Office Memorandum • SECURITIES AND EXCHANGE COMMISSION

DATE: July 21, 1975

TO : Roderick M. Hills
Counsel to the President

FROM : Harvey L. Pitt
Executive Assistant to the Chairman

SUBJECT: Application of the Federal Securities Laws to the Arab Boycott

Introduction

In response to the request received from your Office, I have set forth below a brief discussion of how certain of the statutes administered by the Securities and Exchange Commission could be employed -- and how some of them are being employed -- to proscribe participation, by those subject to the Commission's jurisdiction, in underwriting syndications which engage in discriminatory practices at the behest of certain Arab investment banks. In addition, I have also set forth the bases upon which this Commission could assert jurisdiction to retard or prohibit discriminatory practices in connection with the purchase or sale of securities.

The discussion that follows of the Commission's broad mandate in this area does not represent an official statement of policy by the Securities and Exchange Commission. The purpose of this document, as I understand it, is solely to furnish a basis for discussion pursuant to which the Administration may review its existing policies and stated positions. As a practical matter, the Commission has not considered whether it would implement each of the possible applications of the federal securities laws discussed below.

Background

There are virtually an unlimited number of areas of commerce which are potentially subject to commercial discrimination or boycott-related activities. Similarly, there are a variety of statutory provisions which prohibit, or could be construed as prohibiting, such abuses in particular areas of activity subject to federal regulation. But, as Assistant Attorney General Antonin Scalia has recently noted, in a memorandum to the Honorable Philip W. Buchen, Counsel to the President, most of

these provisions have

> "such limited application, they seem inappropriate as the basis for any Presidential action except a general instruction to all agencies to prevent unlawful discrimination in regulated commercial services. Beyond that, the application must be considered within the context of a particular abuse in a specific area of commerce."

Nevertheless, Mr. Scalia suggested that certain other federal regulatory provisions, including the antitrust laws, civil rights legislation and the Export Administration Act of 1969, are omnibus in character and could be looked to as an effective prophylactic.

The same reasoning also applies to make appropriate the application of the federal securities laws to boycott activities in connection with the purchase or sale of securities. While the federal securities laws could not serve as an effective deterrent to discriminatory conduct in a wide range of nonsecurities contexts, the pervasive regulatory scheme entrusted by Congress to the administration of this Commission has application to a broad spectrum of commerce -- at least to the extent that commercial financing requires access to, and participation in, public capital markets. Thus, a broad implementation of the policies reflected in the federal securities laws presents the most appropriate and flexible means of addressing many of the restrictive trade practices for which a federal remedy may be sought.

Indeed, the federal securities laws may furnish the only appropriate federal remedy presently available for securities-related discriminatory acts, at least with respect to entities subject to the Commission's pervasive regulatory jurisdiction. Recently, for example, in resolving a case presenting a question of implied repeal of the antitrust laws in favor of the federal securities laws -- an implication not favored and not casually countenanced -- the Supreme Court noted

> " . . . Given the expertise of the SEC, the confidence of the Congress has placed in the agency, and the active roles the SEC and the Congress have taken, permitting courts throughout the country to conduct their own anti-trust proceedings would conflict with the regulatory scheme authorized by Congress rather than supplement that scheme. 1/

1/ Gordon v. New York Stock Exchange, ___ U.S. ___ (June 26, 1975) (No. 74-304, U.S. Sup. Ct.).

And, the Court has similarly held:

> "The SEC, in its exercise of authority over association [the National Association of Securities Dealers] rules and practices, is charged with protection of the public interest as well as the interests of shareholders, see e.g., 15 U.S.C. §§780-3(a)(1), (b)(3), (c), and it repeatedly has indicated that it weighs competitive concerns in the exercise of its continued supervisory responsibility .... As the Court previously has recognized United States v. Socony-Vacuum Oil Co. 310 U.S 150, 227 n. 60 (1940), the investiture of such pervasive supervisory authority in the SEC suggests that Congress intended to lift the ban of the Sherman Act from association activities approved by the SEC." (Citations omitted) 2/

Discussion

Earlier this year, it was reported in the media 3/ that some investment bankers were attempting to condition their participation in certain underwriting syndicates, organized to distribute securities to the public, on the exclusion of investment banking firms owned by those of Hebrew origin or supportive of the State of Israel. 4/

2/ U.S. v. National Association of Securities Dealers, __ U.S. __ (June 26, 1975) (No. 73-1701, U.S. Sup. Ct.).

3/ See Exhibit A attached hereto.

4/ For example, the Kuwaiti International Investment Co. reportedly demanded that Lazard Freres & Co. be ousted from an underwriting syndicate formed to sell $50 million in Mexican government bonds and $25 million in bonds to be offered by the Swedish carmaker, Volvo, because the American branch of Lazard Freres was subject to the Arab Boycott. The syndicate manager, Merrill Lynch, Pierce, Fenner & Smith, refused to accede to the demand, and the Kuwaiti company withdrew from the syndicate.

Through its appropriate oversight of securities industry self-regulatory organizations, the Commission has been monitoring industry practices in this regard. At the present time, we are unaware of a successful boycott, but are continuing to review the situation. To the extent that discriminatory practices occur which fall within the shadow of the Commission's pervasive jurisdiction over the activities of those who seek capital from the investing public as well as those engaged in the business of effecting any such undertaking -- including brokers and dealers, investment bankers and investment advisors the Commission is prepared to exercise its full prerogative in prohibiting such practices.

Thus, the registration requirements of the federal securities laws apply to any offer or sale of a security involving interstate commerce or use of the mails unless an exemption is available. Since "interstate commerce" is defined in Section 2(7) of the Securities Act of 1933 to include "trade or commerce in securities or any transportation or communication relating thereto . . . between any foreign country and any State, Territory, or the District of Columbia," this might be construed to encompass virtually any offering of securities made by a United States corporation to foreign investors.

Similarly, Section 15(a) of the Securities Exchange Act of 1934 makes it unlawful for any broker or dealer to use the means or instrumentalities of interstate commerce, including commerce between the United States and any foreign country, to engage in securities transactions unless he is registered with the Commission. Violations of either of these proscriptions may result in civil, administrative and even criminal sanctions.

In an effort, however, to promote increased foreign investment in United States corporate securities and to increase foreign financing for United States corporations operating abroad, the Commission has traditionally taken the position that the registration requirements of the Securities Act of 1933 are primarily intended to protect American investors. Accordingly, the Commission has not taken any action for failure to register securities of United States corporations distributed abroad to foreign nationals, even though the facilities of interstate commerce may be involved in the offering. It is assumed in these situations that the distribution is to be effected in a manner which will result in the securities coming to rest abroad. Much in the same vein, the Commission has generally raised no objection to the participation of foreign broker-dealers participating in such undertakings, but without registration under our laws. 5/

5/ Securities Act Release No. 4708 (July 9, 1964), 29 F.R. 9828.

While, in the past, the protection of American investors has been regarded as effected so long as no United States national purchase securities offered in foreign markets, international business practices that adversely effect American investors will, in the future, require a broader interpretation of the law. Boycotts and other restrictive business practices, such as those described above, can and do adversely affect American, as well as international, capital markets, and can result in the impairment of investment depth and liquidity. A loss in confidence in the integrity of American investment bankers could greatly limit their ability to distribute securities, impeding the capital-raising process and could damage the United States securities markets. Accordingly, the power to proscribe these practices must be considered as within the Commission's mandate to protect investors.

Although some firms subject to the boycott have apparently been excluded from several offerings of securities not registered with this Commission, we have not found any instance involving offerings of securities registered with the Commission or managed by investment banking firms subject to the Commission's jurisdiction. 6/ Moreover, we understand, there have been underwriting syndicates in which both Arab and supposedly boycotted firms have participated. We are confident that investment bankers and broker-dealers subject to the Commission's jurisdiction will neither promote nor acquiesce in such practices; political and religious considerations aside, such conduct is simply not good business and will ultimately be rejected by the world financial community.

As Chairman Garrett pointed out, however, in a letter to Congressman John E. Moss concerning the boycott of certain investment banks, 7/ the Commission does not have specific authority under the federal securities laws to control the composition of financing syndicates.

The National Association of Securities Dealers, Inc. ("NASD"), an industry self-regulatory association specifically subject to the Commission's jurisdiction, has, however, prescribed Rules of Fair Practice, which require, among other things, that its members observe just and equitable principles of trade in the conduct of their business. 8/ The Committee on Corporation

---

6/ Typically, even in offerngs not subject to registration with the Commission, it is the prerogative of the syndicate manager or managers, after consultation with the issuer, to invite other firms to participate in an underwriting.

7/ Letter from Ray Garrett, Jr., Chairman, to the Honorable John E. Moss, May 2, 1975. Attached hereto as Exhibit B.

8/ NASD Rules of Fair Practice, Art. III, Sec. 1.02. Attached hereto as Exhibit C.

Financing of the NASD discussed the boycott problem in February, 1975, and generally agreed that participation by NASD members in underwritings subject to such restrictions would likely be in violation of just and equitable principles of trade which the NASD, by law, must enforce, subject to oversight by this Commission.

On the instructions of that Committee, the NASD's staff is monitoring the membership of financing syndicates to assure that such participation by NASD members does not occur. Since commencing its monitoring efforts, the NASD reports that it has not discerned any relaxation of those standards. Conduct violative of the NASD Rule we would expect -- and indeed would require -- to be the subject of a vigorously pursued disciplinary proceeding.

At present, therefore, the boycott does not appear to be a factor in the syndicates offering securities traditionally believed to fall within the Commission's jurisdiction, and United States investment bankers appear to be resisting, both individually and through self-regulatory groups, all efforts to implement it. The Commission does believe, however, that beyond the thoughts expressed above, the following sections of the federal securities laws may be relevant to the development of a solution by the Commission to any indication that the Arab Boycott is becoming effective.

I. Action Pursuant to Securities Exchange Act of 1934 for Investment Banking Firms Registered with the Commission

(A) United States investment banking firms are required to register as dealers with the Commission pursuant to Section 15 of the Securities Exchange Act of 1934 (the "Exchange Act"). Pursuant to that section, the Commission has substantial authority with respect to both the registrant and its "associated persons." Associated persons include any person directly or indirectly controlling, controlled by, or under common control with the registrant. Accordingly, if appropriate, the Commission can reach foreign subsidiaries or foreign parents of a United States investment banking firm.

Pursuant to Section 15(b)(7) of the Exchange Act, the Commission is authorized to prescribe by rule that brokers and dealers meet such standards of training, experience, competence and such other qualifications as the Commission finds necessary or appropriate in the public interest or for the protection of investors. In view of the national policy

against discrimination, the Commission could consider adopting rules, imposing as a qualification for engaging in the investment banking business, that registrants undertake to conduct their business without discriminating in the manner described above and not to participate in underwriting syndicates with those who do so discriminate.

(B) Most United States investment banking firms are members of the NASD. The rules of the NASD, as a registered securities association under Section 15A of the Exchange Act, are required by that Act to promote just and equitable principles of trade and may not be designed to permit unfair discrimination between customers, issuers, brokers or dealers.

Specifically, Section 15A(b)(6) of the Exchange Act provides that an association of brokers and dealers shall not be registered as a national securities association unless the Commission determines that the rules of the association are designed "to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system . . . and are not designed to permit unfair discrimination between customers, issuers, brokers or dealers . . . ." As previously noted, it is the NASD's current view that its general rules with respect to just and equitable principles of trade would prohibit discrimination of the type described above by its members in the formation of underwriting syndicates. If necessary, the NASD could adopt a specific rule to implement its current general rules. Any such rule might also prohibit NASD members from participating in any underwriting syndicate any of whose other members were engaged in such discriminatory practices.

If it were believed that such rules should be adopted, and the NASD declined to take that action, the Commission could institute proceedings pursuant to Section 19(c) of the Exchange Act to adopt such rules for the NASD.

Moreover, the NASD is empowered to impose disciplinary sanctions on its members for violations of its rules. Pursuant to Section 19(h)(1) of the Exchange Act, the Commission is authorized, if in its opinion such action is necessary or appropriate, to, by order, suspend, censure or impose limitations upon the activities, functions and operations of a self-regulatory organization if the Commission finds that such self-regulatory organization has violated its own rules or without reasonable justification or excuse has failed to enforce compliance with any such provision by a member thereof.

Furthermore, the Commission is empowered, under Section 21 of the Exchange Act, to conduct investigations to determine whether its rules or the rules of the NASD are being violated and, pursuant to Section 21(d) of the Exchange Act, the Commission may bring an action in the Federal courts to enjoin NASD members from violating NASD rules.

(C) Pursuant to Section 17 of the Exchange Act, investment banking firms must make and file with the Commission such reports as the Commission by rule prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act. Pursuant to this authority, the Commission could require the filing of reports detailing any discriminatory practices, including those described above, which an investment firm engaged in. Not only would any such reports be filed with the Commission and be publicly available, but also, the Commission could require delivery of copies thereof to customers of the firm.

With respect to investment banking firms registered with the Commission pursuant to Section 12 of the Exchange Act (which requires registration for certain publicly-held companies), the Commission could require disclosure to

shareholders of such company of information with respect to discriminatory practices in the various monthly, quarterly and annual disclosure documents required to be filed with the Commission, and in the proxy soliciting materials required to be sent annually to shareholders.

Other issuers are required to file periodic reports with the Commission describing the results of their operations, pursuant to Sections 13 or 15(d) of the Exchange Act. Disclosure under those sections might be required, for example, if the Export Administration Act of 1969 had been violated in connection with acceptance of the discriminatory provisions by the issuer involved. A basic policy of that Act is set forth in 50 App. §2402(5):

> (5) It is the policy of the United States . . . (B) to encourage and request domestic concerns engaged in the export of articles, materials, supplies, or information, to refuse to take any action, including the furnishing of information or the signing of agreements, which has the effect of furthering or supporting the restrictive trade practices or boycotts fostered or imposed by any foreign country against another country friendly to the United States.

In implementing this policy the Secretary of Commerce apparently has required companies to report when they have been requested to participate in a boycott. Participation in a boycott apparently is not prohibited. Nevertheless, the law would be violated if the report has not been furnished. Accordingly, appropriate disclosure might be required.

It should be noted that the Commission, in May, 1975, held public hearings with respect to the extent to which it should require corporate issuers generally to make disclosures covering socially significant issues. 9/ The Commission is presently studying the record of those hearings and expects to address the matters raised in the near future.

9/ See, Securities Act Release No. 5569 (Feb. 11, 1975). Attached as Exhibit D.

(D) To the extent that engaging in discriminatory practices of the type described above may give rise to potential civil liability, the firm involved might be required to reflect contingent liabilities arising in connection therewith in its financial statements and various reports. 10/ For example, a brokerage firm in computing its net capital pursuant to Rule 15c3-1 of the Exchange Act would be required to reflect such contingent liabilities in its computation. Consequently, in appropriate cases, the firm may be required to restrict its activities because of the requirements of the Commission's net capital rule.

10/ With respect to the issuers of securities, Form 10-K, the general form for annual reports by issuers of securities and Form S-1, the basic form for registration of securities, require a registrant to describe briefly any material pending legal proceedings to which the registrant or any of its subsidiaries is a party. The registrant is also required to include similar information as to any such proceedings known to be contemplated by governmental authorities. These are attached hereto as Exhibit E.

Regulation S-X, which sets forth the requirements for the form and content of financial statements filed in compliance with the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935 and Investment Company Act of 1940 and certain other matters pertinent thereto, requires, pursuant to Rule 3-16(i), a brief statement as to contingent liabilities not reflected in the balance sheet.

II. Action Pursuant to the Securities Act of 1933

The Commission might amend its Securities Act of 1933 (the "Securities Act") registration forms to require disclosure in the prospectus of boycott participation. 11/ Disclosure might be required, for example, if the underwriters selected to distribute the securities registered had managed or participated in underwritings, anywhere in the world, in which the boycott had been observed. The required disclosure might include:

> (1) Whether the issuer, or managing underwriter, or any underwriter has managed (or participated in) a syndicate from which, to the knowledge of such manager or underwriter, firms had been excluded pursuant to the boycott; and
>
> (2) Whether the issuer, or any managing underwriter, had any affiliate which managed (or participated) in a syndicate from which, to the knowledge of such issuer, manager or underwriter, firms had been excluded pursuant to the boycott.

Summary disclosure on the cover page of the prospectus might also be appropriate, and the Commission could require a specific bold-face statement to be made in connection therewith. The Commission has long recognized that "sunlight is the best disinfectant," and requiring disclosure of particular practices is frequently sufficient to cause those who would engage in those practices to consider whether they wish their conduct disclosed.

11/ Moreover, the Commission might amend Item 22 (Marketing Arrangements) in Part II, "Information Not Required in Prospectus" of Form S-1, to require a firm to disclose its participation in the boycott.

III. Action Pursuant to the Investment Company Act of 1940

Section 8(b) of the Investment Company Act of 1940 ("Investment Co. Act") requires that a registration statement be filed with the Commission containing, among other things, a recital of certain policies of the registering investment company. Furthermore, the Commission's Guidelines for the Preparation of Forms S-4 and S-5 Including the Prospectus for a Management Company 12/ state that the "company's investment policies (including the types of securities in which it will invest) should be clearly and concisely stated so that they may be readily understood by the investor." This requirement is qualified by the statement that the "discussion should include all the Company's investment policies . . . ." Section 8(b) as interpreted in the Guidelines could be construed to require disclosure of any policy of the investment company which permits its adviser to exercise political, racial, or religious discrimination in the selection of investors for the investment company or in the selection of brokers to execute portfolio transactions for the investment company.

Section 13 of the Investment Co. Act prohibits the deviation by an investment company from the policies recited pursuant to Section 8(b) unless authorized by the vote of a majority of its outstanding voting securities as defined in Section 2(a)42 of the Investment Co. Act.

Accordingly, it could be argued that if any person intends to acquire a controlling interest in an investment adviser of a registered investment company, and to change the investment policies of the investment company or its policies with respect to selecting brokers to execute portfolio transactions for the investment company, or to institute new policies with respect to these matters, appropriate disclosure should be made in any proxy statement or registration statement or amendment thereto required to be filed with the Commission.

12/ Investment Company Act Release No. 7220 (June 9, 1972), at page 4.

The foregoing discussion represents a cursory review of some of the statutory provisions administered by the Commission which could be used to retard or prohibit boycott activities. A further expansion of the ideas set forth herein can be furnished, if desired.