CONFIDENTIAL

October 13, 1938

Chairman Douglas

Commissioner Frank

Dear Bill:

Attached you will find a rough draft of my reactions to Yandell's amazing report. Jimmy Allen, at my suggestion, is also preparing a memo.

As stated in the attached, I feel it imperative that an anticipatory reply should be uttered in the near future -- before the Yandell report gets into general circulation, as it almost surely will. I think this should be done a considerable period before Congress convenes. I feel so strongly about the matter that if you feel unwilling to make such a statement, I shall be tempted to sound off myself, stating that I am expressing my personal views.

The report shocks me first because of its conclusions and second, because those conclusions are based upon what seems to me to be pronounced sycophancy with reference to the English--at a time when certainly most of the American republic is not minded to accept the dogma that America must do whatever is good for the English -- and especially for English speculators.

<u>RE YANDELL'S REPORT</u>

1. The report (a) pictures an alarming situation resulting from the fact that dealings in American securities on American exchanges are regulated and that such dealings on the European exchanges are not, and (b) proposes an amazing remedy, namely, that we rid ourselves of virtually all the regulation of our exchanges. In other words, it proposes that the way to protect American investors (and our economy) from injuries, due to the fact that, as matters stand, we are unable to control foreign trading in American securities, is to remove virtually all domestic safeguards designed for the benefit of American investors.

2. That the situation depicted is alarming appears from the following brief summary of the report:

There are foreign markets – especially the London Exchange – where, with virtually no regulation, American securities are extensively dealt in. At the same time, dealings in American securities on American exchanges are regulated by the SEC.

Those two factors, the report shows, lead to the following:

> (1) The foreign markets can be used by American traders (and are already used by large American traders) to do all the things prohibited by our statutes and regulations - such as <u>manipulation</u>, <u>short selling</u> (of the type we prohibit), <u>insider trading</u> (without reporting) etc., etc. Thus already our statutes and regulations are laughed at by our large traders and almost surely, unless something is done to plug the gap, more and more our regulatory apparatus will come to have little meaning, and the statutes designed by Congress for the protection of American investors will be rendered futile.
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> (2) European traders, even those, like the English, who ordinarily buy securities for income, trade in American securities primarily for capital gain, i.e., they avowedly speculate to a far greater extent than they do in their own securities. They are building up a large speculators' market abroad in our securities. Such unregulated foreign transactions can play hob with our American securities:
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> According to the report, in October, 1937, the European traders' determination to sell American securities out had a serious effect on our markets.
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> [While Mr. Yandell denies that this situation has ever <u>heretofore</u> been used for political purposes, it is obvious that it <u>could</u> be so used in the future: Thus the British government, during the Great War, became the owner of a large quantity of American securities theretofore owned by British citizens. And there is evidence that it was

planning to do so again if a war had broken out recently in Europe. Accordingly, it is quite possible for England or other governments to become possessed of a very considerable quantity of American securities. If the government of any of those countries did not like the party in power in America, it could utilize the sudden sale of American securities to bring about an economic set-back injurious to that party, in such a way as to affect elections in America.]

The report, having depicted an alarming situation, then discusses several proposed ways to meet it through some form of control of dealings in American securities abroad. It rejects all such devices as unworkable. With particular reference to the suggestion that steps be taken to prevent dealings in American securities abroad, the report states that this would have an adverse effect on us since it would prevent the flow of money to this country - as if we needed foreign funds here - and urges that the benefits to us from foreign dealings in our securities offset the disadvantages. The report then concludes with this surprising suggestion: That the only way to safeguard American investors from the results of the situation depicted in the report is to take away all safeguards, thus bringing our markets to the level of the European markets, i.e., making them virtually unregulated.

The report makes it clear that here, as in other contexts, free (unregulated) foreign trade and free (unregulated) domestic trade (i.e., laissez faire) are twins: If, says the report, we are to have unrestricted foreign trading in American securities, we must have unrestricted American trading in our securities.

It certainly has been generally accepted in this country that regulation of dealings in American securities is imperative for several reasons:

(a) Unregulated dealings may have a seriously adverse effect on our economy.

(b) Even assuming that unfairness to the average investor has no effect on our economy (regarded merely as a machine), yet such unfairness certainly arouses the ire of investors. If they are seriously mulcted, they will grow impatient with a government that allows such things to happen. Such an attitude will pave the way for Fascism -- and a Fascism which will lead to a deadly attack on the very investment bankers and security traders who are today loudest in their protests against regulation.

As indicating the sentiment of the country, (at least that part of it not too close to Wall Street) one need but glance at the remarks made in newspapers in the west and middlewest.

Thus, one recent editorial said: “This gambling has hampered investment seriously. The public impression that the exchanges provided means for gambling only and not for long-time investment had been growing. Anyone with common sense knows no security could be worth $40 at 10 o’clock, $42 at 11 o’clock, $39 at noon and other varying figures throughout the exchange day. ‘Market comment,’ unfounded and often libelous to an extreme, has been used to support the gambling element; to cause wild swings in prices seldom justified by fact. The nation will be glad to see honesty and decency govern investment of the millions of dollars it annually pours into the common fund for business development." (Standard of Palmyra, Mo., February 23, 1938).

And another recent editorial reads as follows: "We all have short memories. The 1,000-page report filed with Judge Wilkerson in Chicago by the special referee in the Insull bankruptcy may help us all to recall more vividly just why the New Deal enacted an SEC, a truth-in-securities law and a public utility holding company act.

" 'I have received from the very exhaustive investigation that I have made of the affairs of Middle West Utilities,' the attorney for one of the trustees found, 'that its earnings for a period of ten years were faked by Mr. Insull and that he knew it, and that in the spring of 1929 he hit upon a plan of refinancing Middle West by the sale of $10,000,000 worth of common stock, by means of that money cut the preferred stock, retire a bond issue of $20,000,000 and place all his common stock on a stock dividend instead of a cash dividend basis.'

"Between August 1, 1928, and September 30, 1930, Insull and his associates succeeded in selling $65,000,000 of securities in all his interlocking corporations to the public. "Part of the vast financial operation . . . was the artificial bidding up of the price of Middle West Utilities stock.'" (Independent, Helena, Montana, June 10, 1938.)

And still another editorial reads as follows:

"Those who look back at the Hoover collapse in 1929, which crisis was aggravated by the uncontrolled "boom" in stocks preceding it, must be pleased with the progress being made by William O. Douglas and other members of the Securities and Exchange Commission in cleaning up Wall Street so that trading there will be somewhat on the level. By controlling the sales of stocks to legitimate demand, the first consideration toward safety in security investment has been met. The craps game in the street has been stopped by federal policing through the commission. With reorganization of the stock exchange, it will be held to the only purpose it should serve, as a clearinghouse for actual and legitimate investment in stocks and bonds." (Demo. Carthage, Mo., May 1, 1938.)

Having in mind the sentiment expressed as in the foregoing, persons like Mr. Yandell should think carefully before they advise the American public that it is for the welfare of Americans to tear down the regulatory structures we have erected in order that the world shall be made safe for speculators -- and especially for foreign speculators. It surely would not be welcome Gospel that we need to destroy our safeguards to American investors in order to help the British -- in the light of the manner in which the British have recently conducted themselves. Time was when Anglophile attitudes were so strong that whatever was good for the English was necessarily accepted as beneficial for Americans, or as something required to be furthered even if Americans suffered. Almost surely that is not the governing American attitude today.

The report tries to create the impression that foreign trading in American securities is of value to us. In part it seeks to create this impression by stressing the fact that, earlier in our history, our economic expansion was promoted by foreign investment here. That, of course, was true. But we owe no debt of gratitude on that score, which needs now to be paid, since those foreigners who made investment here were doing it out of their own desire for gain and not any altruistic desire to assist us. The important question is whether foreign trading in our securities is now of any benefit to us. The report makes no effort to show that such is the case. The truth of the matter is that the benefits are all the other way: We do not need foreign funds in this country. The conduct of foreign speculators in our securities (in 1929 and again in 1937) may be compared to the boy's trick of feeding the cat with a piece of meat tied to a string which the boy yanks out of the cat's insides at the boy's pleasure.

And the report utterly neglects the fact that much of foreign investment in our securities of recent years was made possible by America's purchase of gold -- which we now own in such quantities that the stuff is virtually useless to us. In other words, we made a gift of many of those securities to foreigners.

There was perhaps some justification, in thus giving away our securities, for it gave the English a nest egg of American securities which they could use in case of war. But that justification existed at a time when some persons felt that we needed to stand by the English, to aid them in a coming conflict with the Nazis. The recent conduct of the English should do much to diminish the weight of any such justification.

The Yandell report is likely in one way or another to get into the hands of persons who will rely upon it to attack SEC and its regulation of security markets. It would seem wise that we should anticipate such an event. We might publish the report and comment adversely on it. Better still, without publishing it we might say that there are some persons who hold the following views (summarizing the report) and then answer it. Perhaps that should be done in a speech by the Chairman or in an interview with him.

It is of considerable interest to note that the report, admittedly, is based on Mr. Yandell's mere "<u>impressions</u>" as a result of interviewing persons in foreign countries. Now, the Commission would reject such "impressions," even of Americans, as to the condition of the American market. It certainly ought not be asked to rely on "impressions" of foreigners on that subject.

> [It is significant that, while Mr. Yandell makes light of tax evasions by Americans through transactions abroad, he advised Mr. Purcell that he thought it most inadvisable for him to act as an agent of our Treasury Department in obtaining income tax reports filed in England by American citizens, on the ground that for him to make such a study would be inconsistent with his role of <u>friendly relations</u> with foreigners with whom he was consulting.]

In this connection it is of very considerable interest to note that Mr. Yandell concludes that the markets abroad for American securities are "<u>better</u>" than exist here. <u>He is not very careful to define the word "better".</u> But his conclusion in that respect is based, as the report shows, on the views of anonymous foreigners with whom he consulted. Thus, the report, on page 60, says: "... the main cause seems to be that at times better markets exist abroad in leading American securities than exist in New York. This, in turn, is generally attributed by foreigners to the regulations and restrictions and have been imposed on the New York market. From these a vicious circle is thought to arise, wherein the thinner the New York market becomes and the more vulnerable it is to selling, etc., etc. . ."

It is interesting in that connection to note the attached article from the Wall Street Journal of October 10, referring to proposals in England to enact a statute for the prevention of fraud in investments. It will be noted that in that article it is stated that in some quarters those resisting such legislation are referring to the undesirability of our legislation and of SEC activities pursuant thereto. It would seem as if Mr. Yandell had been fraternizing in England with persons voicing that kind of objection.