only by brokers but also by banks and other lenders of money. It is simple and practical because it is based on the actual current market price of securities. It is certainly preferable to a cumbersome system based upon assumed and inaccurate factors.

IV.

The third principle on which the draft regulation is founded is the adoption of the statutory standard as the means for determining the amount of credit which may be maintained by brokers. Strictly speaking, these provisions of the draft regulation do not establish a maintenance margin. They merely provide that an account which fails to meet the standard established for the initial extension of credit becomes frozen. The broker having such an account upon his books is prohibited from permitting transactions
which might in any way weaken the account or increase the amount by which the account fails to meet the statutory formula.

The statutory standard is difficult of application even in the case of initial extensions of credit. If it is made the test of the maintenance of credit, the difficulties are multiplied because the maintenance of credit involves the determination, from day to day, of the value of the securities carried in the account. In a simple account involving only a single security this day to day difficulty is not immediately apparent, but the average customer's account rarely if ever consists of only a single security. Accounts with 10, 20, 50 and even 100 different securities are usual. In the case of accounts carried for out-of-town brokers, it is not rare to have several hundred different securities. The daily computation of margin on the statutory formula in accounts of this magnitude is simply impossible as a practical matter.

V.

In a letter addressed to me by the Secretary of the Board yesterday it was suggested that I include in this memorandum not only the points which the Exchange thought objectionable, but also any suggestions as to alterations in the regulation. In reply to this suggestion the New York Stock Exchange respectfully urges:
First, that without in any way limiting its right to control any form of credit extended by brokers, the Federal Reserve Board should adopt, for the present at least, a regulation applicable only to margin accounts, and to credit extended by brokers for the purpose of evading or circumventing the regulations imposed upon margin accounts.

Such a regulation would admittedly be a preliminary one, designed to allow the Board to study the proper method of regulating credit used for security speculation. In order to prevent evasions, the Board might reasonably require all brokers to submit monthly reports showing the aggregate amount of credit extended to customers for other purposes. An unexplained increase in the amount of credit extended by a broker for other purposes would indicate the possibility of evasion. A further study of any such case would soon disclose whether or not the broker was attempting to evade the regulations imposed on margin accounts. Such a regulation would be simple and easily understood. Margin accounts are capable of identification and no doubt would exist, either in the minds of brokers or their customers, as to what accounts were subject to the rules laid down by the Federal Reserve Board. It would, in my opinion, achieve the purpose which Congress had in mind when it vested in the Federal Reserve Board power to regulate brokers' credit and it would do so without causing any great inconvenience or disturbance to business.
Second, that the Federal Reserve Board should fix as the maximum amount of credit that may be extended or maintained by brokers on securities registered on a national securities exchange (other than exempted securities) 75% of the current market value.

Such a margin requirement avoids the unworkable features of the statutory standard. It will be easily understood by everybody engaged in the security business. Furthermore, it is flexible and can quickly be changed if the Board should conclude that conditions necessitate the adoption of either higher or lower margins.

I hesitate to make any further specific suggestions because the alterations I have suggested are so fundamental that the whole nature of the regulation depends upon them. There are many other matters of detail which are nevertheless of great importance. Many of these were the subject of discussion when members of the staff of the Board visited New York, and I am advised that others were discussed in more recent conferences here in Washington. The exact form of these minor provisions will have an important bearing upon the effect of the regulation.