Trans. - Just really to be the only summary copy - please return

rec

(8)

Mr. Luxford

April 24, 1944

Mr. Minskoff

Re: Proposed legislation designed to give added protection to American investors in foreign securities in post war period.

It may be anticipated that in the post war period one of the most important international economic and financial problems will be the provision of foreign capital in the form of long term loans to assist in the rehabilitation of foreign economies. Such capital will be required for reconstruction, for the conversion of industries to peace-time needs and for the development of productive resources. To this end, it is understood, thought is presently being given to the creation of an International Reconstruction Bank. The primary aim of the Bank is "to encourage private capital to go abroad for productive investment by sharing the risks of private investors and by participating with private investors in large ventures." In view of the fact that the success of the program depends largely on the extent to which private investment channels are encouraged to participate in making foreign loans it is helpful to give some thought to existing U. S. laws which affect private foreign loans.

Prior to considering the applicable U. S. laws, it is necessary to make certain basic assumptions in order to place the plan for an International Reconstruction Bank in its proper frame of reference. It may be assumed, for example, that the United Nations have defeated Germany and Japan and that, in general, hostilities have ceased throughout the world. It may be assumed further that because of the destruction caused directly or indirectly by the war that the need for reconstruction in general and for replacement of productive facilities in particular will be one of the most pressing necessities of the post war period. It may also be assumed that the ability of many nations to resume trade and commercial relations will depend substantially on the extent to which they are rehabilitated and the extent to which their ability to produce has been restored.

Viewed from the foregoing perspective and considering the purposes for which the Reconstruction Bank is proposed and the lines along which it is intended to operate, an analysis has been made of existing U. S. legislation which may affect the operations of the proposed Bank. The Neutrality Act, the Johnson Act and the Securities Act of 1933,

copies sent to Luxford, Aaron & Lesser

which have a direct bearing on the making of private foreign loans, will be considered in that order.

(A) The Neutrality Act was passed in November 1939 and was designed to minimize the possibility of this Government's becoming embroiled in World War II as a result of financial involvement. It prohibits any person within the United States from extending credit to any belligerent government or any person acting for or on behalf of such government. In February 1942 the Congress by resolution added the following language to the section prohibiting financial transactions with belligerents: "This section shall not be operative when the United States is at war." As a result, the restrictions of the Neutrality Act on foreign loans have been removed for the duration. It may be observed also that on the basic assumption that there will be a world-wide cessation of hostilities when Germany and Japan are defeated there will be no country to which the provisions of the Neutrality Act would apply.

(B) In 1934 the Congress of the United States enacted what has become known as the Johnson Act. This statute was intended primarily as a penalty against foreign governments and political subdivisions thereof which had defaulted on their obligations to the Government of the United States. The Act prohibits any person within the jurisdiction of the United States from extending credit to any foreign government or political subdivision thereof, or anyone acting on their behalf which "is in default in the payment of its obligations, or any part thereof, to the Government of the United States."

Unlike the Neutrality Act, the Johnson Act by its terms and prohibitions would carry over to the post war period and would remain an effective obstacle to private investors who might otherwise be willing to participate in the reconstruction of the productive facilities of foreign governments which are presently in default to the United States. Since practically all the European countries have been declared to be in default, the prohibitions of the Johnson Act would defeat the purpose of the Bank and make its operation impossible.

Of course it may be possible to circumvent the Johnson Act to a certain extent by making loans to private firms through their governments or guaranteed by their governments instead of making the loans to the foreign governments directly. However, it may be thought that such loans skirt rather close to the edge of the restrictions imposed by Congress and that it would be preferable in any event to have a congressional mandate in so important a field.

When the whole problem of foreign loans is reconsidered, particularly in the light of the magnitude of this Government's Lend-Lease expenditures for Allied and other nations whose defense the President

deemed vital to the defense of the United States, the conclusion may well be reached that the restrictions imposed by the Johnson Act upon private foreign loans are no longer appropriate or realistic.

From a conviction that the Johnson Act as an instrument of reprisal against defaulting nations, however appropriate and justified it may have been when enacted, should now be set aside in view of the compelling historical changes that have taken place, thought has been given to the repeal of the Johnson Act and the substitution therefor of other legislation which would simultaneously:

1. Remove the present prohibitions against making loans to defaulted foreign governments; and

2. Establish adequate safeguards to protect American investors who, as a result of the repeal of the Johnson Act and the stimulus furnished by the Reconstruction Bank, may be encouraged to take part in post war reconstruction and development of the world's productive facilities.

Prior to discussing the methods or techniques or type of machinery required for setting up the proper protective devices for American investors, it is useful to examine the existing controls for the protection of American investors in foreign securities which were established by Congress in the Securities Act of 1933.

(C) Securities Act of 1933. The provisions of this Act may be considered in conjunction with the Securities Exchange Act of 1934 (establishing the Securities and Exchange Commission). Together they set up an elaborate machinery to prevent the dissemination of false and misleading information regarding securities publicly offered and sold in interstate commerce or through the mails. The Commission is authorized to compel a full and fair disclosure to investors of the material facts with respect to such securities. To this end registration statements are required to be filed on forms approved by the Commission and to contain specified information including financial statements, exhibits and a form of the prospectus proposed for use in selling the securities.

The key to the Commission's operational control is found in the provisions relating to registration statements. Except for certain exemptions no securities may be offered or sold to the public in interstate commerce or through the mails through issuers, underwriters, or dealers unless there is in effect a registration covering the securities. The Commission's primary power rests on the fact that it may refuse registration in cases where the information given is incomplete or misleading and where such registration has already become effective it may suspend

registration on the same grounds. Moreover, no registered security may be sold through the mails or in interstate commerce unless the prospective purchaser is furnished with a prospectus giving the pertinent facts as to the issue.

It may be noted that although the Act provided both for foreign as well as domestic securities the actual administration of the Act has been practically exclusively confined to issues of domestic securities. The reason for this is somewhat obvious in view of the history of the past 10 years.

The Securities Act was passed during a world-wide economic depression in which the confidence of potential investors was thoroughly shaken. Then, in 1934, the passage of the Johnson Act placed a legal quietus on loans to foreign governments and political subdivisions thereof which were in default, and a psychological damper on other foreign financial commitments. Subsequently, the Johnson Act was fortified by the parallel prohibitions embodied in the Neutrality Act with respect to belligerent nations. Finally, with the coming of war to the United States and even before then with the advent of Lend-Lease most important extentions of credit were on a government to government basis.

As a result, during the past 10 years while the Securities Exchange Commission was accumulating a wealth of experience and precedent in the handling of domestic securities, the field of foreign securities was largely untouched.

From the foregoing brief review of existing legislation pertaining to the extensions of credit abroad it may be concluded that
(1) the Neutrality Act, on the assumptions made at the outset, will not affect the functioning of the proposed Bank,
(2) the Johnson Act, unless amended or repealed, would frustrate the purpose of the Bank, and
(3) the Securities Act of 1933 would furnish a measure of protection to the American investors who were encouraged to venture into the foreign investment field.

It seems manifest that implicit in the plan for an International Reconstruction Bank along the lines proposed is the suggestion that the Johnson Act be modified or repealed. Aware of the fact that in passing the Johnson Act the Congress was as much concerned with protecting American investors as it was with punishing foreign defaulters, and cognizant that the exigencies of post war cooperation demand extensions of credit from the one nation which is capable of extending such credit and whose tremendous accumulated liquid reserves make it advantageous for it to participate in the post war reconstruction, it is submitted that the Johnson Act should be repealed or amended and that simultaneously with such action there should be a strengthening of existing controls for the protection of American investors abroad.

There are at least two methods of accomplishing this objective.

1. Amendment to the Johnson Act. Under this method of procedure the prohibitions of the Johnson Act would be retained but a proviso would be added which would permit the avoidance of those prohibitions upon compliance with specified terms and conditions. However, this method of dealing with the problem has a number of shortcomings. To begin with, it would not give any additional protection to purchasers of foreign securities where the issuer is not itself in default although it may be a political subdivision of a country in default or a corporation owned or controlled by a country in default. Also any rigid formula applicable only to defaulting nations, and to persons real or juridical acting on their behalf, would lend itself to abuse and would in any event be too restricted in scope to affect the bulk of foreign investments.

2. Amendment to Securities Act. An alternative method of dealing with the problem would be to repeal the Johnson Act entirely and to amend the Securities Act of 1933 with respect to securities issued by "foreign persons." The use of this technique would have a number of important advantages.

(a) It would permit the safeguards adopted to protect American investors to apply to all purchases of foreign securities and would not be limited to loans made to nations which had failed to service their debts of World War I. Conceivably such a nation might be a considerably safer risk for further loans than one which was not in default to the United States as such but which may well have been in default to private investors of the United States.

(b) The adoption of the techniques and procedures already available in the Securities Act would simplify the task of giving adequate protection to American investors in foreign securities. Moreover, the language of the Securities Act has been carefully worked out and has been interpreted in hundreds of favorable decisions which strengthened its scope and effectiveness.

(c) Assuming that the function of administering the "amended" Johnson Act would fall to the Securities and Exchange Commission, which is well suited for that work, it would manifestly be desirable to permit it to operate within the framework of the Securities Act with which it is familiar and thus gain the full benefit of its experience in handling domestic securities.

(d) To the extent that the duties imposed by the "amended" Johnson Act parallel those imposed by the existing Securities

Act there would be needless duplication and possible confusion.

On the assumption that the second of the above methods would attain the desired objective more effectively and with less disturbance to existing controls and procedures the remainder of this memorandum will be devoted to a concise description of the proposed amendments to the Securities Act of 1933 and a brief discussion of the purpose each amendment is intended to serve.

1. The meat of the proposed amendment to the Securities Act of 1933 is the change in the provisions dealing with the "taking effect of registration statements" with respect to foreign securities. Under existing law on the 20th day after the filing of a registration statement the registration becomes automatically effective unless the Commission has taken affirmative steps prior to that time to indicate its refusal to permit such statement to become effective and has given notice for hearings at which its ruling could be contested. With respect to domestic securities these provisions remain intact: With respect to foreign securities the proposed amendment contemplates a complete change of approach.

A registration statement relating to a foreign security does not become automatically effective as a result of inaction by the Commission for 20 days but requires affirmative action by the Commission to make it effective. The proposed amendment requires the Commission to file a report on the security and it is only after this report is filed and published that the registration statement becomes effective. The pertinent amendatory language reads as follows:

> "* * * the effective date of a registration statement relating to a security issued by a foreign person shall be the 40th day after the filing thereof or the 10th day after the Commission has filed and published its report on such security containing such conclusions of fact and other relevant material as it deems necessary to safeguard the public interest and protect investors, whichever date is the later. This report should contain the Commission's findings with respect to the matters dealt with in the registration statement and should include particularly a consideration of
>
> "(1) The balance of payments position of the country of such foreign person as affecting the ability of such person to meet the provisions of the security with respect to repayment, servicing, payment of dividends and the like;
>
> "(2) The exchange control laws and the exchange control policies of the country of the foreign person as affecting

the likelihood of the foreign person's meeting the provisions of the security with respect to repayment, servicing, payment of dividends and the like;

"(3) The proposed use of the funds to be obtained from the sale of the security as affecting the likelihood of the foreign person's meeting the provisions of the security with respect to repayment, servicing, payment of dividends and the like;

"(4) Whether the security is reasonably adapted to the revenue producing capacity of such foreign person;

"(5) Whether the security is reasonably adapted to the financial structure of such foreign person;

"(6) Whether the financing by the issue and sale of a particular security is necessary or appropriate to the economic and efficient operation of the business of such foreign person or, where it is a government or political subdivision, of its commerce and industry;

"(7) Whether the fees, commissions, or other remuneration, to whomsoever paid, directly or indirectly, in connection with the issue, sale or distribution of the security are reasonable;

"(8) Whether the terms and conditions of the issue or sale of the security are detrimental to the public interest or the interest of investors."1/

It will be noted that although the Commission is given broad discretion, it is obliged to meet specific minimum requirements which include, in addition to an analysis of the matters dealt with in Schedule B of the Securities Act of 1933 2/ special consideration of the above enumerated

---

1/ Paragraphs 4, 5, 6, 7 and 8 were lifted almost entirely from the Public Utilities Holding Company Act.

2/ SCHEDULE B

(1) Name or borrowing government or subdivision thereof;

(2) specific purposes in detail and the approximate amounts to be devoted to such purposes, so far as determinable, for which the security to be offered is to supply funds, and if the funds are to be raised in part from other sources, the amounts thereof and the sources thereof, shall be stated;

(3) the amount of the funded debt and the estimated amount of the floating debt outstanding and to be created by the security to be offered, excluding intergovernmental debt, and a brief description of the date, maturity, character of such debt, rate of interest, character of amortization provisions, and the security, if any, therefor. If substitution of any security is permissible, a statement of the conditions under which such substitution is permitted. If substitution is permissible without notice, a specific statement to that effect;

items. Although the foregoing items are almost self-explanatory, it may be helpful to state, briefly, the functions they were intended to perform:

(1) and (2) deal with factors which, in the case of foreign persons other than governments, are matters over which the issuer of the security has no control. They deal with the balance of payments position, the exchange control laws and the exchange control policies of the country of the issuer which may affect the ability of the issuer to meet its contractual obligations with respect to repayment, servicing, payment of dividends, etc., in a specified currency.

2/ continued:

(4) whether or not the issuer or its predecessor has, within a period of twenty years prior to the filing of the registration statement, defaulted on the principal or interest of any external security, excluding intergovernmental debt, and, if so, the date, amount, and circumstances of such default, and the terms of the succeeding arrangement, if any;

(5) the receipts, classified by source, and the expenditures, classified by purpose, in such detail and form as the Commission shall prescribe for the latest fiscal year for which such information is available and the two preceding fiscal years, year by year;

(6) the names and addresses of the underwriters;

(7) the name and address of its authorized agent, if any, in the United States;

(8) the estimated net proceeds to be derived from the sale in the United States of the security to be offered;

(9) the price at which it is proposed that the security shall be offered in the United States to the public or the method by which such price is computed. A variation in price may be proposed prior to the date of the public offering of the security, but the Commission shall immediately be notified of such variation;

(10) all commissions paid or to be paid, directly or indirectly, by the issuer to the underwriters in respect of the sale of the security to be offered. Commissions shall include all cash, securities, contracts, or anything else of value, paid, to be set aside, disposed of, or understandings with or for the benefit of any other persons in which the underwriter is interested, made, in connection with the sale of such security. Where any such commission is paid, the amount of such commission paid to each underwriter shall be stated;

(11) the amount or estimated amounts, itemized in reasonable detail, of expenses, other than the commissions specified in paragraph (10) of this schedule, incurred or borne by or for the account of the issuer in connection with the sale of the security to be offered or properly chargeable thereto, including legal, engineering, certification, and other charges;

(12) the names and addresses of counsel who have passed upon the legality of the issue;

(13) a copy of any agreement or agreements made with any underwriter governing the sale of the security within the United States; and

(14) an agreement of the issuer to furnish a copy of the opinion or opinions of counsel in respect to the legality of the issue, with a translation, where necessary, into the English language. Such opinion shall set out in full all laws, decrees, ordinances, or other acts of Government under which the issue of such security has been authorized. May 27, 1933, c. 38, Title I, schedules A, B, 48 Stat. 88, 91.

(3) and (4) deal with the ability of the issuer to meet its obligations, taking into consideration its present financial position, i.e., its "revenue producing capacity" and the effect upon that of the use to which it intends to put the funds, i.e., whether a productive use or a mere bailing out of defaulted bondholders.

(5), (6) and (7) are regulatory provisions in the sense that the Commission is required to pass upon the method and technique of the issuer of the security in obtaining funds. Such questions as whether the corporation should finance itself by floating a loan as distinguished from issuing more capital stock would be pertinent under those provisions. Under these provisions also the Commission could examine into the corporate structure of the issuer and, in a negative way, decide what kind of security would be "reasonably adapted" to its purpose. Further this gives the Commission an opportunity to call attention to the size of the fees and commissions paid in connection with the issue, sale or distribution of the security.

(8) is a mixed question of financial soundness and public policy. How far the Commission could go or would be willing to go in its report in discussing the question of whether the particular security is detrimental to the public interest is uncertain, but the fact that the power is there may be a useful weapon in keeping in line foreign firms and governments desiring to make use of American capital.

The proposed amendment to the TAKING EFFECT OF THE REGISTRATION STATEMENT represents a compromise between the Securities Act, which does not go far enough, and the Utilities Act which goes further than it may be desirable to go in dealing with foreign securities.

The Securities Act provides that the registration statement becomes effective automatically after the 20 days unless the Commission has taken affirmative action to prevent its becoming effective. On the other hand, under the Utilities Act, securities cannot be issued until after the Commission has passed upon their merits. Thus, if the Commission should find that, with respect to a particular utility, the security offered is not reasonably adapted to its financial structure or its earning power, or that the fees, commissions, etc., are unreasonable, or that the terms or conditions of the issue of sale are detrimental to the public interest or interest of investors, such determination would prevent the issuance of the security.

The present amendment to the Securities Act is an in-between measure. The Commission investigates and reports upon these various items

and others, which are in the nature of factual conclusions, but such report no matter how adverse, does not have the effect of preventing the registration statement from becoming effective. In other words if the issuer has filed a true and accurate registration statement and the Commission has filed and published its report, the issuer may thereafter proceed with the marketing of the security regardless of whether the report was favorable, neutral, or adverse.

The advantages to be derived from requiring a responsible governmental agency to make an independent impartial appraisal of the significant factual data is too self-evident to warrant elaborate justification. Suffice it to say that under the proposed amendment the United States investor will not only have the protection of a truthful prospectus but will have, in addition, the benefit of an unbiased, expert analysis of the information submitted and an evaluation of certain ultimate facts which may be relevant in determining not only whether the issuer is financially responsible, but whether it will be prevented from meeting its contractual obligations as a result of factors beyond its control such as its country's unfavorable balance of payments position, restrictive exchange controls, etc.

It is not proposed that the Commission will have any responsibility for passing on the question of whether a particular security is a good investment. It will be the function and duty of the Commission, however, to call attention to the pitfalls that may be anticipated and provide a warning against those dangers which the experienced and well informed can reasonably foresee. If the issuer submits a registration statement which fairly and fully discloses the material facts the Commission is powerless to prevent such registration statement from becoming effective. This would seem to be true even though the statement were so long and so complex and so highly technical that it would be fully understandable only to the most highly trained technicians. In such a case the report of the Commission would perform an invaluable service.

In addition to the principle proposed amendment, described above, there are several other minor supplementary proposed changes in the Securities Act.

2. Under DEFINITIONS the additional term "foreign person" is added. The proposed amendatory language reads:

> "The term 'foreign person' shall include any person acting for or on behalf of a foreign person."

In the present Securities Act the word person is defined and the word foreign is not defined, and, therefore, may be deemed to be used in its ordinary sense. The proposed amendment does not attempt to define the word foreign but merely broadens the concept by including as a foreign

person "any person acting for or on behalf of a foreign person." This is similar to the coverage of the Johnson Act which referred to "any organization or association acting for or on behalf of a foreign government or a political subdivision thereof."

Of course the use of the term "foreign person" is a very substantial broadening of the coverage of the Johnson Act because person is not limited to a government or a political subdivision but includes individuals, corporations, partnerships, etc. In another sense the coverage of the Securities Act even as "amended" would be narrower than that of the Johnson Act in that the Securities Act is limited to public offerings, whereas the Johnson Act covered any extension of credit to a defaulted foreign government.

3. Under the section dealing with the PROHIBITIONS RELATING TO INTERSTATE COMMERCE AND THE MAILS, an additional prohibition is added with respect to securities issued by a foreign person. The original Act dealing with domestic as well as foreign securities focused on the sanctions which the Federal Government could use with respect to interstate commerce and the mails. It may be that these sanctions which can be very potent, if properly enforced, are adequate for the purpose. On the other hand, in view of the fact that foreign securities are being singled out for special treatment in other respects, it would seem that the full power of the Federal Government over foreign commerce could be invoked to make a forthright prohibition against the sale or purchase of such securities "anywhere in the United States or in any place subject to its jurisdiction."

4. Under the section dealing with INFORMATION REQUIRED IN PROSPECTUS, the amendment requires that in addition to other information called for by the Securities Act a copy of the Commission's report shall be appended to the prospectus. Thus, although the Commission cannot prevent an undesirable security from being issued, it can be certain that the investing public will be aware of its findings and conclusions.

5. Under the section dealing with SECURITIES EXEMPTED FROM THE APPLICATION OF THE ACT two amendments were added. One relieves securities which have complied with existing law from the necessity of going through a second registration under the new law. The other specifies that certain of the exemptions are not to apply to "foreign persons."

6. Under the section dealing with UNLAWFUL REPRESENTATIONS there is an amendment which prohibits the use of the Commission's report as a basis for representations concerning the contents of the registration statement. This amendment is of a purely technical nature and is intended to avoid misrepresentations.

EEM:iej
4/24/44

Memorandum sent to Mr. Brenner.

7/11/45