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EXTENSION OF GUARANTEED REA LOANS FROM SECURITIES AND EXCHANGE COMMISSION

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HEARING

BEFORE THE

SUBCOMMITTEE ON AGRICULTURAL CREDIT AND RURAL ELECTRIFICATION

OF THE

COMMITTEE ON AGRICULTURE AND FORESTRY

UNITED STATES SENATE

NINETY-THIRD CONGRESS

SECOND SESSION

ON

HR. 12526

A BILL TO AMEND SECTIONS 306 AND 308 OF THE RURAL
ELECTRIFICATION ACT OF 1936, AS AMENDED

JULY 18, 1974

Printed for the use of the Committee on Agriculture and Forestry

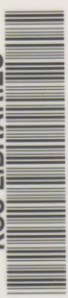


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EXTENSION OF GUARANTEED REA LOANS FROM SECURITIES AND EXCHANGE COMMISSION

THURSDAY, JULY 18, 1974

U.S. SENATE,
SUBCOMMITTEE ON AGRICULTURAL CREDIT AND
RURAL ELECTRIFICATION,
COMMITTEE ON AGRICULTURE AND FORESTRY,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 o'clock a.m., in room 324, Russell Senate Office Building, Hon. George McGovern (chairman of the subcommittee) presiding.

Present: Senators McGovern and Dole.

STATEMENT OF HON. GEORGE McGOVERN, A U.S. SENATOR FROM THE STATE OF SOUTH DAKOTA

Senator McGOVERN. The purpose of today's hearing by the Subcommittee on Agricultural Credit and Rural Electrification is to consider H.R. 12526, a proposed amendment to the Rural Electrification Act of 1936, as amended. This bill would exempt securities issued and guaranteed under the auspices of the Rural Electrification Act from most laws administered by the Securities and Exchange Commission.

The intent of the bill is to facilitate the issuance of securities that would support the process of rural electrification. The needs for additional capital, extension of service, and improvement of service are vital for rural America and the country as a whole.

The current money market conditions and inflation rates are making it increasingly difficult for all people and businesses, but I think it has been especially difficult for our rural electric borrowers. Knowing the need and seeing the difficulties in finding adequate money to meet the needs causes me to be very receptive to any measure that might improve the situation.

I am aware, however, that the SEC is concerned about some provisions of this bill and the possible implications upon their efforts to control the securities market. I am sure it is not the intent of the House, and I know it is not the intent of the Senate to undermine the SEC's operations.

I am hopeful that as we examine the bill and hear the testimony we can reach a satisfactory agreement that will both assist in rural electrification and at the same time retain the integrity of the SEC.

Other members of the subcommittee may wish to comment on this bill at some point, but we have distinguished witnesses ready to testify, so, I will not extend my own comments at this time, but will leave as much time as possible for the witnesses.

I would like to add that a staff explanation of H.R. 12526, prepared by the committee staff, and the bill, will be printed at this point in the record.

[H.R. 12526 plus the staff explanation follows:]

[H.R. 12526, 93d Cong., 2d sess.]

AN ACT To amend sections 306 and 308 of the Rural Electrification Act of 1936, as amended.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 306 of the Rural Electrification Act of 1936, as amended, is amended—

(a) by adding at the end of said section 306 the following:

“Any security, representing beneficial ownership in a note or block of notes guaranteed under this title, issued by a private entity shall be exempt from laws administered by the Securities and Exchange Commission, except sections 17, 22, and 24 of the Securities Act of 1933, as amended; however, the Administrator shall require that (i) the issuer place such notes in the custody of an institution chartered by a Federal or State agency to act as trustee and (ii) the issuer provide such periodic reports of sales as the Administrator deems necessary.

“Evidences of indebtedness, issued by such a legally organized lending agency, which provide that such evidences of indebtedness shall at all times be secured by (i) a principal amount of, and interest which has accrued on, guaranteed loans, (ii) an amount of cash or (iii) a principal amount of, and interest which has accrued on, any securities of a class exempted by section 3(a)(2) of the Securities Act of 1933, as amended, from the provisions of said Act, or (iv) any combination of the foregoing, in an aggregate amount which shall at least equal the principal amount of, and interest which has accrued on, said evidences of indebtedness, shall be exempt from laws administered by the Securities and Exchange Commission, except sections 17, 22, and 24 of the Securities Act of 1933, as amended; however, the Administrator shall require that (i) the issuer place said guaranteed loans, cash, and exempted securities in trust for the benefit of the holders of said evidences of indebtedness with an institution chartered by a Federal or State agency to act as trustee and (ii) the issuer provide such periodic reports of sales as the Administrator deems necessary.

“A guaranteed loan, including the related guarantee, may be assigned to the extent provided in the contract of guarantee executed by the Administrator under this title; the assignability of such loan and guarantee shall be governed exclusively by said contract of guarantee.”; and

(b) by inserting the word “initially” before the words “made, held, and serviced” in the sixth sentence of said section 306.

SEC. 2. Section 308 of the Rural Electrification Act of 1936, as amended, is amended by striking therefrom the words “of which the holder has actual knowledge” and substituting in lieu thereof the words “of which the holder had actual knowledge at the time it became a holder”.

Passed the House of Representatives May 21, 1974.

Attest:

W. PAT JENNINGS,
Clerk.

STAFF EXPLANATION OF H.R. 12526, SENATE COMMITTEE ON
AGRICULTURE AND FORESTRY

H.R. 12526 would amend the Rural Electrification Act of 1936 to exempt from regulation by the Securities and Exchange Commission (except for specified fraud provisions of the Securities Act of 1933) two types of securities: (a) securities, issued by REA-guaranteed lenders, representing beneficial owner-

ship in notes guaranteed by REA, and (b) evidences of indebtedness issued by such lenders which are fully secured by REA-guaranteed loans, cash, or other securities exempt from SEC regulation.

The bill provides that the Administrator of the Rural Electrification Administration shall require that the issuers of each type of such securities (a) place the guaranteed notes underlying the first type or the guaranteed loans, cash, and exempted securities underlying the second type, with an institution chartered by a Federal or State agency to act as trustee, and (b) provide such periodic reports of sales as the Administrator deems necessary.

In addition, the bill also—

(1) Expressly authorizes assignment of REA-guaranteed loans, and

(2) Clarifies the Rural Electrification Act by providing that an assignee's vulnerability to the defenses of fraud or misrepresentation arises only if the assignee had actual knowledge of the fraud or misrepresentation at the time he became a holder of an REA guarantee.

[The following material was subsequently received for the record:]

EXECUTIVE OFFICE OF THE PRESIDENT,
OFFICE OF MANAGEMENT AND BUDGET,
Washington, D.C., July 18, 1974.

HON. HERMAN E. TALMADGE,
Chairman, Committee on Agriculture and Forestry,
U.S. Senate,
Washington, D.C.

DEAR MR. CHAIRMAN: The Office of Management and Budget would like to present its views on HR 12526, "To amend sections 306 and 308 of the Rural Electrification Act of 1936, as amended," as passed by the House, and currently under consideration in your committee.

This bill proposes credit policies which are undesirable both in this specific instance and as precedents likely to be demanded as equal treatment for other programs.

More specifically, HR 12526 would exempt securities backed by REA guaranteed loans from most requirements of laws administered by the Securities and Exchange Commission. There is no special justification for exempting security issues backed by REA guaranteed loans, that could not also be used to support similar exemptions for privately issued securities backed by any other loans guaranteed by the government. This is particularly so when the issuer may be a unique form of financial organization not subject to supervision and regulation by any other Federal or State regulatory agency. We thus concur with and support the report of the Securities and Exchange Commission.

As to the language proposed for the incontestability clause, the language in the REA act already goes beyond that which has been established as a standard for other programs. The standard clause now provided agencies drafting new legislation reads: "... the validity of any guarantee so made shall be incontestable, except for fraud and material misrepresentation, in the hands of the holder of the guaranteed loan." The present REA act narrows the government's contestability rights further in that any fraud and misrepresentation would have had to be known to the holder. And the proposed amendment would narrow the government's rights to contest still further, by requiring that any exempted fraud or misrepresentation be known to the holder at the time the loan was acquired.

Such non-standard provisions are neither necessary nor desirable. But to the extent they might be argued for one program of one agency, they could be argued for all. We should not be drawn into a contest to see what special preferences we can give the financing of one agency's programs over others.

The language that would authorize direct pass-through assignment of Federal guarantees of loans to the secondary financing securities issued by a lender is also unneeded and undesirable. We are unaware of any impediments to pledging the proceeds of guaranteed loans and assignment of rights to the proceeds of guarantees to bond holders and trustees, as this is done with some frequency with guaranteed loans under other Federal programs. We thus assume that the proposed amendment is intended to permit making the Government's liability run to bond holders directly. Such assignment of the guarantee to the underlying financing issues is neither customary nor desirable,

as the government would apparently be undertaking to guarantee the performance of the lender and the trustee as well as of the original borrower. Moreover, the assignment apparently could be available at the unilateral option of the lender, in the absence of adequate regulation or administration by some future REA Administrator. Thus, even if this feature were desirable, a statute which appropriately protected the government's interest would need to be much more adequately structured than the present proposal. But, there is no unique justification for providing REA programs with a special facility that would be unavailable to other Federal loan guarantee programs.

We are confident that you and your committee share our objective of the application of sound basic policy principles and standards to the design and management of all of our Federal credit programs. It is in the interests of both the Congress and the Executive that we follow basic standards, and that we resist separate initiatives for adding special preferences to each of our many credit program statutes.

For the reasons stated above, the Office of Management and Budget opposes enactment of HR 12526.

Sincerely,

ROY L. ASH,
Director.

NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION,
Washington, D.C., July 29, 1974.

HON. GEORGE MCGOVERN,
*Chairman, Subcommittee on Agricultural Credit and Rural
Electrification,*

Senate Committee on Agriculture and Forestry, U.S. Senate, Washington, D.C.

DEAR SENATOR MCGOVERN: We appreciate the opportunity and are glad to respond to the contentions made by the Office of Management and Budget in its letter of July 18, 1974, relative to H.R. 12526, which is currently under consideration in your Subcommittee.

For the detailed reasons set forth in our testimony before the Subcommittee on July 18, 1974, we believe that the provisions and policies incorporated in H.R. 12526 are not only highly desirable in the interests of proper functioning of the REA guaranteed loan program but also are entirely justifiable by any test of public interest.

With regard to the contention of OMB that there is no special justification for exempting security issues backed by REA guaranteed loans from laws administered by the Securities and Exchange Commission, we believe the contrary is established by our testimony at the hearing on July 18 before the Subcommittee and by the detailed statement filed by us at the hearing containing an analysis of the SEC's report on this subject. We there pointed out, among other justifications, that the issuers of securities backed by REA guaranteed loans pursuant to H.R. 12526 would be subject to the full supervisory authority of a Federal agency, the REA, to protect the interests of investors; that the specific statutory standards of H.R. 12526, required to be met before such securities could be exempt, and the applicability of the anti-fraud provisions of the securities legislation, all further assured that the interests of investors would be directly protected; and that there are numerous Congressionally approved precedents for the particular type of exemption provided for in H.R. 12526.

The OMB letter of July 18 also contends that the language of the incontestability clause provided for in H.R. 12526 would unduly narrow the Government's contestability rights, and that even the language of the present incontestability clause, now contained in Section 308 of the Rural Electrification Act, "goes beyond that which has been established as a standard for other programs." The clause which OMB deems "standard" and which is now provided by OMB to agencies drafting new legislation reads: "the validity of any guarantee so made shall be incontestable, except for fraud and material misrepresentation, in the hands of the holder of the guaranteed loan."

The present language of Section 308 provides for incontestability "except for fraud or misrepresentation of which the holder has actual knowledge."

This language is the same language that has for many years been part of the legislation administered by the Farmers Home Administration (see 7 U.S.C. 1928), and is almost the identical language used by the Congress in the enactment of Title V of the Housing Act of 1948 (see 42 U.S.C. 1487[d]).

The amendment to this language proposed by H.R. 12526 would merely make clear that the fraud or misrepresentation which would bar a holder from enforcing the guarantee must have been known to the holder at the time he acquired the loan. It would do this by substituting for the words "of which the holder has actual knowledge," the words "of which the holder had actual knowledge at the time it became a holder." It is interesting to note that the equitable rule incorporated in this amendment was adopted by the Department of Agriculture as the proper interpretation of incontestability language of the Rural Development Act which is identical to the present provision of Section 308 of the Rural Electrification Act. The need, nevertheless, for clarifying Section 308 to expressly incorporate this equitable rule arises from the fact that attorneys for investment bankers and other organizations in the financial community, which are expected to purchase securities issued by REA-guaranteed lenders in reliance on the incontestability provision, have raised doubts concerning the proper interpretation of Section 308. These doubts would be laid to rest by the express incorporation of the equitable rule into the incontestability provision.

It should also be emphasized that in a number of instances, Congress has gone much further than H.R. 12526 to limit the Government's contestability rights, even to the extent of eliminating altogether Government defenses arising from fraud or misrepresentation (see, e.g., New Communities Act of 1968, P.L. 91-609, Title III, Sec. 303; 84 Stat. 1780: "Any guarantee . . . shall be incontestable in the hands of a holder of the guaranteed obligation."; and Merchant Marine Act, 46 U.S.C. 1273(e): "the validity of any guarantee, or commitment to guarantee, so made shall be incontestable."). The need for limiting the Government's contestability rights beyond the so-called "standard" provision recommended by OMB, in order to obtain acceptability and lower interest rates in the capital market, has thus been recognized by Congress and appears essential to achieving the purposes of the rural electric loan guarantee program.

Finally, OMB also contends that the provision of H.R. 12526 which expressly authorizes the REA Administrator, to the extent deemed desirable by him, to permit the assignment of guarantees, is unneeded and undesirable. Underlying this conclusion is the stated belief of OMB that the existing Rural Electrification Act appears to contain no impediments to the *pledging* of guarantees, along with the proceeds of guaranteed loans, to bondholders and trustees; that the assumed purpose of this amendment is therefore solely to make the Government's guarantee run directly to the bondholders; and that this type of assignment is not customary and even if it were desirable, authorization thereof could be abused by some future REA Administrator contrary to the Government's interest.

Without pausing to elaborate upon the remarkable contention that a future Government Agency head should not be relied upon to administer his authority under an Act of Congress to protect the Government's interest, both the need and justification for the assignment authority appears to us to have been fully established. As specifically pointed out in the House Agriculture Committee Report on H.R. 12526 (Rep. No. 93-1033), the absence from Section 306 of the Rural Electrification Act of express provision for pledging or assigning guarantees had raised legal doubts in the financial community whether either pledging or other assignment was authorized. These doubts, we may add, arose primarily from the definition of a guaranteed loan under Section 306 as "one which is made, held, and serviced by a legally organized lending agency and which is guaranteed by the Administrator hereunder." The question was raised by some lawyers whether the requirement that a guaranteed loan be "held" as well as "made" by the lender foreclosed anyone other than the lender from "holding" a guaranteed loan. While not all attorneys may agree with this restrictive interpretation, clarification of assignability of guarantees furnished by H.R. 12526 is clearly desirable if the loan guarantee program is to operate effectively in the capital markets which will ultimately furnish the funds to be used in this program.

Furthermore, while OMB may be of the opinion that assignments of Government guarantees directly to bondholders or investors may not be desirable,

others may well conclude to the contrary. In either case, it appears to us essential for the proper effectuation of the rural electric loan guarantee program that the Government Agency, to which the direction of the program has been committed and whose expertise and experience in this field can best be relied upon to achieve Congressional purposes, should have the discretion to make these decisions as to assignability in the public interest. And it is to this Government Agency, REA, that H.R. 12526 properly and expressly delegates the discretion to determine "the extent" to which guarantees may be assigned. In the words of House Report 93-1033:

"Such commitment of assignability authority to Government agency discretion would be entirely consistent with the handling of guarantee assignments in other Federal statutes and with the principle underlying the general Assignment of Claims Act of 1940 (31 U.S.C. 203) that restrictions on assignability of claims against the Government are imposed for the benefit of the Government and may therefore be waived by Government agencies."

Sincerely,

CHARLES A. ROBINSON, JR.,
*Corporate Counsel,
National Rural Electric
Cooperative Association.*

LOUIS A. ROLAND,
*Corporate Counsel,
National Rural Utilities Cooperative
Finance Corp.*

Senator McGOVERN. Our opening witness is Mr. Garrett of the Securities and Exchange Commission; he is accompanied by Mr. McCoy and Mr. Cook. We will be more than happy to have your statement, Mr. Garrett.

STATEMENT OF RAY GARRETT, JR., CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. GARRETT. Thank you, Senator.

Mr. Chairman, I would like to express my thanks and those of my fellow Commissioners to this subcommittee for granting our request to hold this hearing on H.R. 12526 before proceeding further with your consideration of this bill.

As we explained in our letter requesting this hearing, and in the accompanying memorandum, we learned of the existence of this bill only very recently, and at a time when the House of Representatives Committee on Agriculture was ready to report the bill favorably.

Until informed by the Office of Management and Budget, we did not know that the bill would, in effect, amend the securities laws that we administer, nor were we aware of Public Law 93-86, enacted last year, which similarly amended the laws under our jurisdiction. Neither the titles of these bills nor their committee assignments gave us any indication that our laws were involved, nor, of course, until today, were we invited to testify on them. We are, therefore, especially grateful to this subcommittee for being willing to hear us at this late date.

We submitted written comments on H.R. 12526 in the form of a memorandum accompanying my letter to Senator Talmadge, Chairman of the Committee on Agriculture and Forestry, dated June 13, 1974. In order to avoid the necessity for repeating all of the views expressed in that memorandum in my prepared testimony this morn-

ing, I request that the memorandum be made a part of the record of these proceedings.

H.R. 12526 provides comprehensive exemptions from the Federal securities laws for two types of securities. First are securities issued by "a private entity" (which apparently need not be an agency or instrumentality of the U.S. Government) representing "beneficial ownership in a note or a block of notes guaranteed" under the Rural Electrification Act. I will refer to these types of securities as "participations". The participations would be exempt from most Federal securities statutes, provided the private-entity issuer "place(s) such [REA-guaranteed] notes in the custody of an institution chartered by a Federal or State agency to act as trustee" and provided further that the issuer files periodic reports with the REA.

The second category of securities are "evidences of indebtedness issued by a legally-organized lending agency, which provide that such evidences of indebtedness shall at all times be secured by "(1) a principal amount of, and accrued interest on, REA-guaranteed loans; (2) cash; or (3) a principal amount of, and accrued interest on, any securities of a class which are exempted by Section 3(a) (2) of the Securities Act of 1933, as amended; or (4) by any combination of the foregoing. The bill also requires that the issuer shall place the "guaranteed loans, cash, and exempted securities in trust for the benefits of the holders of said evidences of indebtedness with an institution chartered by a Federal or State agency to act as trustee", and that the issuers shall provide periodic reports of sales to the REA Administrator.

The bill provides that both types of these securities "shall be exempt from the laws administered by the Securities and Exchange Commission, except section 17, 22, and 24 of the Securities Act. * * *" Section 17 of that act concerns unlawful interstate sales of securities involving fraud, misrepresentation or deceit, section 22 deals with the jurisdiction of the Federal courts to hear cases involving violations of the Securities Act, and with contumacy of witnesses or refusal to obey a Commission subpoena, and section 24 provides criminal penalties for violations of the act.

Before discussing the applicability of H.R. 12526 to the Federal securities laws we administer, I believe it appropriate to discuss briefly the broad framework of the system of Federal securities legislation. Investor protection has been the primary thrust of the Federal securities laws for 40 years, through extensive disclosure, antifraud and regulatory provisions which are flexible enough to meet new economic conditions. The statutes we administer start from the theory that disclosure to an investor is one of the best means of assuring that investors can make independent judgments regarding the merits of any securities offering.

The Securities Act requires full disclosures about the company and the mode of distribution of its securities in connection with the public offer or sale of securities. After an issuer's securities have been offered for public sale, the Securities Exchange Act of 1934 requires continuing disclosures about the results of the issuer's operations for any issuer of substance. These disclosure provisions are buttressed

by Federal antifraud provisions found in a number of the six acts we administer; and the Federal securities laws also impose comprehensive regulatory obligations upon securities professionals and, where abuses to investors have been shown, upon certain investment vehicles.

Needless to say, the Federal securities laws contain their own exemptions where Congress perceived the protections of these laws to be unnecessary or redundant. While the legislative history of the House of Representatives' consideration of H.R. 12526 evidences an intention to adhere to this standard of justifying securities law exemptions, the Commission is of the opinion that the enactment of H.R. 12526 in its present form would be contrary to the public policy favoring the protection of investors as embodied in the Federal securities laws, and we do not think that the exemptions proposed in this bill, or those in Public Law 93-86, which passed last year and upon which we were unable to testify, can be justified when considered against the light of the history, purpose and experience which underlie our securities laws.

The proposed bill would provide an exemption from the disclosure requirements of two of the statutes we administer, the Securities Act and the Securities Exchange Act. Let me turn first to the Securities Act, and the exemptions that Congress has heretofore provided from its disclosure provisions.

The primary purpose of the Securities Act is to provide investors with full and fair disclosure of all material facts concerning the securities being offered and the issuer of the securities before the securities may be offered and sold to the public. This is accomplished by requiring that the issuer first register the securities under the Securities Act by filing a registration statement on a form prescribed by the Commission. The registration statement is examined by our staff for apparent compliance with the law, and the securities may not be sold until the registration statement is declared effective, following such examination.

The registration statement includes a prospectus, copies of which must be delivered to all purchasers of securities and to all offerees, if offers are made in writing. The act also provides for special liability, more stringent than that of the common law, for material misstatements and omissions in the registration statement and the prospectus. Registration under this act is not required as a penalty to be imposed on issuers, but as a benefit to be provided to investors. In permitting registration statements to become effective, or declaring them to be so, the Commission does not express any judgment on whether the securities are good investments for all investors or any investor, nor does it otherwise pass upon the merits of the offering.

It is the obvious intention of the act, and it has been so construed by many judicial decisions, that all distributions of securities by issuers should be registered in this fashion, unless a specific exemption is available. Congress has provided for a limited number of specific exemptions for certain types of securities and securities transactions where there is no practical need for registration or where the

benefits of registration are too remote. For example, it concluded that any security issued or guaranteed by a bank is exempt from registration in substantial part because the governmental regulatory supervision of banks should adequately protect investors and obviate the practical need for registration. Similarly, it concluded that the benefits to investors of registration of certain small or local offerings are too remote.

Consistent with this rationale, and by virtue of section 3(a)(2) of the Securities Act, it is quite clear that securities guaranteed by the Rural Electrification Administration under the Rural Electrification Act of 1936 are exempt from registration, and this exemption is natural coextensive with any extension of authority granted to the Administrator to issue such guarantees.

Let me quote from this section as it relates to the exemption provided to so-called Government and municipal securities:

Section 3(a) "Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities; * * *

(2) "Any security issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or territory or by any public instrumentality of one or more States or territories, or 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; or any certificate of deposit for any of the foregoing; or any security issued or guaranteed by any bank; * * *"

Congress presumably passed section 3(a)(2) because persons purchasing securities issued or guaranteed by the U.S. Government, or an instrumentality thereof, could look to the Government agency for recovery in the event problems arose, and, consequently, were not in need of the protections of the registration provisions of the Securities Act. There is no reason to treat REA-guaranteed securities any differently.

But, H.R. 12526 does more; it covers situations where a third, non-governmental, party is interposed between the guaranteeing Government agency and the investor. A separate economic and legal relationship arises when the guaranteed securities are pooled by a third party, and the investor is offered a participation in the pool rather than direct ownership in the governmentally guaranteed security, or when the guaranteed securities serve as security for an indebtedness incurred by the third party to the investor.

The investor is not protected because he has purchased a security issued, or directly guaranteed, by a Government agency. Rather, taking the pool situation as an example, the investor must look to the sponsor of the pool for the performance of certain duties with regard to the successful operation of the pool; he cannot look directly to the guaranteeing Government agency to recover his investment if the sponsor of the pool is financially unable to perform his commitments and obligations as issuer of the participation or evidence of indebtedness.

For these reasons, we have consistently maintained that the rationale justifying the Government security exemption does not, and should not, so to speak, flow through to shares or participations in portfolios or pools of Government securities.

Senator MCGOVERN. Mr. Garrett, if you would stop here momentarily. Those pool arrangements would still be under the monitoring and supervision of the REA, would they not; in this case you would still have a government agency that would require responsible arrangements.

Mr. GARRETT. The act would permit the additional guarantee, but such a guarantee would not be required. The bill would require that the pooled securities be deposited with an agency authorized to act as a trustee under Federal or State laws.

Senator MCGOVERN. How much does the SEC go beyond that?

Mr. GARRETT. Well, these securities would be required to be registered under the 1933 act prior to any public offering. The provisions of the Trust Indenture Act would also require rather elaborate provisions for the protection of the holders of the participations, particularly with respect to their relationship with trustees.

Senator MCGOVERN. All right, you may proceed.

Mr. GARRETT. Let me put the case in more concrete terms. Suppose a bank, or some other lending agency, puts together a pot or pool of securities that are themselves exempt under section 3(a)(2)—perhaps guaranteed mortgages or guaranteed telephone loans—aggregating many millions of dollars. There are then offered to the public certificates evidencing an undivided interest in this pool, with the interest rate and maturity and redemption features keyed so that the yield and payments of principal on the underlying securities in the pool will, in the aggregate, meet the obligations set forth in the certificates of participation. Superficially, it would appear as though the certificates of participation are as “good,” in the sense of certainty of payment of interest and principal, as the underlying securities, and that, therefore, if government securities—including government-guaranteed securities—are exempt because of the high degree of probability, if not absolute certainty, that their terms will be met, then the certificates of participation should likewise be exempt.

We do not agree with this conclusion because we think the interpositioning of the depository holding pool between the government guarantee and the ultimate beneficial owner involves the possibility of difficulties which require full disclosure to investors. Necessary disclosures include the solvency of the depository, the identification of the securities making up the pool, the provisions for receipt of payment by the depository and payment over to the holders of the certificate, the full terms of the certificates themselves and any underlying indenture or agreement under which they are issued, the fees being charged by the manager of the pool, other costs investors must incur to purchase participations, redemption rights under the pool agreement, valuation formulas to determine individual interests and the right of collective action by holders of the certificates or the provisions governing the rights and duties of any trustee who has entered into an indenture for the protection of certificate holders.

This information can assist investors in choosing among various available pools, and in determining the degree to which a particular pool's profits will be diminished by management and underwriting fees.

Similarly, in the case of investments in evidences of indebtedness, the potential investor will need information regarding such matters as the financial condition, business, and management of the issuer in order to make an informed investment decision. From the standpoint of investor protection and the investor's need for information, it is difficult to distinguish the "legally organized lending agency" specified in H.R. 12526 from any other issuer, unless the lending agency is a bank or similar entity subject to other comprehensive governmental supervision, which could serve to provide a measure of protection of investors. In such a case, the evidence of indebtedness may be an exempt security under the existing statutory provisions.

In addition to enabling investors to make informal investment decisions, it has also been our experience that the disclosure requirements of the securities acts have helped to assure that fees and underwriting commissions charged in connection with offerings of securities have stayed within reasonable bounds. The Federal securities acts do not provide for the direct regulation of such fees and commissions, but it is not apparent how the imposition of unreasonable charges could be prevented in connection with offerings of securities covered by H.R. 12526.

What I have said about the need for the protections of Securities Act disclosures applies equally to the need for Securities Exchange Act disclosures. The public interest and the protection of investors, in our view, require periodic disclosures about the issuer's management of public funds and the continued ability of the sponsor of these pools to meet the terms of their sale of participations. While H.R. 12526 would grant the REA Administrator the power to require certain reports to be filed by such issuers, the information furnished under such proposed REA reports might not be comparable to the detailed information furnished under our regulations.

H.R. 12526 provides that the issuer of the interests or evidences of indebtedness may be a private entity or "legally organized lending agency". Beyond these bare requirements, the bill contains no precise limitations as to who can form or manage such pools. Moreover, purchasers of interests in such pools would not appear to be entitled to look to any guaranteeing government agency for recovery in the event of default on the security—such purchasers apparently would have only the financial solvency and reliability of the person creating and managing the pool to whom they may look for any return on their investment. Thus the rationale upon which the exemption in section 3(a)(2) of the Securities Act rests does not exist here.

In addition, the provision in the bill for custody arrangement of the underlying securities appears broad enough to permit such custody arrangements with institutions which also do not fall within the categories of exempt institutions as defined in section 3(a)(2)

of the Securities Act since there is no specific requirement that their business be supervised by a banking commission or similar official.

While such an arrangement may attempt to assure safekeeping of the securities in the pool, the bill does not specify any sanctions for a breach of this requirement, does not afford any protection of disclosure to the investors against any misdealings by the pool sponsor, or any other undisclosed aspect of the custody agreement, nor afford investors any remedies in the event of any breach.

While such remedies generally are available to investors by virtue of the antifraud, civil liability, and criminal sanction provisions of the acts we administer, H.R. 12526 would deprive investors in these securities of those protections, with the exception of section 17(a) of the Securities Act, an antifraud proscription limited solely to sales or offers to sell securities.

Thus, H.R. 12526 would not include any of the antifraud provisions of the Securities Exchange Act. In particular, section 10(b) under that Act authorizes the Commission to adopt rules prohibiting any fraud, or any manipulative or deceptive device by any person "in connection with the purchase or sale" of securities in interstate commerce or through the mails, and the Commission has adopted rule 10b-5 under that section. The courts have developed a substantial body of case law under section 10(b) and rule 10b-5; and cases of similar purport are far less numerous under section 17 of the Securities Act. Further, section 17, by its own terms, is not nearly as broad as section 10(b) and rule 10b-5; section 17 covers fraud only in the "offer or sale" of securities, whereas section 10(b) includes fraud in connection with any "purchase or sale" of a security.

I think it is important to realize that H.R. 12526 in certain situations would preclude resort to any Federal antifraud provision, and that in all situations it would preclude resort to rule 10b-5 and the established securities fraud case laws most frequently relied upon by defrauded investors.

As with the case of the Securities Act of 1933, the Commission can perceive no sound basis for the flat exemption in H.R. 12526 for such lending agencies as applied to the antifraud provisions of the Securities Exchange Act. No similar exemption is available thereunder now with respect to persons who sell securities which are issued directly by the U.S. Government. There could scarcely be any reason from investors' viewpoint and the concern for our national economy to provide an exemption for securities under the Rural Electrification Act which is not even available for securities issued directly by the U.S. Government itself.

The Trust Indenture Act of 1939 and the Investment Company Act of 1940, which also are administered and enforced by the Securities and Exchange Commission, provide substantial additional protections to investors, which may be lost or eroded by virtue of the exemptions contemplated by H.R. 12526. The potential importance of these acts are set forth in detail in our memorandum, and I refer the subcommittee to that document.

As we pointed out in our memorandum, H.R. 12526 fails to provide protections for investors comparable to—or as comprehensive

as—those set forth in the Federal securities laws, and the Commission believes that Congress should not deprive investors of these important protections unless comparable safeguards otherwise exist.

Following the submission of our memorandum, we understand that the Department of Agriculture raised certain issues in responding to that memorandum. Essentially, that agency's questions concern the National Rural Utilities Cooperative Finance Corp. Since we believe the issues raised by the Department of Agriculture to be irrelevant to the concerns I have discussed, rather than answer those issues now, for the subcommittee's convenience, I have annexed to my statement a brief memorandum outlining our response to the Department's questions.

I have emphasized the protections afforded investors by the disclosure, regulatory, and liability provisions of the Federal securities laws because a reading of the legislative history of H.R. 12526 to date leads me to believe that at least some of its supporters may have the mistaken impression that the bill merely relieves technical regulatory requirements which are unnecessary in view of the desirable purposes for which public investors' money will be used. Our concern is that the bill would strip investors of important substantive protections in a situation where such protections are needed.

If the intent of the sponsors of this bill is merely to relieve the entities selling the participations or evidences of indebtedness from the expenses and time requirements of registration under the Securities Act, this aim could be achieved by legislation far less drastic than the proposed bill, or, in my view, could be substantially achieved even within the existing statutory framework.

The primary expenses associated with registration stem from the preparation of and assumption of liability for the information called for by schedule A to the Securities Act. However, the act empowers the Commission by rule or regulation to permit the omission of any statutorily-mandated information from the prospectus if it is not necessary or appropriate in the public interest or for the protection of investors. Pursuant to this authority, the Commission has adopted a number of "short form" registration statements which materially lessen the information requirements and which can be prepared and processed more quickly than a full, long-form registration statement. We would be glad to explore the possibility of adopting a "short form" registration statement for offerings of securities covered by the bill with the REA or other appropriate persons and report back to this subcommittee.

The Commission does not favor the enactment of any provision which would grant a blanket exemption to the lending agencies for their issuance of participations against such REA-guaranteed securities and would deprive investors of the disclosure, antifraud and regulatory provisions presently afforded by the Federal securities laws. Accordingly, the Commission urges this subcommittee to reject H.R. 12526. Thank you very much.

Senator MCGOVERN. Thank you for your testimony, Mr. Garrett.

As I understand it, under the terms of this legislation the responsible Federal agency would be the REA. That being the case, if

there were any kind of improper handling in the issuance of these securities, anything that reflected unfavorably on it, the REA would be the agency that would be hurt, is that not correct; they would be Federal agency.

Mr. GARRETT. I don't see anything in this bill that gives the REA authority to determine whether or not these evidences of indebtedness can be issued, or the terms under which they can be issued.

Senator McGOVERN. Well, they are the agency that has the responsibility, as I understand it, under this program for the issuance of the securities; are they not?

Mr. GARRETT. I don't understand that at all. They have responsibility for guaranteeing the underlying loans.

Senator McGOVERN. Yes.

Mr. GARRETT. I suppose they would hold guarantees under certain conditions.

Senator McGOVERN. They have guaranteeing authority.

Mr. GARRETT. For the underlying securities, yes; but not for the participations or the evidences of indebtedness. The issuer of the participations or evidences of indebtedness, is not, as I understand it—

Senator McGOVERN. But REA has some responsibility for the supervision of the security.

Mr. GARRETT. The bill does not so state. They have responsibility for requiring that the underlying securities, guaranteed loans, be deposited with a trustee, and requiring some reports. The bill does not specify what reports.

Senator McGOVERN. Well, it would seem to me, with the broad responsibility that the SEC has, and they are doing a good job in carrying out their obligations, that it would make more sense in this instance, to leave this responsibility up to the REA, which is very specialized in this area, having been involved in this field for a good many years.

Wouldn't they be better equipped to handle a program which affects their own operation, rather than an agency which has broad jurisdiction over a great range of securities?

Mr. GARRETT. I don't mean to be critical of the REA, in any respect, but I think the answer to the question is, no; I don't think they have either experience or any particular expertise with respect to investor protection.

I grant them all the experience and expertise in the world with respect to what loans to utilities should be guaranteed by REA, but that is not what we are talking about. We are talking about securities that are going to be offered to public investors who have no other involvement with rural utility cooperatives. I presume these securities would go into the money market, the financial market, and be sold like any other debt securities.

Senator McGOVERN. Hasn't the record of REA been very good over the years in handling loans responsibly, and conscientiously?

Mr. GARRETT. We are not talking about that at all. We are only talking about the rights of people to protection—ordinary investors being invited to invest in these securities.

Senator McGOVERN. But, the REA is a bona fide government agency, isn't it; the U.S. Government is involved. And, it would seem to me that they, more than any other agency, would have a selfish interest in seeing that this program worked well; that their investors are protected, and the loans properly supervised.

Mr. GARRETT. It would be possible to give the REA the same sort of authority with respect to these offerings as the SEC has with respect to offerings generally. The bill does not do that; in our opinion it would be wasteful.

Senator McGOVERN. Are you recommending that it might be one possible alternative to provide additional authority to the REA?

Mr. GARRETT. We would prefer that to the bill in its present form. We would not prefer that to our basic position, that they not be exempted securities at all.

Senator McGOVERN. We had a letter that I wanted to make part of the record, from the master of the National Grange.

He makes a point here that I would like to ask you to comment on. He said, "The time-consuming and expense of SEC procedures are not necessary when such programs are backed by the full faith and credit of government."

The general thrust of the letter is, and what this bill does is to provide REA with the same exemption recently granted by Congress to similar guaranteed loans under the Rural Development Act, and that REA has some expertise in this field. There is no real reason why they should be put through the additional time-consuming arrangements involved in going through the SEC.

[The above-referred to letter from the National Grange follows:]

NATIONAL GRANGE,
Washington, D.C., July 15, 1974.

HON. GEORGE MCGOVERN,
Chairman, Subcommittee on Agricultural Credit and Rural Electrification, Committee on Agriculture and Forestry, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The National Grange has reviewed the House Agriculture Committee report on H.R. 12526 in detail and find that we are in agreement with the objectives of the Act.

The Grange has had a lifetime interest in rural America and the problems of the residents and family farms that make up the population of our rural countryside.

In our judgment the amendments proposed in H.R. 12526 to the Rural Electrification Act of 1936, as amended by P.L. 93-32, would contribute significantly to the efficient implementation of the guaranteed loan program by permitting such lenders to utilize REA guarantees to obtain for the rural systems the reasonable interest rates which they require.

The amendments would exempt from general Securities and Exchange Commission (SEC) regulations such guaranteed loan programs. It would then provide the REA the same exemption recently granted by Congress to similar guaranteed loans under the Rural Development Act. The time-consuming and expense of SEC procedures are not necessary when such programs are backed by the full faith and credit of Government.

A financially strong REA program is a fundamental prerequisite to a developing rural America. Any assistance in building financially strong rural electric and rural telephone systems should be looked upon as the first step in revitalizing rural America, for without sufficient electricity at reasonable

rates and a sound communication system all other rural development programs will flounder.

Therefore, the National Grange urgently and respectfully requests that the subcommittee report H.R. 12526 to the full committee with a do-pass recommendation.

We thank you, Mr. Chairman and your subcommittee, for holding early hearings on these important amendments to the Rural Electrification Act.

We would appreciate this letter being made a part of the hearing record.

Sincerely,

JOHN W. SCOTT, *Master,*

Mr. GARRETT. Well, if I understand correctly the type of financing that is contemplated by this bill, there will be offerings of notes or other debt securities—whatever they are entitled—in substantial aggregate principal amounts, and widely offered to the public.

I would presume this would be done through investment banks and channels, through an underwriter; you would have to have an agreement with the trustees, and you would have to have some offering materials to hand out to prospective purchasers, even under this exemption.

Now, requiring that such materials be filed with the SEC does not add significantly to the expense, and should not add greatly to the time. The expense of filing is one-hundredth of 1 percent of the aggregate principal amount, as the registration fee; and you would have some additional legal, and some additional accounting, expenses based upon it. For an offering in the neighborhood of \$10 million, for example, it is an expense that is insignificant.

The time involved, given that we do establish a short form similar to our present Form S-9, would be about 3 weeks to 1 month. Once our procedures were set up, probably less time would be involved.

Generally, when public utilities file a bond issue, today on a short form, they go through the registration process within a couple of weeks, without any problem at all. Even on our most crowded days we process such registration statements promptly, because they are routine. If an issuer regularly files with us, and our staff knows the company well, then they cause no problem.

I think the expense and time are grossly exaggerated. When you are talking about an underwritten public offering, the underwriters require 90 percent of the trappings anyway. Underwriters generally require, for their own use, the same sort of financial and other information which we require, as well as opinions of counsel.

Senator MCGOVERN. Are you saying that in terms of any possible delay, the outside would probably be 30 days?

Mr. GARRETT. Well, I don't want to overstate my case, Senator.

I presume that the drafting of the prospectus and the registration statement would probably consume more time and be given greater attention because of the liability that is attached to it if the document is to be filed with us, than not. There might be more time and perhaps more expense involved in getting ready to file.

I can't imagine the actual filing time exceeding a month, it should be less than that, unless the issuer has done a sloppy job, or there is some unusual problem.

Senator MCGOVERN. Well, I just want to make clear what you are getting at. You are saying that, after you get the application, the

prospectus, then the time period would elapse which could run—

Mr. GARRETT. It could run as long as 30 days.

Senator McGOVERN. But the preparation time for meeting your requirements, with respect to what is involved there, is time-consuming, and also costly in terms of the participant.

Mr. GARRETT. I suppose the nearest analog would be offerings by certain railroads and motor carriers that are exempt from the registration requirements of the Securities Act, other regulated industries, such as electric utilities, are not exempt. In most cases, because underwriters want to do a good, professional job, the offering materials for such exempt offerings are prepared with substantially the same care given to the preparation of statements to be filed with the Commission.

There are additional requirements, such as assembling exhibits to the registration statement, and things of that nature, that will add marginally to the preparation time. But, if you assume that these offerings are going to be prepared with due professional care by topnotch accountants, lawyers, and underwriters, while I can't measure the exact amount of additional time that would be required, I would say it would be a week, or perhaps a month.

We, by terror and otherwise, generate good care in the preparation of filing materials; but we think that is what investors are entitled to receive. And we think that investors in the securities contemplated by H.R. 12526 are entitled to it just as much as investors in other securities.

Senator McGOVERN. Senator Dole, do you have some questions?

Senator DOLE. I don't have any questions. I listened to part of the testimony, and I have some conflicts. But, I think what Mr. Garrett said makes sense, and I wonder if there isn't some way to reconcile the differences. We have Mr. Robinson here, the corporate counsel, and he may take a different position; it's pretty hard to argue against protecting investors.

He did make one recommendation that we might incorporate in the amendment; but you don't really press that. I understand.

Mr. GARRETT. Well, I was going to say that if, despite our arguments, the committee is still of the opinion that there should be an exemption from our acts, then I think the REA Administrator ought to be given more responsibility and more authority. He is not, under this bill, given comparable responsibility, or authority, to what we would have under the Federal securities laws.

But, I don't want to press that because I really think they should not be exempt.

Senator DOLE. What about some of the others that are exempt?

Mr. GARRETT. There aren't any other exemptions for pools of Government-guaranteed securities. The Government-guaranteed securities themselves are exempt. But, we think that when you put the pool together, and then sell participations in the pool, you have added another ingredient. And a holder of a \$1,000 certificate of participation in a \$20 million pool of guaranteed loans does not own government securities; he cannot go to the Government and say, give me my money. He has to enforce his rights against the pool, and there

may be several thousands of other people who have similar individual rights as holders of these certificates. As a practical matter, therefore, the individual investor has to enforce his rights through the trustee, and this requires that there be an adequate indenture, which is what the Trust Indenture Act is all about; that the trustee be independent of the issuer, the sponsor, and the underwriter; and that the trustee have the duty, and be given adequate powers, to protect the rights of the holders of participations in these pools of securities.

If you hold a Government-guaranteed security and you are not paid on the due date, you go to the Government and say, give me my money, and you get it; but that is not true of these participations.

Senator DOLE. Does it offer any protection because of the fact that under the REA Act, the REA is given the responsibility to determine who will make and hold these guarantee loans; does that offer any protection?

Mr. GARRETT. No, sir; it does not. Are they? I'm sorry if I misread that.

STATEMENT OF LOUIS A. ROLAND, CORPORATE COUNSEL, NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

Mr. ROLAND. REA guarantees are made by and are assignable at the discretion of the Administrator. I think there are three or four different provisions in the present REA Act and the proposed amendments which give various kinds of controls to the REA Administrator.

One, the Administrator has to approve each lender.

Mr. GARRETT. This lending agency has to be approved?

Mr. ROLAND. The lending agency has to be approved by the Administrator; the Administrator has to enter into a contract of guarantee with each lender, and determine the conditions of that contract of guarantee.

In addition, the Administrator has complete control over the assignability of the guarantee by that lender and anybody else. And the terms and conditions of assignability are specifically vested in the Administrator to administer and supervise. In all these respects, the statutory authority would exist. And in addition, the Administrator, throughout the years, has exercised almost full regulatory control, as people familiar with the REA program know, to the extent authorized in the contractual controls of the loan agreements and mortgages that REA has with its borrowers in these cases; and this would also be true with the guaranteed lenders.

Senator DOLE. In view of that, does that change your position?

Mr. GARRETT. No.

Senator DOLE. A little bit?

Mr. GARRETT. No.

Senator DOLE. I have no further questions.

Senator MCGOVERN. Thank you very much, Mr. Garrett; we appreciate your statement.

Mr. GARRETT. We might sound a little sensitive on the subject, Senator. There are many efforts to get these kinds of exemptions,

and we don't think they are in the public interest. I suppose that sums it up.

Senator McGOVERN. We appreciate your testimony, Mr. Garrett, thank you very much.

Mr. GARRETT. I'm sorry if I misstated the authority of the Administrator. I am really not that familiar with the operations of the REA.

SUPPLEMENTAL STATEMENT OF RAY GARRETT, JR., CHAIRMAN,
SECURITIES AND EXCHANGE COMMISSION

Mr. Chairman, On July 18, 1974, I testified on behalf of the Commission before your Subcommittee on H.R. 12526, a bill to provide certain exemptions from the federal securities laws for securities in connection with programs administered by the Rural Electrification Administration. I would like to comment on two points made that morning.

Spokesmen from the National Rural Electric Cooperative Association and the National Rural Utilities Cooperative Finance Corporation stated at the hearing that the REA, in general, has and exercises considerable oversight authority with respect to the terms of any guaranteed loan to a rural electric cooperative, and that the REA has the authority to require the lender to assent to contractual controls and REA supervision. While we do not dispute this statement, we do not believe it is responsive to our concern for the protection of public investors. Under the statutory scheme set forth in the bill, the REA appears to have no authority to examine, oversee or control the rights and obligations between lenders and public investors in the types of securities contemplated by H.R. 12526. Our review of 7 U.S.C. 930 to 939 does not reveal that the REA is expressly empowered or obligated to use its supervisory powers for the purpose of protecting public investors. If we are correct in this understanding, we believe the interests of investor protection require that the bill include safeguards to assure that REA review of such arrangements is mandatory.

The second point I would like to address concerns the discussion at the hearing relative to the assignment of an REA guarantee to persons acquiring an interest in REA-guaranteed securities. On this point, I wish only to observe that if the government guarantee is transferred to a public investor, there is no need for the bill; the numerous existing exemptions for government-guaranteed securities would apply. Additionally, since assignment of the guarantee is merely permissive and not mandatory in all instances in which the note or an interest therein is transferred, we do not see that assignability of the guarantee is persuasive as a basis for concluding that adequate investor protections exist under the bill.

While we believe the above suggestions represent minimal investor protections which should be included in the bill, we reiterate our opposition to its adoption.

Again, we would like to thank you and the members of the Subcommittee for the opportunity to express our views on H.R. 12526.

[The attachments to Mr. Garrett's statement follow:]

MEMORANDUM RESPONSE OF THE SECURITIES AND EXCHANGE COMMISSION TO THE
ISSUES RAISED BY THE DEPARTMENT OF AGRICULTURE CONCERNING H.R. 12526

The first point made by the Department of Agriculture is that National Rural Utilities Cooperative Finance Corporation (the "CFC") is specifically mentioned in Section 306 of the Rural Electrification Act as a "legally organized lending agency" whose loans are authorized to be guaranteed by REA. We have no quarrel with that contention. As we indicated above, if its securities are fully guaranteed by REA under that Section, then they will be exempt under Section 3(a)(2) of the Securities Act and Section 3(a)(12) of the Securities Exchange Act of 1934, but only because of the REA guarantee, not because CFC is mentioned in Section 306. However, this does not apply to any interests or participations which CFC may offer to the public representing interests in a pool of such REA-guaranteed securities, since CFC does not

meet the exemptive criteria of the federal securities laws. We understand that CFC is a private cooperative and not an agency or instrumentality of the U.S. Government.

The second point raised by the Department is with reference to the similar legislation enacted as Public Law 93-86 as forming a basis for proposing the current legislation. We have already indicated that Public Law 93-86 was enacted without any awareness of such action by the Commission, and that we did not have an opportunity to express our views on it.

The Department then referred to a "no-action" letter which CFC received on April 17, 1970, regarding CFC's status as an exempt institution under Section 3(a)(5) of the Securities Act of 1933. This section is one which applies to certain savings and loan associations, cooperative banks, farmers' cooperatives, etc., which are exempt from taxation under specified sections of the Internal Revenue Code. We have reviewed the correspondence in question and found that it is a letter from the Assistant Chief Counsel of our Division of Corporation Finance addressed to the law firm which presented the matter on behalf of CFC. The question there dealt with the proposed issuance by CFC \$1,000 Membership Certificates and a specified minimum amount of Capitol Term Certificates which would be sold only to members of rural electric systems associated with CFC and not to the public generally. The staff's letter advised that "while the question is not free from doubt", the Division of Corporation Finance would not recommend any action to the Commission if CFC offered such securities without compliance with the registration requirements of the Securities Act of 1933 in reliance upon the opinion of its own counsel that registration is not required. So it may be readily seen that this letter did not "establish" CFC's exempt status. Moreover, it was limited only to the Membership Certificates and Capital Term Certificates discussed therein issued by CFC to its associated members and has no relevance to the securities contemplated under the present bill. Our concern here is not with the securities issued by CFC but with securities—fractional interests or participations in pools of REA-guaranteed securities—issued by vaguely defined "private entities" which are to create and manage such pools, interests in which pools are not guaranteed by the government or any agency of it.

The Department also refers to a July 7, 1970 order of the Commission exempting CFC from the Investment Company Act of 1940. That is, of course, equally irrelevant here for the reasons we have just stated and for the further reasons that the order in question was issued after the Commission had formally considered an application for exemption filed by CFC and found that such exemption met certain statutory criteria including the public interest, the protection of investors, and the policy and provisions of the Investment Company Act of 1940, and also that the order as issued contained certain carefully considered protective conditions which need not be detailed here but which have no counterparts in the proposed legislations.

Copies of the letter of April 17, 1970, and the July 7, 1970, order of the Commission are attached.

Attachments.

IN THE MATTER OF
NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

*Before the Securities and Exchange Commission—Administrative Proceeding—
File No. 3-2467*

Investment Company Act of 1940—Order Pursuant to Section 6(c)
Exempting Company From all Provisions of the Act

National Rural Utilities Cooperative Finance Corporation ("National"), a non-profit cooperative association under the District of Columbia Cooperative Association Act, has filed an application pursuant to Section 6(c) of the Investment Company Act of 1940 ("Act") for an order of exemption from all provisions of the Act.

On June 15, 1970, the Commission issued a notice of the filing of said application (Investment Company Act Release No. 6078), giving interested persons an opportunity to request a hearing and stating that an order disposing of the application might be issued upon the basis of the information stated therein unless a hearing should be ordered. No request for a hearing has been filed, and the Commission has not ordered a hearing.

The Commission has considered the matter and finds that the requested exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.

It is ordered pursuant to Section 6(c) of the Act, that the proposed exemption as set forth in the application are hereby granted effective forthwith, upon the condition that this order shall expire after three years from this date and if at that time or any time thereafter, National is not primarily engaged in the business of acquiring mortgage liens on real estate, National will reapply to the Commission for the necessary exemption.

For the Commission, by the Division of Corporate Regulation, pursuant to delegated authority.

ORVAL L. DuBOIS, *Secretary.*

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., April 17, 1970.

Re National Rural Utilities Cooperative Finance Corporation.

ROGER B. ORESMAN, Esq.,
Milbank, Tweed, Hadley & McCloy,
New York, N.Y.

DEAR MR. ORESMAN: Reference is made to your various letters dated from September 5, 1969 to December 24, 1969 concerning the proposed issuance of securities by National Rural Utilities Cooperative Finance Corporation. The salient facts are as follows.

National Rural Utilities Cooperative Finance Corporation (NRUCFC) was incorporated as a non-profit cooperative association under the District of Columbia Cooperative Association Act. NRUCFC will be owned and operated by and membership in will be limited to organizations eligible to receive loans from the Rural Electrification Administration (REA). The purpose of NRUCFC is to assist in meeting the needs for financing the nations rural electric systems, supplementing the basic direct federal financing program of the REA by borrowing funds in the market place and re-lending exclusively to its member rural systems. The member rural electric systems are not only the sole eligible borrowers from NRUCFC but are also its sponsors and founders.

NRUCFC and the proposed plan of financing was formulated as a result of the dissemination of a great deal of data referring to financing plans and full consideration and discussion at regional and national meetings of the National Rural Electric Cooperative Association commencing in 1963. NRU-CFC has been endorsed by the REA Administration as a supplemental financing source. In addition the Administrator will give recognition to members investments in NRUCFC not of their general funds which are subject to REA lien and controls.

In order to provide initial capitalization for its financing program NRU-CFC will require each REA electing to participate to purchase a \$1,000 membership certificate and a minimum amount of Capital Term Certificates Based on a formula each member will be required to purchase additional capital term certificates in a specified ratio to its borrowing. Capital Term Certificates will mature 50 years from date of issuance, will be redeemable at par, will not be freely transferable, except to other members, will be fully subordinated to all outside financing, and will bear interest at 3% per annum. Only members of NRUCFC will be holders of these certificates.

Under the Rural Electrification Act, the Administrator has virtually absolute discretion, exercises extensive and rigid supervision and control over the cooperative borrowers. The cooperatives books and records must be kept in accordance with the REA Uniform System of Accounts. Appointment of its manager, counsel, and other key personnel are subject to approval by REA. It can not merge or consolidate or sell or encumber any of its property without REA approval. The government's mortgage lien attaches to each of its extensions and it can not build extensions except with additional REA financing or with REA approval of other financing. All contracts of the member REA, including those for the purchase and sale of electric energy, must be approved by REA. NRUCFC will consider loan applications from its members only after a feasibility study of such application has been made. The feasibility study will be conducted with the cooperation of the REA.

technical staff. In case of joint loans by NRUCFC and the REA, the primary responsibility for the feasibility study will be in the hands of the REA. In considering loan applications, member rural electric systems will be divided in three classes: those member rural systems who are financially strong enough to pay the higher interest rates charged by NRUCFC, those rural systems who are not financially strong enough to pay the interest rates charged by NRUCFC, and the remaining members who do not fit either of these classifications. The first group will borrow from NRUCFC exclusively. The second group will borrow exclusively from the REA. The third group will borrow jointly from REA and NRUCFC. It is expected that most members will fall in this latter group.

You have expressed your opinion that the proposed offering of securities by NRUCFC is exempt from the registration requirements of the Securities Act of 1933 by reason of Section 3(a)(5) of the Act. While the question is not free from doubt, in view of all the above enumerated facts including the regulation by the REA, this Division will not recommend any action to the Commission if NRUCFC offers securities without compliance with the registration requirements of the Securities Act of 1933 in reliance upon your opinion as counsel that registration is not required.

Sincerely yours,

JOHN HENEGHAN,
Assistant Chief Counsel.

Senator MCGOVERN. Our other witness for today is Mr. Charles A. Robinson, Jr., who is the corporate counsel for National Rural Electric Cooperative Association.

Mr. Robinson is one of the Nation's authorities with respect to power and the financing of power. He is held in high regard, and we are grateful for his appearance here today, Mr. Robinson.

**STATEMENT OF CHARLES A. ROBINSON, JR., CORPORATE COUNSEL,
NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION**

Mr. ROBINSON. Mr. Chairman, you are more than generous, sir.

My name is Charles A. Robinson, Jr. I am corporate counsel of the National Rural Electric Cooperative Association, which is the national trade association of some 950 consumer-owned, nonprofit electric cooperatives.

I am accompanied today, Mr. Chairman, by Mr. Louis A. Roland, corporate counsel of the National Rural Utilities Cooperative Finance Corp., which is also a member-owned nonprofit cooperative, a member of NRECA, which has been organized to provide supplemental financing for some 860 rural electric cooperative members located in 46 States.

We are deeply appreciative, Mr. Chairman, for your taking time from what all of us recognize is an extremely busy schedule, especially this year, to hear us this morning because we think that is an extremely important piece of legislation; and we are indeed thankful to you.

At its annual meeting in February this year, the NRECA membership unanimously adopted a resolution strongly urging enactment of H.R. 12526 to enable rural electric systems to obtain the most effective and economic implementation of the REA loan guarantee program as authorized in the Rural Electrification Act. A copy of the resolution is attached as exhibit I¹ to this statement. We appear

¹ See p. 32.

in support of this bill and to substantiate our conclusions that each of its provisions is essential to the viable functioning of the REA loan guarantee program enacted last year.

And, Mr. Chairman, we feel we can demonstrate to the complete satisfaction of this committee that the enactment of H.R. 12526 will not expose the public to fraudulent activities in the securities field, or interfere with the objectives of the Federal securities laws.

The bill, as passed on May 21, 1974, by a vote of 386 to 9 in the House of Representatives, would: (1) amend section 306 of the Rural Electrification Act [the "Act"] expressly to authorize the assignment of REA guarantees to the extent permitted by the REA Administrator; and I might add there, Mr. Chairman, under the complete control and supervision of the REA Administrator, a point which I feel Mr. Garrett missed.

Senator MCGOVERN. That was the point I was trying to get at in my questioning of Mr. Garrett, whether or not the REA Administrator would not have some supervisory power over these securities and their issuance. I understood him to say that he did not, the bill did not give him that authority. Could you speak on that point to clarify it?

Mr. ROBINSON. Mr. Chairman, we think he is wrong on that, we take issue with him on that. Mr. Roland, who is the Corporate Counsel of CFC is an expert in that field; for more than 30 years he was in the General Counsel's office of the Department of Agriculture, working with REA; and he is now the chief legal officer of CFC. I would like to call on him to answer that question.

**STATEMENT OF LOUIS A. ROLAND, CORPORATE COUNSEL, NATIONAL RURAL UTILITIES, COOPERATIVE FINANCE CORPORATION—
Resumed**

Mr. ROLAND. As I started to say before, the present act, even before the amendments that are being proposed, already vests ample authority in the REA Administrator to supervise not only the direct making and guarantee of the loans to these rural electric cooperatives, but also the marketing of securities by lenders with REA guarantees.

The only lenders that would be authorized to issue the securities that are the subject of discussion here, would be lenders who have been approved by the REA Administrator.

The REA Administrator, in addition, must enter into a detailed contract of guarantee with each lender; and the terms of this contract of guarantee, as provided in the act, would require the lender to actually perform all functions in connection with the servicing of the loan. That alone would obligate a lender subject to the supervision of the Administrator to all functions of not only collections and normal servicing of loans, but also in carrying out mortgage and other obligations of the borrower. So, that there is immediately a very close relationship established between the REA and each of these lenders.

It's not a situation of hundreds of banks, or lenders of all kinds coming and being able to issue securities. The program so far enun-

ciated by REA, the guarantee program, has related to the power-supply field in which bulk power facilities are to be financed and guaranteed. And the first four commitments made by REA for guarantees have been with respect to loans involving from \$100 to \$500 million. These are going to be very large, very closely controlled, and worked loans.

And, you can be assured that REA in connection with each one of these things must carefully investigate these lenders, and will carefully provide the terms and conditions of that contract of guarantee.

Now, this bill specifically calls attention to the fact that one of the factors under REA control would be the assignability of the guarantee by the lender. The guarantee will of course go to the lender who has made the loan. The lender, in turn, will be selling its securities backed by these guaranteed loans.

The fact is that the Administrator could in his discretion and within the express terms of this bill directly authorize the assignment of the government guarantees to the holders of lenders' securities under some circumstances, so that the holders of the securities might have direct claims against the government through the assignment of the guarantee. Or, through protective devices incorporated in trust indentures, which the REA Administrator would review and supervise, protection for the investor could be provided with respect to these guarantees such that if the lender were to fail, or simply be unable to pay his obligations to the investors, the investors would have the right to enforce the government guarantees, perhaps through the trustee, but outside the control of the lender, by virtue of the assignment of the guarantees to the trustee and by virtue of the controls that the REA Administrator would naturally exercise over these indentures.

Senator MCGOVERN. Well, what was your answer to Mr. Garrett's argument, then, that there is a third party imposed through the pooling arrangement whereby the investor who participates in these pools really has no claim against the U.S. Government?

Mr. ROLAND. Well, I must disagree with the SEC Chairman for the reason that he has left out of consideration the fact that the REA Administrator may permit these government guarantees, backed by the full faith and credit of the United States, to be effectively assigned, under terms and conditions specified by the Administrator, to the holders of those securities.

Senator MCGOVERN. That gets back to the good faith of the U.S. Government.

Mr. ROLAND. Right. So, that the holder of this security does not have to look only to this so-called third party, or lender, but will be able to look to the government directly, or through a trustee acting under provisions of an indenture, which would be subject to the review and supervision of REA.

Senator MCGOVERN. Can either of you gentlemen shed any light on why there was a misunderstanding? He seemed to be very definite on that.

Mr. ROLAND. If I might say so, I don't think he was familiar with the present act provisions on the authority of the Administrator, or

with the proposed provisions regarding assignment. I find in his statement, as well as his prior brief, a disregard of the assignability feature of this guarantee, and of the supervisory authority of the Administrator, not only with respect to the immediate guaranteed loan, but also with respect to assignees of that guarantee. The Administrator would have supervision over the entire process, including the rights of those ultimate investors to look to the government.

Senator McGOVERN. Well, that has been my understanding of the bill all along, and I was surprised when the chairman of the SEC argued that there was no supervisory authority there, and no real government guarantee. It seems to me that was a misstatement of what was in the bill, that is why I wanted to draw you out on that point.

Senator Dole?

Senator DOLE. Are you familiar with the Bellmon amendment?

Mr. ROLAND. Yes, reasonably so.

Senator DOLE. I think that would, in regard to government national mortgage association guarantees, participation of Farmers Home Administration, guaranteed loans—do you favor that amendment?

Mr. ROLAND. Well, so far as CFC is concerned, and I believe NRECA, we would have no objection to that amendment. We feel that it's adapted more for the farmers home program than it would be for the REA guarantee program. We believe that the rural electrification guarantee program could best be served by the proposed amendments in H.R. 12526, rather than the Bellmon amendment because the latter has certain disadvantages. Also, the REA guaranteed loan program is not subject to the types of problems that the Farmers Home lenders have suffered, that is, difficulties with secondary markets, which might make necessary for them the type of guarantee provided in the Bellmon amendment.

In other words, we don't have any objection to the Bellmon amendment, but we don't think that it is suitable for use in the REA program.

Mr. ROBINSON. Mr. Chairman, I think what Mr. Roland is saying, is that we would have no objection whatever if the Bellmon amendment were attached to this bill. We do not believe that it would constitute an acceptable substitute for the bill; but we have no objection to attaching it to the bill.

I might nail down the answer to Mr. Garrett's principal argument. On line 6 on page 2 of the bill it makes very clear the fact that all of the certificates issued by these pools which would be exempted, must be fully and 100 percent secured by government, guaranteed government backed paper, or cash. And the security, this 100 percent security, the government guaranteed paper or the cash, must be placed beyond the reach of the issuer, about whom Mr. Garrett is worried. Mr. Garrett is worried about this third-party being inserted between the government and the guaranteed purchaser.

That third party must place the government backed securities, which are collateral for the participation, beyond his own reach;

and they must be placed with an institution chartered by Federal or State agencies to act as a trustee.

Those of you who have had experience in dealing with agencies, or organizations chartered to act as trustees recognize that in all States they must satisfy some pretty high requirements, and be bonded, and generally be institutions of stature and institutions of substance in the community. A major bank, for instance, would be a suitable depository for these government guaranteed securities that must be placed beyond the reach of the issuer of these participation certificates. So, you are not going to deposit the collateral for these exempt notes with any fly-by-night organization. They have to be deposited with an organization chartered to act as a trustee. And even every bank is not chartered as a trustee, these have got to be organizations in the States with trustee powers; and that requires satisfying some pretty strong statutory standards in each case.

So, there is going to be more than adequate security and protection for the ultimate purchaser of these exempt certificates.

In the event that these conditions are not met, unless there is 100-percent backing by Government guaranteed paper, and unless all of that paper is placed beyond the control of the third party, then the exemption does not apply, and the SEC has all of its authority to go in there and crackdown.

So, this is a very narrow exemption. It's an exemption under which the purchasing public is very adequately protected.

Senator DOLE. On page 3 it says, "A guaranteed loan, including the related guarantee, may be assigned," will that be done in all cases? That's permissive.

Mr. ROLAND. Well, if I may answer.

Mr. ROBINSON. Certainly.

Mr. ROLAND. I assume, from the original intent of the act, that it was contemplated that these guarantees would always be assigned.

Senator DOLE. They changed that to "shall."

Mr. ROLAND. Well, it seems to me the terms and conditions of the assignment would still have to be determined, and I should think that REA, as the Government agency, would still have the discretion over such terms and conditions.

But, what I'm speaking about is this, that the act contemplated, in fact named, CFC as a lender under the guaranteed program, in so many words. And it was well known that the CFC doesn't have the funds itself, that it has to raise the funds in the capital market.

So, for these guarantees to be of any value at all in reducing the rates of those securities for the benefit of the rural electric cooperatives, they've got to be assignable, at least to the trustee who is holding the securities in trust for the investors, and possibly even in some circumstances directly to the investors. So, there has to be some form of assignment of the guarantee to make the plan effective.

Mr. ROBINSON. I think that the answer to Senator Dole's question is, that in some cases there will be no assignment. It depends on who makes the loan. If a primary lender makes the loan, he may just want to hold onto the guarantee himself and not assign it. And, if you put "shall" in there, you have language that makes it difficult

for the primary source of money to advance it because he will then under legal consumption to assign and there will not be an assignee.

In other words, the language or its stand would make certain that the secondary lender, such as CFC, after advancing the money, could go the open market to raise it, and would be in a position to have the security follow the evidence of indebtedness.

Senator McGOVERN. It seems to me the language that you are referring to, Mr. Robinson, on line 6 of page 2 is very clear. I am really puzzled as to why the SEC does not think so, that it is a properly secured program. That language seems very explicit to me, beginning on line 7,

* * * shall at all times be secured by a principal amount of, and interest which has accrued on, guaranteed loans, an amount of cash or a principal amount of, and interest which has accrued on, any securities of a class exempted by section 3(a)(2) of the Securities Act of 1933, as amended.

Now, that seems pretty clear to me, I don't see how you could get stronger collateral than the good faith of the United States. And even the cash rests on the good faith of the Government.

Mr. ROLAND. I think it is also important to emphasize that to the extent there is any departure from these act requirements on security, the act would not exempt those securities, and the securities issues would be subject to all the possible civil fraud, or criminal penalties which he would be subject to under the SEC legislation.

So, the exemption applies only in connection with these very narrow security requirements, and these narrow requirements have to be followed literally and completely for the exemptions to apply.

Mr. ROBINSON. Mr. Chairman, to go down to line 20, the (i) there, you can see that one of the conditions of the exemption is that the issuer place this collateral beyond his own reach.

So, he may not issue those exempt securities and then sell the collateral because they won't have the legal authority to do it, and they won't be able to get possession of the securities.

Senator McGOVERN. Beyond that, he has to provide periodic reports of sales that the Administrator deems necessary. That seems to me to clearly involve the Administrator in a supervisory and monitoring role.

Mr. Robinson, why don't you proceed with your statement, or if you just want to highlight it, I'll leave that to your judgment.

Mr. ROBINSON. It's a short statement, Mr. Chairman, I think I will read it.

(2) Clarify the provisions of section 308 of the act, which states the conditions under which the Government guarantee remains incontestable, to assure that the guarantee will be incontestable in the hands of assignees except for fraud or misrepresentation of which the holder had actual knowledge at the time it became a holder: and (3) exempt from laws administered by the Securities and Exchange Commission, except for specified fraud provisions, securities which are issued by REA-guaranteed lenders where such securities represent beneficial ownership in, or are fully secured by, REA-guaranteed loans.

The first two provisions I have described are technical amendments which clarify the intent of the Congress in enacting sections 306

and 308 of the act, and which are, we believe, entirely noncontroversial. These amendments are essential to the proper functioning of the REA-guaranteed loan program because investment bankers and other organizations in the financial community, which are expected to purchase securities issued by REA-guaranteed lenders, and thereby provide the funds required to make REA guaranteed loans, have raised questions regarding the act's present language on assignability and incontestability of REA guarantees. These questions on assignability and incontestability would be answered by the clarifying amendments of the bill.

The third amendment proposed by the bill, which provides the SEC exemption, is, we believe, equally essential if the REA guaranteed loan program is to serve the basic purpose stated in the preamble to the 1973 amendments to the act, of providing investment capital for rural electric systems from their own financial organizations, like CFC, which Mr. Roland represents today; and other non-REA sources at rates they can afford to pay.¹

Exemption from expensive and time consuming compliance with SEC procedures is necessary and desirable in order to effectuate the congressional intent of providing rural electric systems capital from private sources efficiently and inexpensively. The purpose of SEC regulation—protection of the investor—would not be endangered by this legislation.

Our conclusion in this regard is reinforced by the Report of the House Committee on Agriculture on the legislation which was Report No. 93-1033, in which it is pointed out that the exemptions from SEC procedures provided in the bill for securities based on or backed by REA-guaranteed loans parallel the same exemptions recently granted by Congress in Public Law 93-86 for securities representing beneficial ownership in guaranteed notes under the Rural Development Act's guaranteed-loan program. The report clearly indicates that the SEC exemption would serve the interest of effective and inexpensive implementation of the guaranteed loan programs of both REA and Rural Development Acts, and recognizes that the interests of investors would nevertheless be fully protected.

We note, however, that in a memorandum of June 6, 1974, submitted by the Chairman of the SEC with his letter of June 13, 1974, to the Chairman of the Senate Committee on Agriculture and Forestry, and Chairman Garrett's testimony this morning, the SEC contends that H.R. 12526 would leave investors in such securities insufficiently protected contrary to the policies of the security laws. Our detailed analysis of the SEC memorandum of June 6 with our reasons for believing the SEC position to be unfounded is attached to this statement as exhibit II.²

¹ The preamble to the 1973 amendments to the act which established the guaranteed loan program contains the following statement of congressional policy: "... it is hereby declared to be the policy of the Congress that adequate funds should be made available to rural electric and telephone systems through direct, insured and guaranteed loans at interest rates which will allow them to achieve the objectives of the Rural Electrification Act of 1936, as amended; and that such rural electric and telephone systems should be encouraged and assisted to develop their resources and ability to achieve the financial strength needed to enable them to satisfy their credit needs from their own financial organizations and other sources at reasonable rates and terms consistent with the loan applicant's ability to pay and achievement of the Act's objectives. . . ."

² See p. 33.

Under H.R. 12526, as in Public Law 93-86, the remedies of investors for the broad types of fraud, misrepresentation and deceit described in section 17 of the Securities Act of 1933 are expressly preserved. In addition, if, as it appears from its memorandum, the SEC is of the opinion that the body of antifraud law developed by the courts under the analogous section 10(b) of the Securities and Exchange Act of 1934 would offer protection against fraud, we have no objection to adding section 10(b) to the fraud provisions already excepted from the exemptions of H.R. 12526.

Mr. Garrett stated in his presentation, Mr. Chairman, that section 10 of the Securities Act would provide more protection against fraud than section 17, therefore we say, okay, put section 10 in if you want to leave it there; we have no objection to that.

If you want to except from the provisions of this bill section 10 of the Securities and Exchange Act, we don't object at all, that's the antifraud provision. We are not out to defraud anybody. Any antifraud provisions they want to add to the act is fine with us, section 10 in addition to section 17.

SENATOR MCGOVERN. I think we will ask the staff, then, to take a look at that.

MR. ROBINSON. 10(b) of the Securities and Exchange Act of 1934, would go in at line 10 of page 1 of H.R. 12526 after the word "except".

While the disclosures to investors required by the securities laws and SEC supervision associated therewith are removed in both H.R. 12526 and Public Law 93-86, it should be emphasized that in both cases provision is made for specific protective requirements in the interests of investors as well as for Agency supervision of these requirements. Thus, H.R. 12526 expressly requires that exempted securities of lenders must represent beneficial ownership in, or be secured 100 percent by REA-guaranteed notes. If a lender were to issue securities which do not meet these specific statutory requirements, the securities would not be entitled to any exemption from the Federal securities laws and the lender-issuer would be subject, at its peril, to all civil and penal sanctions provided for violation of these laws.

Unless every one of the conditions of this bill are met, none of the exemptions apply.

The REA Administrator is further expressly mandated by H.R. 12526 to require the issuer of the exempted securities: (a) to place the REA guaranteed notes in the custody of an institution chartered to act as a trustee by a Federal or State agency, or to place the guaranteed notes or equivalent security in trust with such a trust institution and (b) to provide periodic reports to the Administrator. These statutory requirements, added to the requirement that exempted securities must be fully based on or backed by Government guarantees assure that the exempted securities of the issuer will in effect be Government-guaranteed securities; since the securities are placed beyond the reach of the issuer, the investor is not subject to risks resulting from any financial difficulties of the issuer. The investor is thus obtaining, essentially, a Government-guaranteed se-

curity, and the policy of the Federal securities laws plainly favors exemptions for such securities.

Moreover, H.R. 12526 grants the Administrator express authority to specify the conditions under which REA guarantees may be assigned by lenders, and section 306 of the act authorizes him to approve or disapprove lenders and to determine the conditions governing contracts of guarantee with lenders. Under all these provisions, the REA Administrator is amply empowered to supervise, in the interests of protecting investors, the terms and conditions of custody agreements, trust or security indentures, contracts of guarantee and assignments of Government guarantees.

These are all the points that Mr. Garrett made, and the REA Administrator is quite obviously, we think, and completely clothed with authority to exercise this kind of jurisdiction.

The plan of H.R. 12526 is thus clear, to specify requirements for exempted securities which essentially assure the investor of the rights of a holder of Government-guaranteed securities, and to grant ample supervisory authority for investor protection to the informed discretion of REA, the Agency to which is committed the direction, supervision and effectuation of all other aspects of the guaranteed loan program. Surely, Congress may properly determine that the Agency best informed and most directly concerned in effectuating the program with minimum delays and at least cost to the RECs, should also be vested with the responsibility of supervising the act's provisions for the protection of investors who will purchase the securities which make the guaranteed loans possible. This could hardly constitute a uneconomic creation of a "little SEC" for the REA-guaranteed loan program, since REA need in any event, in connection with its other responsibilities for the program, keep itself fully informed and supervise the actions of its approved lenders.

Nor is this plan of H.R. 12526 for the protection of investors at all unique. In fact, Congress has often exempted securities from the operation of the Federal securities laws and from associated SEC supervision on the basis, and in many instances solely on the basis, that other governmental agencies, Federal or State, had the authority to provide protective supervision.¹

¹ Thus, under section 3(a) of the Securities Act of 1933 the following types of securities are exempted from the operation of that act: (1) "Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia" (subsec. 8); (2) "Certificates issued by a receiver or by a trustee in bankruptcy, with the approval of the court" (subsec. 7); (3) "Any security issued by a common or contracts carrier, the issuance of which is subject to the provisions of section 20a of the Interstate Commerce Act, as amended" (subsec. 6); (4) "Any security issued (A) by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution (with certain exceptions) . . . or (B) by (i) a farmer's cooperative organization exempt from tax under section 521 of the Internal Revenue Code of 1954, (ii) a corporation described in section 501(c)(16) of such Code and exempt from tax under section 501(a) of such Code, or (iii) a corporation described in section 501(c)(2) of such Code which is exempt from tax under section 501(a) of such Code . . ." (subsec. 5); and (5) "Any security issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or territory or by any public instrumentality of one or more States or territories, or 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; or any certificate of deposit for any of the foregoing; or any security issued or guaranteed by any bank . . ." (the term "bank" being defined as any national bank or any state bank "supervised" by a state bank commission or similar official) (subsec. 2).

Senator MCGOVERN. We will see that that will all be made part of the record, as well as the exhibits you have submitted, Mr. Robinson.

Mr. ROBINSON. Thank you very much, Mr. Chairman.

And similar exemptions from securities law requirements have been granted by Congress through laws or amendments of laws other than the Federal securities laws.¹

Finally, in the light of the foregoing, we believe that the proposed securities law exemptions of H.R. 12526 are not only highly desirable from the standpoint of the rural electrification program, but also are entirely justifiable by any test of the public interest.

Again, Mr. Chairman, we very much appreciate this opportunity to present our views, and we appreciate your patience and your understanding of the program.

Senator MCGOVERN. Thank you very much, Mr. Robinson, that was a very clear and self-explanatory statement. There is just one point I wanted to ask you, if you and Mr. Roland could elaborate on further.

In your statement, you refer to one of the advantages of this bill, where it provides exemptions from expensive and time-consuming compliance with SEC procedures.

I believe, if there is anything we need to do in Government today that everybody has agreed on, it would be to eliminate any unnecessary redtape, any delay, any expense, in implementing the Government programs; they are sometimes very frustrating even at best. I wonder, if you could just elaborate further on the particular advantages you see in this bill.

Mr. ROBINSON. Mr. Chairman, Mr. Roland has first-hand experience, so, I would like to have him answer that.

Mr. ROLAND. Well, as an illustration of the delays, the time, the effort, and the expense, CFC in December of 1972 had its first bond issue, and in connection with that issue—of course these were securities which were not in any way exempt from SEC jurisdiction—it took, I think, more than 12 months of continuous work on the registration statement, on the prospectus, and on the trust indenture, to fully prepare those documents to comply with the applicable requirements of the SEC legislation.

So, there is a great length of time needed for preparation of documents, besides the expenses of the specialized SEC-oriented lawyers, and the underwriters, and all the things that go with SEC requirements; the expense is not small. And then there is, of course, the additional time that SEC approvals take in order to be able to proceed with the bond issues.

So there is much more involved here than just a 30- or 60-day delay in getting approval from the Securities and Exchange Commission, and paying its fees.

Furthermore, we think that the whole tenor of the REA-guaranteed loan program is to reduce expenses in connection with marketing these securities, all for the benefit of the rural electric coopera-

¹ Such as, for example, the National Bankruptcy Act (sections 264 and 393, as amended June 22, 1938, and September 25, 1962), the Bretton Woods Agreements Act (as added by act of June 29, 1949, 22 U.S.C. 286 k-1); and the Inter-American Development Bank Act (22 U.S.C. 283 h and i).

tives. And reduction of these expenses certainly carries out the basic purpose of the guaranteed program.

Senator McGOVERN. Thank you very much, gentlemen. I think, as we have gone along, most of the questions have been answered.

I'm not asking for comments on this, but, while you are here, I just want to make a couple of observations for the record. I know what the position is of the NREPA on this bill, but some months ago the Senate passed legislation, S. 2150, which would recognize the changing nature of the market which the rural electric cooperatives are asked to serve. We provided that the farmers' voting control requirements for borrowers from banks for cooperatives would be set at 60 percent in the case of these cooperatives instead of 80 percent, as now required.

The bill passed the Senate some time ago, but I just want to serve notice that I am going to ask the committee, to add that bill as an amendment to the legislation you are testifying on today. I know NARCP supported the bill at the time it was passed, but I wanted you and others to know that it is my intention to bring this up as an amendment to the legislation you testified on before us today.

There is another matter which I think we ought to consider, and again, I am not asking for any comments on it. The Rural Telephone Association already has a Federal bank from which they can borrow, and I would like to talk with them about this, subject to their approval. I think it might be wise for us to consider a provision, in this legislation providing that loans can be made from Federal financing banks for the RTA, since they are already taken care of.

I have just submitted these two points for the public record so that we can have a little more time to consider them.

Again, I thank you for your appearance today.

Mr. ROBINSON. Mr. Chairman, we appreciate your patience.

[The attachments to Mr. Robinson's statement, are as follows:]

EXHIBIT I

ANNUAL MEETING OF NRECA, 1974

RESOLUTION NO. D-8

AS UNANIMOUSLY ADOPTED BY THE MEMBERSHIP

Subject: Amendments to Sections 306 and 308 of the Rural Electrification Act.

Representative W. R. Poage of Texas, Chairman of the House Committee on Agriculture, on February 4, 1974, introduced a Bill, H.R. 12526, to amend Sections 306 and 308 of the Rural Electrification Act.

The Bill would:

- (a) amend Section 306 expressly to authorize the assignment of REA guarantees;
- (b) clarify the provision of Section 308 which sets conditions under which the Government guarantee remains uncontestable; and
- (c) exempt from Securities and Exchange Commission regulation of securities issued by a lender which are fully backed by loans guaranteed by REA.

Enactment of H.R. 12526 will enable the rural electric systems to obtain the most effective and economic implementation of the REA loan guarantee program and will furnish desirable clarification of the guarantee provisions of the Act.

The N.R.E.C.A. strongly urges Congress and the Administration to enact H.R. 12526.

EXHIBIT II

SUMMARY OF POINTS MADE IN SEC MEMORANDUM

CONCERNING H.R. 12526, 93RD CONGRESS, AND COMMENTS IN RESPONSE

Point 1. (p. 4 *et seq.* of the SEC memorandum)

Exemptions from the registration requirements of the Securities Act of 1933 are provided for securities the common characteristic of which (with a few exceptions not here material, such as short term securities or the securities of religious or educational and similar organizations) is that they are issued or guaranteed by governments, instrumentalities of governments or by entities subject to the supervision of governmental bodies. This is said to be not pertinent to the present case.

Response.—These existing exemptions are indeed most pertinent to H.R. 12526. The proposed exemption of securities issued by legally organized lending agencies secured by, or representing beneficial ownership in, loans fully guaranteed by REA has the same rationale and justification as these existing exemptions. That is, the Administrator of REA, before guaranteeing a loan which the United States might be required to repay, would have full authority to require the lender (the issuer of the securities to be exempted) to assent to contractual controls and supervision by REA of the lender. As illustrated in our Statement to which these comments are attached as an exhibit, there are numerous instances in which such governmental agency supervision has been deemed an adequate substitute for SEC oversight. Furthermore, in respect of evidences of indebtedness issued pursuant to H.R. 12526 by an REA-approved lending agency and collateralized by guaranteed loans (including, as authorized by the bill, an assignment of the guarantee), the holder of such evidences of indebtedness would look to the Government agency for recovery. Accordingly, in this situation, as the SEC memorandum states on page 6 in respect of the existing exemptions, "the protections afforded by registration . . . [are] unnecessary." (Securities issued by the lender and representing pool participations are discussed below under Point 2.)

Point 2. (p. 6 *et seq.* of the SEC memorandum)

Purchasers of securities evidencing beneficial interests in a pool consisting of government-guaranteed securities need the protection afforded by the 1933 Act because such purchasers could not look to the guaranteeing government agency for recovery in the event of default on the security.

Response.—In view of the bill's express provision permitting assignment of the guarantee on terms and conditions to be established by the Administrator of REA in the contract of guarantee, this argument is without merit. With such an assignment by the issuer for the benefit of holders of evidences of beneficial interests in the pool, such holders would be able to recover from the Government and would not, in the words of the SEC memorandum at page 7, "have only the financial solvency and reliability of the person creating and managing the pool to whom they may look for any return on their investment." Furthermore, the proposed legislation, by requiring that the securities in the pool be placed in trust with a custodian which would be approved by REA, would place these underlying securities beyond the reach of the issuer of the participations and thus give their purchasers added protection.

The *Derryberry* case cited in the footnote on page 7 of the SEC memorandum is unreported, but the *Haynes* case there cited clearly does not support the SEC argument. The gravamen of the SEC complaint in that case was that the defendant committed fraud in that he did not inform purchasers of participations that the proceeds would be applied to investment in E bonds and not just to a chemical importing business which the defendant stated was to be the sole basis for the prospect of profit. Furthermore, unlike the situation before the Subcommittee, there was no intention in *Haynes* to collateralize the participation with the E bonds.

Point 3. (p. 7 *et seq.* of the SEC memorandum)

The requirement of the proposed legislation that the pooled guaranteed securities be placed in the "custody of an institution chartered by a Federal or State agency to act as trustee . . ." is inadequate protection because such a custodian would not necessarily be supervised by a banking commission or similar official. In addition, the legislation provides no sanctions if an agency not so supervised is used, and affords no protection against pool spon-

sor misconduct, excessive fees to the sponsor or any other undisclosed aspect of the custody agreement.

Response.—The short answer is that if custodians ought to be restricted to such a class, the Administrator of REA, pursuant to his authority under H.R. 12526 and Section 306 of the REA Act, could and would establish that requirement as a term of the contract of guarantee. Moreover, the terms and conditions of the custody agreement would also be subject to approval or supervision of the Administrator.

Once the requirement as to the character of the custodian and required terms of the custody agreement are administratively specified in the contract of guarantee, adequate sanctions could also be fashioned and specified in the contract for failure of the pool manager-lender to comply.

As to "misdealings by the pool sponsor, excessive fees or remuneration to the sponsor, or any other undisclosed aspect of the custody agreement" (SEC memorandum, p. 8), REA control through the terms of the guarantee agreement and other forms of supervision of the activities of the lender would constitute more effective protection for investors than requiring compliance with the Securities Act, since SEC jurisdiction in this respect relates to "disclosure" rather than direct regulation of "misdealings, excessive fees or remuneration," and only in respect of "disclosure" would the jurisdiction of SEC be as effective as (and it would be no more effective than) the authority vested in REA to supervise the pool manager-lender through the terms of the guarantee contract.

Point 4. (p. 8 *et seq.* of the SEC memorandum)

The proposed legislation, while retaining the anti-fraud provisions of the 1933 Securities Act, does not also make the anti-fraud provisions of the 1934 Securities Exchange Act applicable.

Response.—Supporters of the legislation clearly do not wish to reduce investors' protection against fraud. We would have no objection, therefore, to adding section 10(b) of the 1934 Act as an exception to the exemption from SEC jurisdiction.

Senator McGOVERN. We will keep the record open for five days for any additional statements; the hearing is now adjourned.

[Whereupon, at 11:20 a.m., the subcommittee adjourned, subject to call of the Chair.]



