2/21/1938

Memorandum re attached plan entitled
"Credit for Small Industry"

The plan was developed originally as a suggested mechanism for meeting the credit and capital requirements for small industry, and is submitted only as a general outline in preliminary form, many details as to organization and operation being omitted.

In view of the continued unsatisfactory condition of the capital market, it has been suggested that government aid for business should be extended to the larger corporations as well as to the small ones. This could be accomplished by a government-sponsored industrial credit corporation such as is proposed in the attached plan, with amendments as follows:

1. Removing the maximum limitation of $1 million to any one borrower.

2. Permitting the corporation to invest in existing securities so as to assist the capital market, absorbing undigested issues or taking any other appropriate action.

It has been further suggested that under present conditions any plan for furnishing capital aid to business in order to be of substantial effect and to serve as a recovery measure, must be based upon a rather liberal credit policy. It would likely be necessary under present conditions that the credit corporation make a substantial portion of its advances or investments upon the security of junior securities, including preferred stocks, and on terms more favorable than can be obtained presently in the capital market. In other words, it is reported that some large corporations would today undertake capital improvements if they could market their securities on favorable terms, which is not possible in the present state of the capital market. If these suggestions are to be followed, the portfolio of the credit corporation would not permit the ready sale of debentures by the corporation at a low enough coupon rate to permit the corporation to make the indicated loans at rates which would induce business to undertake capital expansion under present economic conditions. Therefore, to carry out such a program it would be necessary to have the government guarantee the debentures of the credit corporation, also that the capital of the corporation be substantially increased above the amount proposed in the attached plan.

February 21, 1938

Credit for Small Industry

I. The Problem.

Small industry's need of enlarged credit facilities arises from two causes.

A. Depression: Creditors are aware of the deterioration of the risks in existing credits to small business and are pressing for payment or reduction. This tends to further restrict the operations of small business and if continued will bring about a great deal of insolvency and bankruptcy. Thus there is a need of short or medium term credits, partly for refunding and partly for maintaining or increasing present output.

B. Capital Expansion: While at the moment there is probably a limited demand by small industry for capital expansion, there is unquestionably some demand and with any general resumption in business the demand will be acute. Therefore, a mechanism should be in operation at an early date to anticipate this need.

II. Present facilities for capital inadequate:

As against the period of the '20's the following developments have impeded the flow of capital to industry generally and particularly to small industry. This is not in criticism of the legislation and regulations referred to in their general purposes but simply to show factually the effect of them on the flow of capital to industry.

A. Underwriting by banks of deposit: This has been prohibited by law. While the underwriting of security issues by investment bankers is still permissible, a great deal of investment banking

capital was wiped out by the depression and it is generally admitted that there is a shortage of capital in that field at present. Underwriting by banks was always an important adjunct of the capital market and while it is impossible to estimate just what difference its absence is making in the present situation, it is reasonable to suppose that it is an important factor.

B. The Securities Act of 1933: This Act and the regulations issued pursuant thereto have discouraged the issue of stocks and bonds generally and have prevented almost entirely the flotation of securities by small industry. This is not due to the registration fee which is very nominal, but to the fact that the registration process is necessarily complicated and technical so that relatively heavy expense is incurred for lawyers, engineers, underwriters' expense, etc., which is proportionately heavier for smaller issues. From a statistical survey by the SEC of the estimated costs involved in the issuance of new securities (bonds, notes and debentures) from January 1, 1936, to June 30, 1937, the following percentages of cost as against gross cash realization of the securities illustrate the heavier burden on the smaller issues, particularly under one million dollars.

(In thousands)	Under $250	$250-499	$500-749	$750-999	$1,000-4,999	$5,000-9,999	$10,000-24,999	$25,000 or more
Number of issues ..	11	8	6	6	50	11	37	35
Commission and discount	6.4	6.2	5.2	4.2	3.4	2.3	2.2	2.1
Other expenses	2.2	2.0	2.5	2.0	1.4	1.1	0.9	0.6
Total	8.6	8.2	7.7	6.2	4.8	3.4	3.1	2.7

The exemptions from registration as to "private offerings" would afford some relief if liberalized. However, any change in the registration requirements would be of no effect unless accompanied by appropriate changes in the Comptroller's Regulation on Investment Securities next referred to.

C. The Comptroller's Regulation on Investment Securities: Even if there were no registration requirement whatever, the Comptroller's Regulation would effectively prevent small industry from obtaining capital from member banks through the issue of securities. The statute leaves wide discretion to the Comptroller to regulate the type of "investment securities" that may be purchased by member banks. The Regulation very properly endeavors to define "investment securities" so that unsound or speculative issues are not eligible. The definition, however, lays stress not only upon the inherent quality of the obligations but requires that they be "marketable". Marketability is obviously closely related to the extent of distribution and the Regulation proceeds on that ground by requiring that the issue be of a sufficiently large total to make marketability possible and in addition that such marketability be protected or insured by a public distribution unless it is an exempted security. In effect, this means that small issues, hence local issues, cannot quality under the Comptroller's Regulation. Small business, therefore, is now effectively blocked from the capital market.

But, one may ask, should banks be permitted to invest in small issues? Should they have securities of limited marketability? This comes down to the question of "liquidity" in banks and involves the whole question of Federal Reserve credit policy and bank examination policy, discussed below. Suffice it to say at this point that small business is today effectively barred from obtaining needed capital from security issues, which furnish a substantial part of the capital requirements of large industries.

D. Capital loans and bank examination policy: In the light of the obstacles to the issue of securities by small industry and their purchase by banks, outlined above, the natural question is, why do not the banks make direct capital loans to small industry, thus avoiding, for the bank, the Comptroller's Regulation and, for the borrower, the heavy expense and long delay involved in registration and underwriting? The average banker would reply, "I don't like capital loans in the first place, and in the second place, if I made any, the bank examiner would criticize them severely." This is perfectly true. By tradition bankers are fearful of capital loans and if there were any disposition on the part of banks to make such loans the bank examiners would soon discourage it. At the same time it is considered highly proper for a bank to invest in rated bonds which are simply another form of capital loan. But here the banker feels that

he is following sound practice because the bond is "marketable". Experience has shown, however, that marketability is an illusory quality and invariably disappears at a time when the bank most needs to dispose of its securities. The Federal Reserve System, under the authority of the Banking Act of 1935, has recognized the inconsistency of looking at the form rather than the substance of a bank loan and has consequently made all sound assets of member banks eligible for advances at the Federal reserve banks. Hence, if any member bank or group of banks should make a sound capital loan to a local industry, this loan would be available for credit at the reserve bank in case of need. Nevertheless such a loan would unquestionably be severely criticized by bank examiners of whatever authority, Federal or State. Examiners, like most bankers, have the liquidity complex and classify loans as "slow" if the maturity is beyond a few months. There should be no "slow" classification. A loan is either good or it is a loss, in varying degree; and maturity should not enter into the classification. A step in this direction was made by the Examiners Conference of 1934 called by the Treasury, but the "slow" classification still exists and should be eliminated by all the Federal supervisory agencies. Undoubtedly the State supervisory authorities could be brought into agreement. Mr. Crowley, Chairman of the FDIC, has already expressed the concurrence of his organization in this suggestion. Such a move would be in line

with the present policy of the Reserve System in recognizing sound credits regardless of form and maturity. But the attitude of examiners should be changed even farther so as to encourage banks to make sound capital loans to local industries.

Summary of the Problem:

Small industry today has need of credit facilities to provide:

1. A certain amount of short or medium-term credit for current operations and to arrest the present deflationary contraction of credit. This is urgent.
2. Capital funds for expansion and refunding. This will become urgent with any recovery of business activity.

Meeting both these needs would contribute in an important manner toward recovery, first by arresting the current deflation and secondly by encouraging capital expansion.

The suggested program which follows does not deal with the question of underwriting by banks but would remove other barriers, as well as set up an entirely new mechanism.

III. The Program.

A. The objective. To provide (1) short or medium-term credit for which the depression has created an urgent need, and (2) capital funds to commercial and industrial businesses of smaller size, such funds to be used for expansion, refunding, modernization or otherwise.

B. Four complementary methods proposed:

(1) Liberalization of SEC regulations or amendment to the Securities Act of 1933 if necessary, in order to encourage the issue of local securities. (See Appendix "A")

(2) Liberalization of rules regarding purchase of investment securities by member banks through amendment to the regulations of the Comptroller of the Currency. (See Appendix "B")

(3) Changing examining policy so as to eliminate the "slow" classification and encourage sound capital loans to local industry, already discussed heretofore.

(4) Establishment of a permanent industrial loan facility by the Government. The "industrial loan" operations of the Federal reserve banks and the RFC under present authorizations and policies do not meet the problem either in its current or its permanent aspects. (See Appendix "C") There are several ways in which the mechanism for furnishing the credit requirements of small business might be provided. The RFC could be empowered by necessary legislative amendments. Since, however, the mechanism should be permanent, there is an apparent inconsistency in having such operations performed by an emergency organization. Similarly, legislation could be framed to authorize the Federal reserve banks to carry on the suggested activities but it is felt that the reserve banks, being banks of issue, should not take into their portfolios long-term capital loans and preferred stocks. It would appear, therefore, that the suggested activity could best

be carried on by a newly formed corporation which would specialize in the field and have no other activity. It is desirable, however, that in the interest of a prompt beginning of the operations as well as in the interest of economy, such a corporation be housed and staffed by some existing government agency. The Federal Reserve System has an almost ideal territorial distribution of facilities in the twelve banks with their twenty-five branches all located so as to best serve the various trade areas of the country. At the present time the Reserve System is extending very little credit to its member banks. At the same time each reserve bank must be prepared to extend such credit and hence must maintain a well equipped discount and credit department so that there is presently an overstaffed condition in such departments. It is suggested, therefore, that in the interest of speed and economy, the proposed corporation be owned and operated by the Federal Reserve System, the twelve banks with their branches furnishing the necessary field agencies and the Board of Governors with its staff furnishing the necessary head office direction and personnel. Therefore, with the addition of a few experts in the investment banking field, the System, as agent of the corporation, could very promptly begin lending to industry and insuring industrial loans made by insured banks.

The more detailed discussion hereafter, in which the Federal

Reserve System is connected up with the proposed corporation, is suggestive only, and if it is decided that the corporation should be owned and operated by some other agency of government, the purposes of the corporation could be carried out just as fully although not with the same promptness as to initial operations nor with the same economy.

IV. Industrial Loan Corporation.

A. Method of operations. It is proposed to create by law a corporation to supply capital funds to small businesses, and to insure loans made by insured banks (FDIC System) to small businesses, the insurance mechanism to be similar to Title I of the Federal Housing Act. This corporation would have a board of three directors. The Board of Governors from time to time would designate three of its own members as directors of the corporation and would also designate three alternate directors from among the remaining members of the Board of Governors or members of its staff. The corporation would utilize, as officers and employees, such officers and employees of the Board of Governors as might be necessary. The corporation would be authorized to utilize the Federal reserve banks as its agents, or, if it deemed it desirable, to designate other agents or set up its own agents. No director of the corporation and no officer or employee of the Board of Governors or a Federal reserve bank would receive any additional

compensation for his services for the corporation. The Federal reserve banks as agents would receive applications for industrial loans and make loans in the name of the corporation. They would also handle the insurance of loans made by insured banks of their district. The corporation would reimburse the Reserve Board and banks or other agencies for their expenses on such basis as might be determined by the Board of Governors.

B. Capitalization and Debentures. It is proposed that the Treasury pay over to the Federal reserve banks $100,000,000 (being a part of the unpaid remainder authorized under section 13b of the Federal Reserve Act). The Federal reserve banks would utilize the $100,000,000 to subscribe for stock in the industrial loan corporation. The Federal reserve banks would pay to the Treasury the amounts due the Treasury on account of sums received from it under section 13b, within a period not exceeding ____ years, and after the new corporation begins business the Federal reserve banks would make no new loans or commitments under 13b. Stock in the corporation would have no voting rights.

The corporation would have authority to issue debentures up to five times its capital and surplus; but it would be required to pay all earnings into a reserve fund for losses until this fund equaled five per cent of outstanding loans. Thereafter (so long as the reserve did not fall below this ratio) earnings

might be paid to surplus. The debentures would not be guaranteed by the United States.

It is further proposed that Congress appropriate $50,000,000 as an insurance fund to be administered by the corporation as set forth below.

C. Nature of loans to be made by corporation. The corporation would be authorized through the acquisition of notes, debentures, bonds or other similar obligations or of preferred stock to supply funds in amounts not exceeding $1,000,000 to any one enterprize. The obligations acquired would mature in not more than ten years, and at least forty per cent thereof must be paid off through partial payments before maturity. This would not prevent the renewal or extension of obligations at maturity.

D. Insured loans. The $50,000,000 insurance fund would be available to the corporation if and when needed to meet losses on insured loans made by any insured bank up to 20 per cent of the aggregate of all loans and advances made by such bank to any commercial and industrial business. The maximum amount of any such loans to one borrower would be $50,000, but a loan exceeding $_____ would be submitted to the corporation or its agent for approval before being made. No such loan could be made for the purpose of paying in whole or in part any existing indebtedness of the loaning bank. Any insured loan would have a maximum

maturity of ten years and provide for equal regular instalment payments under which the entire loan would be retired not later than the date of maturity. The total liability for insurance which the corporation might have outstanding at any time, plus amounts paid in settlement of insurance claims, could not exceed the amount of the insurance fund. This would provide insurance for a maximum of $250,000,000 of loans.

E. Regulations and reports. All the operations of the corporation, including insurance of loans, would be subject to a broad authority in the corporation to make rules, regulations and requirements, with a right in the Board of Governors to review and revise such rules, regulations and requirements from time to time. The Board of Governors would transmit to Congress with each of its Annual Reports an Annual Report of the corporation regarding the operations of the latter.

February 19, 1938.

APPENDIX A

Registration of Private Issues under Securities Act of 1933

Law. - Section 5(a) of Title I of the Securities Act of 1933 reads as follows:

> "Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—
>
> "(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell or offer to buy such security through the use or medium of any prospectus or otherwise; or
>
> "(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale."

Exemptions. - A number of classes of securities are exempt from registration requirements under section 3 of Title I of the Act. Subsection (11) of such section exempts the following:

> "Any security which is a part of an issue sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory."

Among other classes of securities which are exempt are Government securities, commercial paper, securities of religious and charitable organizations, securities of building and loan associations and similar organizations, securities exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is given, and others. The Commission is authorized by section 3(b) to exempt by regulation securities of an issue

which does not exceed $100,000 and under this authority it has exempted securities sold entirely for cash, the aggregate offering price of which does not exceed $100,000, and other issues not exceeding $100,000. With the possible exception of the exemption of securities sold entirely in the issuer's State, the above exemptions are believed to be of little significance in connection with the present problem, but the exemption discussed below for transactions not involving a public offering is believed to have important potentialities.

Private Offerings. - Section 4(1) of Title I of the Securities Act provides that the prohibition upon the use of interstate commerce and the mails for the purchase or sale or transportation of unregistered securities is not applicable to "transactions by an issuer not involving any public offering", and informally the Commission has taken the position that, generally speaking and subject to exception, securities which are offered to not more than twenty-five persons do not involve a public offering. However, this exemption applies only with respect to transactions by an issuer and not to transactions by a dealer or underwriter. It is understood, however, that in some circumstances an underwriter may be utilized in connection with unregistered issues not involving any public offering without violating the law where he is employed merely to attend to the details of the issue and he does not in fact perform the usual functions of an underwriter, i.e., purchase the securities with a view to public distribution.

Proposal. - It is believed that there is some uncertainty or misunderstanding as to the extent to which an underwriter may be utilized in connection with unregistered issues not involving a public offering without violating the statute and a more explicit ruling or statement by the Securities and Exchange Commission, which could be publicized, as to the circumstances under which an underwriter might be utilized would be very helpful in encouraging issues where no public offering is involved.

It would also be beneficial for the Commission to rule that an offering of securities exclusively to banks insured by the Federal Deposit Insurance Corporation of a limited number or in a restricted area would not be a public offering. The General Counsel of the Commission has stated that "the basis on which the offerees are selected is of the greatest importance. Thus, an offering to a given number of persons chosen from the general public on the ground that they are possible purchasers may be a public offering even though an offering to a larger number of persons who are all the members of a particular class, membership in which may be determined by the application of some pre-existing standard, would be a non-public offering." The General Counsel has also stated that another factor to be considered is the business of the purchaser, as for example, "whether the purchase of such a block of securities for investment is consistent with its general operations." Since insured banks as a class have facilities and experience which

enable them to evaluate securities and to protect themselves against fraud better than members of the public and since, as a rule, they purchase securities for investment rather than for resale, it is believed that a ruling such as that proposed above would be consistent with the position heretofore taken by the Commission.

Statutory Amendments. - Further liberalization of the registration requirements with respect to local, private, or small issues could be effected only through amendments to the law, and it is believed to be desirable that, as soon as practicable, amendments to the law be obtained as follows:

(1) Exempting securities which are part of an issue sold only to persons resident within a State in which the issuer has its principal business instead of requiring, as the existing law does, that a corporate issuer not only do business within the State but be incorporated therein.

(2) Increasing from $100,000 to $250,000 or $500,000 the maximum amount of an issue of securities which may be exempted from the Act by regulation of the Commission.

February 19, 1938

APPENDIX B

Purchase of Investment Securities by Member Banks

Law. - Under section 5136 of the Revised Statutes, a member bank "may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe." The section further provides that "the term 'investment securities' shall mean marketable obligations evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term 'investment securities' as may by regulation be prescribed by the Comptroller of the Currency."

Existing Regulations. - The regulations of the Comptroller of the Currency on this subject include the following provisions:

> "Under ordinary circumstances the term 'marketable' means that the security in question has such a market as to render sales at intrinsic values readily available.
>
> "In determining whether a given security is marketable, it must meet the following minimum requirements:
>
> "(a) That the issue be of a sufficiently large total to make marketability possible;
>
> "(b) (1) That a public distribution of the securities must have been provided for or made in a manner to protect or insure the marketability of the issue, or, in the alternative
> (2) other existing securities of the issuer have such a public distribution as to protect or insure the marketability of the issue under consideration, and such issue must be registered under the provisions of the 'Securities Act of 1933' as amended,

unless it is exempt from registration under Section 3 thereof.

"(c) That where the security is issued under a trust agreement, the agreement must provide for a trustee independent of the obligor, and such trustee must be a bank or trust company."

Since securities which have a public distribution must be registered under the Securities Act of 1933, it is obvious that as a practical matter all investment securities purchased by a member bank must be registered unless expressly exempt from registration.

Many securities which are floated in small issues or which are issued only locally are both sound and marketable, but nevertheless can not comply with the requirements of the Comptroller's regulations either because the issues are not sufficiently large in amount or because the securities do not have a public distribution. If a practicable means can be found by which member banks may purchase such securities, small businesses will be greatly aided in their endeavors to borrow capital funds on a medium or long term basis.

The regulations of the Comptroller also include the following provisions:

"The purchase of 'investment securities' in which the investment characteristics are distinctly or predominantly speculative, or 'investment securities' of a lower designated standard than those which are distinctly or predominantly speculative, is prohibited. The purchase of securities which are in default, either as to principal or interest, is also prohibited."

A footnote provides:

"The terms employed herein may be found in recognized rating manuals, and where there is doubt as to the eligibility of a security for purchase, such eligibility must be supported by not less than two rating manuals."

Proposal - Small or Local Issues. - It is proposed, therefore, that the regulations of the Comptroller of the Currency regarding the purchase of investment securities by member banks be modified so as to substitute for the existing marketability provisions other less restrictive provisions with respect to issues of a small or local character. Securities which are part of an issue of less than $_____ and which are part of an issue which is distributed locally--that is, not beyond a radius of, say, 100 miles of the principal office of the issuer--could be exempted from the marketability provisions of the regulation. In lieu of such provisions it would be required that the bank be able to show that there is or would be a reasonably ready market for the securities at intrinsic values if they were offered for sale, but not necessarily that they might be immediately disposed of at intrinsic values. The bank would be limited to 20 per cent of the amount of the issue or $50,000, whichever is greater. The bank should be in a position to demonstrate the marketability of any such securities that it purchases by evidence of the financial condition of the issuer, the standing of the issuer in the community, evidence of demand for the securities when issued, the ease with which they were sold and other facts tending

to show probable ability to dispose of them if the bank wished to do so.

Rating Manuals. - The present regulations prohibit the purchase of investment securities in which the investment characteristics are distinctly or predominantly speculative and permit the use of rating manuals to establish the eligibility of the securities for purchase. The use of rating manuals is obviously not appropriate for securities of a local character, and it is suggested that the reference to rating manuals as a method of determining whether a security is an investment or a speculation be eliminated altogether from the regulation.

APPENDIX C

Although Federal Reserve banks have authority under section 13b of the Federal Reserve Act to make industrial loans for working capital purposes, and although the Reconstruction Finance Corporation has authority to make loans to industry under certain conditions, these provisions do not meet the needs of the present situation and would not afford the same liberal basis for supplying funds to industry as that here under consideration.

Loans by Federal Reserve Banks under Section 13b of the Federal Reserve Act. - Federal Reserve banks are authorized under this section to make loans to established industrial or commercial businesses, either directly or in cooperation with financing institutions.

However, such loans can be made only for the purpose of providing working capital, must have a maturity of not exceeding five years, and can be made only to established businesses.

Many applications have been received by the Federal Reserve banks for loans under this section which could not be granted because the proceeds of the loan, or a substantial portion thereof, were to be used for fixed or permanent capital or for paying off existing indebtedness instead of for working capital. Applications have also had to be refused because the business applying for the loan could not demonstrate that it was "established", even though the management was highly regarded and its prospects for successful operations appeared good.

The plan now under consideration would provide for loans for fixed capital as well as working capital and for other purposes, and would not be restricted to established businesses. Such loans could be made with maturities up to ten years, on an amortized basis requiring 40 per cent of principal to be paid before maturity.

(Here insert such material as may be supplied by Mr. Smead's office.)

Loans by Reconstruction Finance Corporation. - Loans may be made by the Reconstruction Finance Corporation, either directly or in cooperation with lending institutions, to any industrial or commercial business for the purpose of maintaining and increasing the employment of labor.

Such loans, however, can be made only until June 30, 1939, must mature not later than January 31, 1945, and must be so secured as reasonably to assure repayment.

In order to afford small commerce and industry an assurance of the continued and permanent availability of capital funds, it is believed that the authority to make loans to business should not be of a temporary or emergency character, expiring next year, but should be placed upon a permanent basis; and for this purpose the plan under consideration would set up a permanent corporation to supply funds to industrial and commercial businesses.

Moreover, capital loans to business should not be limited to those which must mature within less than seven years, as under the Reconstruction Finance Corporation, because businesses frequently need to borrow for longer periods. The Industrial Loan Corporation proposed to be set up would have authority to make loans for ten years, and renewals or extensions might be made.

The requirement that loans must be "so secured as reasonably to assure repayment" may have the effect of preventing the making of many loans which would otherwise be possible. This requirement is believed to be unduly restrictive in certain meritorious cases where the financial statement and character of management of the borrower, together with its prospects for successful operation, are such as to warrant the granting of the loan although it is unable to offer the most desirable collateral security.

(Here insert such material as may be supplied by Mr. Smead's office.)