Louchheim W. C.

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON

May 16, 1946

Honorable Ganson Purcell
Chairman
Securities and Exchange Commission
18th and Locust Streets
Philadelphia 3, Pa.

Dear Ganson:

I am enclosing herewith a copy of a memorandum which has been prepared for the National Advisory Council by the General Counsel for the Treasury Department relative to questions arising in connection with securities to be issued or guaranteed by the International Bank for Reconstruction and Development. This memorandum discusses federal legislation which may affect the marketing in the United States of the Bank's bonds, with particular reference to the Securities Act of 1933 and Securities Exchange Act of 1934.

Permit me to call to your attention the conclusion of the memorandum to the effect that it does not appear that the Council need to take any action toward amendment of federal laws at the present time.

I am sending copies of this memorandum to Messrs. Roger Foster and Baldwin Bane with a request for comments.

Sincerely yours,

Walter C. Louchheim, Jr.
Adviser on Foreign Investments

Enclosure

COPY

May 6, 1946

To: Secretary of the National Advisory Council on International Monetary and Financial Problems

From: General Counsel for the Department of the Treasury

Preliminary Memorandum on Questions Arising in Connection with Securities to be Issued or Guaranteed by the International Bank for Reconstruction and Development

In accordance with your request, the following preliminary memorandum discusses Federal legislation which may affect the marketing in the United States of securities issued or guaranteed by the International Bank for Reconstruction and Development.

1. Registration under Securities Act of 1933

The Securities Act of 1933, as amended, makes it unlawful for any person directly or indirectly to use any means of interstate transportation or communication for the sale of a security unless a registration statement is in effect as to that security. The Solicitor of the Securities and Exchange Commission has concluded in an opinion to the Commission that securities issued or guaranteed by the International Bank for Reconstruction and Development may not be considered to be exempt from this registration requirement. A copy of his opinion is attached hereto.

The Solicitor believes that the only possible ground for exemption of such securities is under section 3(a)(2) of the Securities Act which exempts securities "issued or guaranteed * * * by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States * * *." 1/ He notes that since securities issued or guaranteed by the Bank may not be sold in this country without the consent of the United States representative on the Bank, it might be argued that in its capacity of floating securities in this country, the Bank is a person controlled or supervised by and acting as an instrumentality of the United States within the meaning of section 3(a)(2).

However, the Solicitor concludes that securities issued or guaranteed by the Bank should not be considered to be exempt under that section because the United States has only minority participation in the Bank and accordingly the Bank is not a person supervised by and acting as an instrumentality of the United States as contemplated by the Securities Act.

1/ U.S.C. title 15, sec. 77c(a)(2).

This conclusion is supported by statements made by both Senators Barkley and Taft in the course of debate on the Bretton Woods Agreements Act. These statements clearly indicate that it was understood by Congress that securities of the Bank would be subject to registration. 2/

Although as the Solicitor suggests, it might be possible as a matter of legal construction to reach another conclusion, it does not appear that the opinion of the Solicitor can be effectively contested, particularly in view of the statements appearing in the legislative history of the Bretton Woods Agreements Act. The question then arises as to the desirability of recommending that legislation be enacted exempting securities of the Bank from the registration requirements of the Securities Act.

In resolving this question, it should be noted that the requirement that Bank securities be registered under the Securities Act is not necessarily inconsistent with the fact that the floating of such securities in the United States must be approved by the National Advisory Council nor will such a registration requirement reflect on the action of the NAC. The functions to be performed by the two agencies in this situation are distinct, and their determination can be complementary. The NAC will undoubtedly base its approval or disapproval of the marketing of a security in the United States on the merits of that security with particular reference to its relation to the economic and other interests of the United States. The Securities Act registration requirements, on the other hand, will merely serve to make available full information about the Bank's securities to the investing public.

There is precedent for exempting securities from registration when they must be approved by another governmental body. Section 3(a)(6) of the Securities Act 3/ exempts any security which is subject to the provision of section 20(a) of the Interstate Commerce Act. 4/ Pursuant to

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2/ These remarks of Senators Barkley and Taft are quoted in full in the Opinion of the Solicitor of the Securities and Exchange Commission. Section 4 of the Bretton Woods Agreements Act provides that the National Advisory Council on International Monetary and Financial Problems shall make all decisions as to whether securities issued or guaranteed by the Bank may be sold in the United States. Although this might weaken the opinion of the Solicitor in so far as it is based on an analysis of the Bank, it does not affect the statements of Senators Barkley and Taft on which he places great emphasis.

3/ U. S. C. title 15, sec. 77c(a)(6).

4/ U.S.C. title 49, sec. 20a.

that section, the Interstate Commerce Commission authorizes the issuance of a security by a railroad upon a finding that the security is for a lawful object compatible with the public interest and necessary or appropriate for the proper performance of the railroad's service to the public. Thus, the functions of the Commission and the Bank in their relation to the SEC are analogous.

Despite this precedent for statutory exemption of the securities of the Bank, it may be preferable not to request such legislative action at the present time. Public support of the Bank or reliance upon its securities would not be enhanced by attempts to obtain special exemptions for securities of the Bank. Moreover, registration under the Securities Act will furnish a convenient way to give full publicity and information about such securities to the public. It does not appear that the information ordinarily required on a registration statement would be more than the Bank may be expected to obtain for its own use. The form of the registration statement may be worked out by agreement of the SEC and the Bank. While there is a theoretical possibility that the SEC might insist on more information than the Bank is prepared to supply, it should be noted that the NAC as the coordinating United States organization in the field of foreign financial and monetary transactions would be in a position to work out the problem with the SEC.

Accordingly, it is suggested for consideration that no attempt be made at this time to secure legislation exempting the securities of the Bank from the registration requirements of the Securities Act of 1933. 5/

2. Registration under Securities Exchange Act of 1934

Registration is required under the Securities Exchange Act of 1934 before any security (other than an exempt security) may be dealt with on a National Securities Exchange. Section 3(a)(12) of that Act exempts securities which are "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." 6/

5/ Document No. 16 of the Technical Committee of the National Advisory Council recommends that no attempt be made at this time to obtain such an amendment of the Securities Act. This recommendation is stated to be based in part on the opinion that the registration requirement would not impose an undue burden upon the Bank and that any specific problems can be worked out satisfactorily by cooperation between the SEC and the Bank.

6/ U.S.C. title 15, sec. 78c(a)(12).

While it would appear that this authority could be construed to permit the Secretary of the Treasury to exempt the securities issued or guaranteed by the Bank, the statements made by Senators Barkley and Taft in connection with the Bretton Woods Agreements Act and the considerations which weigh against seeking a statutory exemption to the Securities Act also afford reason for the Secretary not to take such action at the present time. 7/

3. Civil Liabilities of Sellers of Bank Securities under the Securities Act of 1933

Under section 11(a) of the Securities Act of 1933 8/ liability to the extent of the loss suffered in case any part of the registration statement contains an untrue statement of a material fact or omits to state a material fact is imposed upon every underwriter with respect to such security. The term "underwriter" is defined by section 2(11) as "any person who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking * * *; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission." 9/

There is some doubt whether the Bank will require underwriting services of this nature. It is possible that the services of private concerns will be needed only as distributors or sellers of the securities issued or guaranteed by the Bank. In that event, those dealing in these securities probably would not be subject to a civil liability under section 11. However, this question can not be resolved until the manner of sale and distribution of the Bank's securities is finally determined.

7/ The Solicitor of the Securities and Exchange Commission indicates that the Secretary of the Treasury has the power to designate Bank securities as exempt under the Securities Exchange Act and states, "If the Secretary interprets the legislative history as we do, such designation presumably would not be made." Document No. 16 of the Technical Committee of the National Advisory Council also concludes that it would be inadvisable to employ this power of exemption in favor of securities of the Bank.

8/ U.S.C. title 15, sec. 77k (a).

9/ U.S.C. title 15, sec 77b(11).

Section 12 of the Securities Act of 1933 imposes liability upon any person who sells a security, by the use of any interstate transportation or communication, "by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading * * * and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known of such untruth or omission." 10/

It is difficult to see reasons for exempting dealers in the securities of the Bank from liability for material misstatements or omissions of which they have knowledge. However, it would seem to be undesirable to subject a dealer in these securities to a civil liability as a result of the use of a registration statement of the Bank which contains such an untrue statement or omission. It would seem that this result could be reached under section 12 as it would be reasonable to conclude that a seller would usually be able to sustain the burden of proof that he did not know and in the exercise of reasonable care could not have known of untruths or omissions in the registration statement of the International Bank for Reconstruction and Development.

It is suggested that, as soon as the procedure for distribution and sale of securities of the Bank has been determined, the opinion of the SEC should be requested as to the possibility of civil liability under section 11 of the Securities Act being imposed on persons engaged in such distribution and sale. Opinion should also be requested as to the possibility of liability under section 12 because of the use of a registration statement or other official document of the Bank. If, in either case, a possibility of civil liability exists or if a reasonable doubt might remain in the minds of prospective sellers or distributors, it would appear to be incumbent upon the Administration to request the Congress to clarify these provisions of the Securities Act of 1933 by amendment.

10/ U.S.C. title 15, sec 771.

4. Marketing of Bank Securities by Commercial Bankers

Section 5136 of the Revised Statutes, as amended, applicable to member banks of the Federal Reserve System, provides in part:

> "* * * The business of dealing in securities and stock * * * shall be limited to purchasing and selling such securities and stock without recourse, solely upon order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: * * *. The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof, or obligations issued under authority of the Federal Farm Loan Act, as amended, or issued by the Federal Home Loan Banks or the Home Owners' Loan Corporation, or obligations which are insured by the Federal Housing Administrator pursuant to section 207 of the National Housing Act, if the debentures to be issued in payment of such insured obligations are guaranteed as to principal and interest by the United States, or obligations of national mortgage associations: * * *." 11/

It is clear that member banks of the Federal Reserve System may not buy and sell the securities issued or guaranteed by the Bank except upon the order and for the account of their customers. It will be noted that the only exception to this prohibition relates to securities issued or guaranteed by the United States Government or the securities of a State or political subdivision thereof.

The reasons for this prohibition appear to be: (1) the general advantage to the financial structure to be gained by a complete separation of commercial and investment bank activities; (2) protection to depositors and other creditors by preventing a bank from assuming the risks of security market operations; (3) assurance that a bank may not market securities in which it or its officers have an interest.

The securities exempted by the statute are those in which the danger of loss is reduced to a minimum and which the bank and its officers would not have a personal interest in marketing. Securities issued or guaranteed

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11/ U.S.C. title 12, sec. 24.

by the Bank offer substantially the same protective features and accordingly it would be reasonable to request an amendment which would permit commercial bankers to deal in such securities.

On the other hand, the view has been expressed that such amendment of section 5136 of the Revised Statutes might be a step which would lead to further exceptions and tend to break down the dividing line between commercial and investment banking. 12/

Because of this balance of interests, it is suggested for consideration that no effort be made at this time to obtain an amendment to section 5136. However, in connection with the study of the means of sale and distribution of securities of the Bank, consideration should be given to whether other means of sale and distribution will be completely adequate and as to the volume of securities which would be handled by commercial bankers if they were permitted to market them. At that time, if it appears that the services of commercial bankers may be needed, and if a substantial amount of securities will be marketed by them, legislation could be requested exempting securities of the Bank from the prohibition of section 5136 of the Revised Statutes.

Conclusion

It does not appear that the Council needs to take any action looking toward amendment of federal laws affecting the marketing of securities of the International Bank for Reconstruction and Development at the present time. The considerations leading to this conclusion may be summarized as follows:

(1) It appears that the registration requirements under the Securities Act and the Securities Exchange Act may be worked out by agreement of the Council and the Commission, that they will not be unduly burdensome and will have the offsetting advantage of making information about securities of the Bank available to the public.

(2) A final determination on civil liabilities of distributors of the securities of the Bank may not be made until the procedure and manner of such distribution has been formulated. At that time the view of the Securities and Exchange Commission may be requested and legislation recommended if a possibility of civil liability exists.

(3) Legislation permitting commercial bankers to deal in securities of the Bank need not be requested until the actual necessity for the services of commercial bankers in marketing securities has been determined.

(Signed) J. J. O'Connell, Jr.

12/ Minutes of Meeting 14 of the National Advisory Council, Feb. 27, 1946, p. 5.