MEMORANDUM

DATE March 10, 1948

TO: Commissioner Edmond M. Hanrahan

FROM: Walter C. Louchheim, Jr., Adviser on Foreign Investment

SUBJECT: International Bank for Reconstruction and Development

I attach hereto National Advisory Council Document No. 627 of March 10, 1948, which incorporates a letter of March 9th to the Chairman of the NAC from Eugene R. Black, U. S. Executive Director of the International Bank for Reconstruction and Development. This letter contains a recommendation that the Council take appropriate steps to bring before the Congress legislation to amend the Securities Act of 1933 and the Securities Exchange Act of 1934 so as to exempt securities issued or guaranteed by the International Bank.

The Chairman of the National Advisory Council has asked me to convey its invitation to the Commission that its Chairman be present at the next meeting of the Council tentatively set for Tuesday, March 16th, at which this matter will be discussed.

I have asked the Secretary of the Commission to give me an opportunity to discuss this matter briefly with the Commission tomorrow morning.

National Advisory Council
Document No. 627
March 10, 1948

INTERNATIONAL BANK FOR

RECONSTRUCTION AND DEVELOPMENT

WASHINGTON 25, D.C.

March 9, 1948

Honorable John W. Snyder
Chairman, National Advisory Council
on International Monetary and Financial Problems
Washington, D. C.

Dear Mr. Chairman:

As you know, in April of last year I recommended that the National Advisory Council on International Monetary and Financial Problems propose to the Congress legislation to permit member banks of the Federal Reserve System to deal in securities of the International Bank for Reconstruction and Development. I also at that time recommended legislation to amend the Securities Act of 1933 so as to exempt securities of the Bank from that Act. My request was based on the need for removing unnecessary restrictions on the borrowing operations of the Bank in order to facilitate the flotation of its securities and the maintenance of an orderly market in them. After considerable discussion I agreed to withdraw my request on the understanding that I might renew it at a later date, if experience should demonstrate the need for such legislation.

The International Bank is now and will for some time to come be dependent mainly on the securities markets of the United States for the raising of funds for use in its lending operations. In July of last year the Bank floated two issues of its bonds aggregating $250,000,000, principal amount. Although the initial distribution was successful, the subsequent market for the bonds has been narrow. Furthermore, as the aggregate amount of its bonds outstanding increases, the Bank undoubtedly will encounter increasing difficulty in placing new issues. It is, therefore, important that the Bank's bonds shall be distributed to a widening circle of investors.

In view of the pressing need for loans which the Bank will face during the next few years, it is also of importance that, in so far as shall be consistent with proper protection to United States investors, legal restrictions which tend to hamper the Bank in its borrowing operations should be removed. I believe that the international character of the Bank and its established reputation for open and sound methods of operation

entitle it to a confidence which makes many of the restrictions that now impede its operations unnecessary in the public interest. I am, therefore, writing in order to bring to your attention the facts with regard to such restrictions and to request your aid in having them removed.

The restrictions to which I refer are contained in or arise out of the following statutes:

The Securities Act of 1933
The Securities Exchange Act of 1934
Section 5136 of the Revised Statutes

I shall here discuss them in the above order. I also enclose with this letter a memorandum setting forth concrete suggestions for legislation to remove such restrictions.

1. The Securities Act of 1933

As you know, this Act regulates the public offering of securities in interstate commerce. Before any such offering can be made an elaborate registration statement must be filed with the Securities and Exchange Commission and must have become effective.

Neither the Securities Act of 1933 nor the Securities Exchange Act of 1934 was drawn with any institution such as the Bank in mind and their provisions are not, therefore, adapted to the operations of the Bank. In fact, securities issued by the Bank are within the spirit, if not the letter, of the exemptions specified in those Acts. The Securities and Exchange Commission tacitly recognized that fact when, prior to the offering by the Bank of its bonds in July, 1947, the Commission adopted a number of rules which in effect exempted the bonds from certain provisions of such Acts. Those rules, however, did not remove the basic inconsistencies which arise in attempting to apply those Acts to the borrowing operations of the Bank. In particular, the application of the Acts to securities of the Bank not only imposes on the Bank restrictions which are not imposed on the Federal Government or the states or municipalities in the marketing of their securities, but, because of the manner in which the Bank must as a practical matter market its bonds, it even imposes on the Bank more stringent restrictions than are imposed upon private issuers. I shall indicate a few of the more serious of such inconsistencies and their effect upon the Bank.

In connection with the offering by the Bank in July, 1947, of two issues of bonds aggregating $250,000,000, principal amount, the Bank decided, after consultation with a number of investment bankers and securities dealers and thorough consideration of various suggested methods of distributing its bonds, that the

most effective and economic method would be to offer the bonds for sale on a commission basis through a widespread group of securities dealers. Accordingly, the Bank's bonds were sold through over 1700 dealers in 43 states of the United States and the District of Columbia at a commission of ½ of 1% on the 25 year bonds and ¼ or 1% on the 10 year bonds. The participations of the dealers ranged from $5,000 to $3,465,000, principal amount, of bonds and their commissions ranged from $12.50 to $13,950.00.

In order to prepare to market such a large issue through such a large and far flung group of dealers, it was necessary for the Bank to consult with bankers and securities dealers throughout the country as to the terms of the issue and the arrangements for the offering. Since the Securities and Exchange Commission would not permit the registration statement to become effective under the Securities Act until the prices and terms of the bonds and the arrangements for their offering had been determined and set forth in the registration statement, most of such consultation took place before the registration statement became effective.

The Securities Act prohibits the use of instrumentalities of interstate commerce or the mails "to sell or offer to buy" a security (except exempt securities) unless a registration statement is in effect for such security. For that purpose the term "sell" is defined in the Act to include "every contract of sale or disposition of, attempt or offer to dispose of, or solicitation of an offer to buy, a security" not including however, preliminary negotiations or agreements between an issuer and any underwriter. Under that definition, and in view of the Bank's method of selling its Bonds through a large group of dealers, the Securities and Exchange Commission was of the opinion that the preliminary communications between the Bank and securities dealers before the registration statement became effective constituted an offering of the bonds for sale contrary to the provisions of the Securities Act. The Bank did not and does not agree with such an application of the Act. Nevertheless, it would be seriously embarrassing to both the Commission and the Bank, if the Bank should again offer its securities to the public in a manner which the Commission should consider to be contrary to the provisions of the Securities Act.

In that connection it should be borne in mind that, on the one hand, securities of the United States Government and of any state or political subdivision thereof are exempt from the provisions of the Act and, on the other hand, private issuers who offer their securities through underwriters are permitted to make preliminary agreements with underwriters before their registration statements became effective. The Bank could, of course, do the same thing, if it should offer its bonds through underwriters, but it is neither practical

nor economical for the Bank to do so. Consequently, as I have said before, as a practical matter the Securities Act as interpreted by the Commission would restrict the marketing operations of the Bank more than those of such governmental of private issuers.

A further instance of that is to be found in the liability which is imposed on dealers in the Bank's bonds by Section 12 of the Act. The Commission, by rule, has exempted such dealers from liability as underwriters under Section 11 of the Act, but such dealers remain subject to liability under Section 12. That section provides in substance that any person who sells a security (except certain exempt securities) in interstate commerce by means of a prospectus which contains an untrue statement of a material fact or which omits to state a material fact shall be liable to repurchase the security or to pay damages if the security has been disposed of, unless he can show that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission. In the usual case of the distribution of securities through underwriters, they make an extensive investigation of law and fact and the dealers through whom the bonds are sold customarily rely on that investigation for protection against liability under Section 12 of the Act. As is stated above, the Bank does not sell its securities through underwriters but sells them directly to a large group of dealers. It is not feasible for those dealers to make any investigation with regard to the statements contained in the prospectus for the Bank's securities, especially as many of the statements contained in the prospectus with regard to the lending operations of the Bank may be based on the results of months of investigation by the Bank both in this country and abroad. It is, therefore, both incongruous and unfair to impose upon dealers in the Bank's securities legal responsibility for the accuracy of the statements which are made in the prospectus.

Both because of the international character of the Bank and because of the large amounts of securities which the Bank will have to sell and the desirability of as widespread a distribution of its securities as is possible, offerings of securities by the Bank partake more of the character of offerings of United States Government securities (which are expressly exempted from the Securities Act) than of offerings by private issuers which are subject to the Act. Accordingly, for the reasons which I have set forth above, I believe that the Securities Act of 1933 should be amended so as to exempt therefrom securities issued or guaranteed by the Bank.

2. The Securities Exchange Act of 1934

The Securities Exchange Act of 1934 contains provisions for regulating securities exchanges and over-the-counter markets and transactions on such exchanges and markets. As I have said, this Act also was not drawn with any institution such as the Bank in mind and its provisions are not adapted to the Bank.

At the request of the Bank, the Securities and Exchange Commission has made certain rulings under which the Bank's securities are exempted from some of the more burdensome provisions of the Act. There are, however, other provisions of the Act which tend to hamper the Bank in its operations and with which it should not be required to comply.

For example, the Act contains provisions regulating purchases and sales of securities which, while intended to prevent fraudulent manipulation of the prices of such securities, are so broad or confer such broad regulatory power on the Securities and Exchange Commission as to hamper the Bank in its operations. Because of the large amount of securities which the Bank may ultimately issue and the operation of the amortization and redemption provisions of its loans, the Bank may frequently find it necessary or advisable to purchase and also to sell its own securities, while at the same time it may be preparing for a public offering of its bonds. Furthermore, the Bank may quite properly find it advisable at times to stabilize the market for its bonds. Differences of opinion as to the proper application of the provisions of the Act and the regulations of the Commission to such transactions are bound to arise to the embarrassment of both the Commission and the Bank. That is especially true because the definition under the Act of lawful "stabilization" of securities has not been clearly drawn either by the Securities and Exchange Commission or the courts.

Securities of the United States Government, of any state or agency thereof (such as, the Port of New York Authority) and of municipal governments are exempt from such provisions. Also exempt, pursuant to designation by the Secretary of the Treasury, are securities of various corporations in which the United States Government has an interest, such as, Federal Farm Loan Bonds and Federal Home Loan Bank Debentures. Under its Articles of Agreement the Bank cannot buy and sell its securities in the United States without the approval of the United States Government (Article IV, Section 8). Consequently, even if securities of the Bank should be exempt from such provisions of the Securities Exchange Act, there would be no danger that the Bank might trade in its securities in any way that would be contrary to the public policy of the United States.

To cite another example, under Sections 7 and 8 of the Securities Exchange Act, the Federal Reserve Board has issued regulations which prohibit brokers and dealers from extending credit on a security registered on a national securities exchange (other than an exempted security) in excess of 25% of its current market value. There would obviously be a broader market for the Bank's securities if they were not subject to such restrictions.

Sections 12 and 13 of the Securities Exchange Act require the filing of certain information in connection with the registration of securities under that Act and the filing of certain periodic reports designed to keep the original registration up to date. Although at present such requirements impose no great burden on the Bank, nevertheless as the volume of the Bank's operations increases, the necessity of filing such information, in the form and in the detail prescribed by the Securities and Exchange Commission, may well impose a considerable burden on the Bank.

Under Section 3(a)(12) of the Act obligations of the United States and of any state or political subdivision or agency thereof are classed as "exempted securities." In addition, the Secretary of the Treasury is authorized to designate as exempted securities obligations of "corporations in which the United States has a direct or indirect interest," and the Securities and Exchange Commission is authorized to exempt other securities from the operation of one or more provisions of the Act. Both the Secretary of the Treasury and the Securities and Exchange Commission have heretofore denied requests by the Bank that its securities be exempted from the Act.

Accordingly, I propose that Section 3(a)(12) of the Act be amended so as expressly to exempt from the Act securities issued or guaranteed by the Bank.

3. Statute Restricting Power of National Banks to Deal in Securities.

Under Section 5136 of the Revised Statutes and the regulations of the Comptroller of the Currency which have been issued thereunder, national banks and state member banks of the Federal Reserve System cannot underwrite, or engage in the business of dealer or broker for profit in, securities of the Bank. (Section 5136 of the Revised Statutes, as amended; 12 U.S.C. 24; See also, Section 9 of the Federal Reserve Act, as amended; 12 U.S.C. 335).

In order that the borrowing operations of the Bank shall be effective, it is essential not only that its bonds be widely distributed but also that there be an active sustained market for its bonds. At present, the market for the Bank's bonds is narrow and subject to relatively wide and erratic fluctuations. That is not a healthful condition. If national banks and member banks of the Federal Reserve System are permitted to deal in the Bank's bonds, they could not only participate in the initial distribution of such bonds, thus broadening the group of dealers, but they would also be interested in maintaining a market for

such bonds, which would have a stabilizing effect on their prices.

Accordingly, I propose that Section 5136 of the Revised Statutes be amended so that national banks and state member banks of the Federal Reserve System may be authorized to deal in securities of the Bank, as they presently may do in obligations of the United States or of any state or political subdivision thereof, and of the Federal Land Banks, Federal Intermediate Credit Banks and Federal Home Loan Banks.

I enclose herewith a memorandum of concrete suggestions for legislation to effect the purposes above set forth. As I have said, I believe that the international character of the Bank and the reputation which it has already established for open and sound methods of operation entitle it to the cooperation of the United States Government in the removal of the above-mentioned restrictions.

May I interject at this point that the exemption of securities of the Bank from the Federal and state securities acts will not mean that the investing public will be deprived of any information concerning the Bank which would otherwise be available to it. The Bank would continue to publish a prospectus in connection with its bond issues, which will be as fully informative as that required under the Securities Act. The Bank will continue to publish its annual report and quarterly financial statements, which contain even more information than is contained in the reports that the Bank is required to file under the Securities Exchange Act of 1934.

Accordingly, I respectfully request that the National Advisory Council take appropriate steps to bring the matter before the Congress. If you or the Council shall require any further information concerning the matters herein referred to and you will so advise me, I shall be glad to endeavor to furnish it.

Very truly yours,

/s/ Eugene R. Black

Eugene R. Black
United States Executive Director

Enclosure

National Advisory Council
Document No. 627

MEMORANDUM*

ACT TO AMEND THE SECURITIES ACT OF 1933, THE SECURITIES EXCHANGE ACT OF 1934 AND THE NATIONAL BANK ACT.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Section 1. Paragraph (a)(2) of section 3 of the Securities Act of 1933 as amended (U.S.C. title 15, sec. 77c) is amended by adding to the end thereof the following words: "or any security issued or guaranteed by the International Bank for Reconstruction and Development;".

Section 2. Paragraph (a)(12) of section 3 of the Securities Exchange Act of 1934 as amended (U.S.C. title 15, sec. 78c) is amended to read as follows:

(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; securities issued or guaranteed by the International Bank for Reconstruction and Development; 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."

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* Underlinings indicate new matter added.

Section 3. Paragraph seventh of section 5136 of the Revised Statutes as amended (U.S.C., title 12, sec. 24) is amended by adding at the end thereof the following new sentence: "The limitations and restrictions herein contained as to dealing in and underwriting investment securities shall not apply to obligations issued by or guaranteed as to principal and interest by the International Bank for Reconstruction and Development; PROVIDED, that the limitation hereinbefore set forth with regard to the amount of investment securities of any one obligor or maker which may be held by the association for its own account shall apply to obligations so issued or guaranteed by said Bank."

Section 4. This act shall take effect immediately.