To All Reserve City Banks in the Eleventh Federal Reserve District:

Enclosed is a copy of the Supplementary Statement of the Under Secretary of the Treasury given before the Senate Finance Committee July 14, 1967. You will note that the suggested new procedure outlined in this statement provides that Reserve City member banks will become participating custodians authorized to issue validating certificates for the transfer of foreign securities between U. S. citizens.

According to our information as of this date, the suggested rules and regulations in Attachment A to the Under Secretary's statement have not yet been given Congressional approval, but the Under Secretary proposed that they become effective July 15, 1967, pending such approval.

As additional information on this matter becomes available to us, we will forward it promptly.

Very truly yours,

WATROUS H. IRONS
President

Enclosure
I would like now to discuss with you the Interest Equalization Tax evasion problem.

As you know, the IET does not apply to purchases of foreign securities by Americans from American sellers. We have found that tax evaders are selling foreign securities in the United States with false representation as to American ownership.

The evidence does not indicate widespread individual non-compliance with IET laws but rather that a limited number of unscrupulous persons have operated to evade the IET. Indications are that the fraud became sizeable toward the end of 1966, perhaps stepping up in the first part of 1967, and probably substantially cut back by the end of last month as a result of our investigations. The Internal Revenue Service investigations of evasions over the past six months have identified, on a projected annual basis, illegal security transactions in the order of $100 million to $150 million. If left unchecked, the amounts involved in evasions could go considerably higher.

We are concerned by any evasion and I want to describe in some detail both the manner in which evasion has been taking place and our proposals for stopping it.
Since the law went into effect, the Internal Revenue Service has conducted an educational campaign about its requirements, primarily for the benefit of security brokers. Delinquency checks were initiated to determine whether the tax was being paid on taxable purchases. Reports of alleged fraudulent transactions have been investigated. A special Grand Jury established in the Southern Judicial District of New York has returned indictments against six individuals and one corporation. The cases are awaiting trial for IET offenses and are scheduled for hearings in September.

Although considerable publicity has resulted from these legal actions, they have not achieved the degree of deterrence hoped for at the time of the establishment of the Grand Jury. This spring, the Securities & Exchange Commission provided the Internal Revenue Service with information obtained from a study of foreign securities trading which indicated that IET violations were taking place, possibly on a substantial scale.

For example, there appeared to be a large volume of transactions in which foreign-owned foreign stocks were channeled through foreign broker-dealers into the United States as if they were American-owned foreign stocks. In many cases, the certificate of American ownership, which was arranged to accompany the
stock, was signed by an American citizen of unsubstantial means, residing outside of this country. These certificates were false. In some cases, documentation was arranged to make the American signing the certificate appear as the *bona fide* owner and seller of the stock. In some other cases, the American simply signed a certificate of American ownership in blank in exchange for a "fee" which sometimes amounted to $10 per certificate.

The foreign broker-dealer would generally sell the foreign stocks, accompanied by the false certificates, to a small American over-the-counter broker-dealer. Typically, this dealer, in turn, would then re-sell the stock in the United States to larger broker-dealers specializing in foreign securities, confirming to them that the stock was American-owned. In the case of over-the-counter trading, a written confirmation received from a member of the National Association of Security Dealers, an association covering almost all American broker-dealers, is accepted as conclusive proof of prior American ownership, unless the confirmation is qualified, or unless the person making the acquisition has actual knowledge that the confirmation is false in any material respect. The larger broker-dealers presumably rely on this "clean confirmation" procedure, as it is called. In some cases, involving substantial volumes of stock, the foreign broker-dealers would sell directly to large American
broker-dealers, some of whom are members of the major national securities exchanges.

These transactions appear to have been concentrated in foreign stocks with special appeal. The prices of these stocks abroad are generally several points or more below the price of the same shares when they are sold by one American to another on a tax-free basis. This spread of several points furnishes the profit resulting from these tax-evading transactions.

I come now to the possible solutions. At one end of the range of alternatives would be application of the Interest Equalization Tax to transactions in foreign stocks between Americans, as well as to the purchase of such stocks by an American from a foreigner. To take this action would mean penalizing many legitimate transactions which do not hurt our balance of payments, in order to catch those fraudulent transactions which do hurt our balance of payments. This does not seem an appropriate solution.

At the other end of the range of alternatives would be an amendment of the IET law to exempt from the tax the purchase of outstanding foreign stocks from foreigners. This was suggested when the IET was first considered. The suggestion was discarded at that time, and I think properly so. The reasons are as follows.
Failure to tax outstanding equities at the same rate as new issues would lead to their substitution for the new issues as a means of raising capital in the U. S. No one can distinguish new shares of stock from old once they are issued, and a sizable potential would be opened for the movement of American funds to Europe through secondary distribution of unissued stock, or stock assembled for sale from a group of foreign stockholders.

These techniques are well known. It would not be much of a problem for a potential European borrower to exchange new stock for outstanding blocs of foreign stock in his own stockholder's hand and then offer the latter to American customers as a means of raising funds tax free in the U. S. American-owned foreign companies could be formed to do the same thing.

On the demand side, American investors have in the past and may again, in the absence of a tax on purchases of outstanding foreign stocks, become heavy buyers of such stocks with consequent adverse effect on our balance of payments. We simply cannot afford a weakening of this important legislation during this period of substantial balance-of-payments deficits.

Instead of either of the extreme solutions mentioned above, we are proposing one aimed, essentially, at eliminating the possibility of tax-free transactions among Americans in foreign securities based on false American certificates of ownership.
The Treasury recommends the establishment, effective Saturday, July 15, 1967, of a new system with respect to transactions between American buyers and sellers of foreign securities. The new system is designed to prevent evasion of the Interest Equalization Tax.

In the past, sellers of foreign securities to American buyers could exempt the purchaser from payment of the Interest Equalization Tax by assertion, on their part, of U. S. citizenship and ownership of the securities in question. Proof of American ownership was evidenced by an American ownership certificate signed by the seller.

Under the new system, the seller must, in addition to establishing his U. S. citizenship and ownership, establish that he obtained the securities "validly."

The seller can satisfy this requirement in the following manner:

1. He can obtain a "validation" from an eligible broker-dealer.

2. He can obtain a "validation" from an eligible bank.

3. He can obtain a "validation" from the Internal Revenue Service.
The effect of the new requirements is to replace a system under which certificates of American ownership signed by any U.S. person exempted the buyer from payment of the tax with a new system under which certificates issued by a limited number of institutions and the Internal Revenue Service are required to provide the buyer with this exemption.

To insure compliance at the "eligible" broker-dealer and bank level new reporting and record keeping requirements are being established, involving segregation of transactions in foreign securities from transactions in domestic securities.

To effect the transfer to the new system, the list of eligible broker-dealers will initially encompass all members of the New York Stock Exchange, the American Stock Exchange, and those members of the National Association of Security Dealers with net worth of over $750,000 or who engaged in 300 or more transactions in foreign securities either during the week beginning July 2, 1967, or the week beginning July 9, 1967. The list of these firms will be set forth in the Federal Register and in Attachment A.

The list of eligible banks will initially encompass Federal Reserve member banks classified as reserve city banks.
Additional firms and banks will be added to these lists on appropriate indications that they will meet the reporting and record-keeping requirements.

Eligible broker-dealers and banks may validate foreign securities held in their custody for American owners as of July 14, 1967. The Internal Revenue Service will establish by Monday, July 17, 1967, validation procedures with respect to other foreign securities.

The new procedures, described in detail in Attachment A, have been prepared in consultation with industry experts in order to minimize technical problems when trading commences on the basis of these new rules on July 17, 1967. In addition, we are making special efforts to disseminate information on the new procedures as quickly and broadly as possible; material is being distributed to the financial community at this moment, giving all the necessary information.

I urge upon this Committee the necessary legislative action on the amendments which will make these new procedures effective so that this evasion ends.
DEPARTMENT OF THE TREASURY
OFFICE OF THE SECRETARY

RECOMMENDED AMENDMENTS TO THE PROPOSED
INTEREST EQUALIZATION TAX EXTENSION ACT OF 1967

Exemption for Prior American Ownership; Due Date of Interest Equalization Tax

On July 14, 1967 the Treasury Department recommended that the Senate act favorably on H. R. 6098, 90th Congress, 1st Session (the proposed Interest Equalization Tax Extension Act of 1967) as passed by the House of Representatives but with amendments, effective with respect to acquisitions of stock or debt obligations made after July 14, 1967, which would:
(a) Replace the exemption for prior American ownership with an exemption for "prior American ownership and compliance". The new exemption would apply to the acquisition of stock or a debt obligation of a foreign issuer or obligor if it is established that the person from whom such stock or debt obligation was acquired (the "seller") (i) was a United States person throughout the period of his ownership or continuously since July 18, 1963, (ii) had not acquired such stock or debt obligation under an exemption which made him ineligible to sell such stock or debt obligation as a United States person, and (iii) had complied with his interest equalization tax obligations with respect to such stock or debt obligation (i.e., the seller acquired such stock or debt obligation in an acquisition
which was not subject to the interest equalization tax or the seller paid the tax).

(b) Provide that if stock of a foreign issuer or a debt obligation of a foreign issuer or obligor was acquired by a United States person in a transaction subject to the interest equalization tax, the United States person is required to file an Interest Equalization Transaction Tax Return accompanied by proper payment prior to any disposition of the stock or debt obligation if the acquisition had not been reported on the appropriate Interest Equalization Quarterly Tax Return accompanied by proper payment.

(c) Specify the manner, described below, under which the exemption for prior American ownership and compliance can be established.

(d) Amend the provisions with respect to "regular market" trading on certain national securities exchanges and "clean comparison" trading in the over-the-counter market set forth in section 4918 of the Internal Revenue Code so that they are applicable only to those members and member organizations of national securities exchanges or national securities associations registered with the Securities and Exchange Commission, which have agreed to comply, and do comply, with the amended statutory provisions and with the documentation, record-keeping and reporting requirements established by the Secretary or his delegate (referred to in this Notice as "Participating Firms"). During the period beginning July 15, 1967
and until a notice or notices to the contrary are published by the Internal Revenue Service, it will be presumed that (i) all members or member organizations of the New York Stock Exchange, (ii) all members and member organizations of the American Stock Exchange, and (iii) those members or member organizations of the National Association of Securities Dealers, Inc., which either reported a net capital (as defined in Rule 15c3-1 under the Securities Exchange Act of 1934) of $750,000 in the latest financial statement filed with the Securities and Exchange Commission on Form X-17A-5 prior to July 13, 1967, or which have effected 300 or more transactions in foreign securities during either the week commencing July 2 or commencing July 9, 1967 (which members or member organizations of the National Association of Securities Dealers, Inc., are listed below) have agreed to comply, and are complying, with such amended statutory provisions and with the documentation, record-keeping and reporting requirements and shall be Participating Firms.

Participants Firms As Of July 15, 1967

The Participating Firms as of July 15, 1967, are as follows:

All members and member organizations of the New York Stock Exchange.

All members and member organizations of the American Stock Exchange.

The following members and member organizations of the National Association of Securities Dealers, Inc., not members or member
organizations of the New York Stock Exchange or the American Stock Exchange:

3. Allison-Williams Company, Minneapolis, Minn.
7. Calvin, Bullock Ltd., New York, New York
11. City Securities Corp., Indianapolis, Ind.
14. Dayton Bond Corp., Dayton, Ohio
17. Donald B. Litchard, Boston, Mass.
27. First Investors Corp. of New York, New York, New York
28. First Southwest Co., Dallas, Tex.
34. Hamilton Management Corp., Denver, Colo.
35. Henry Spiegel, New York, New York
39. IDS Securities Corp., Minneapolis, Minn.
44. John W. Clarke & Co., Chicago, Ill.
51. Parsons & Co., Inc., Cleveland, Ohio
54. R. S. Dickson & Co., Inc., Charlotte, N. C.
58. Stern Brothers & Co., Kansas City, Mo.
60. Stone & Youngberg, San Francisco, Calif.
61. Stryker & Brown, New York, New York
63. Thomas, Haab & Botts, New York, New York
64. Thomas McDonald & Co., Chicago, Ill.
67. Waddell & Reed, Inc., Kansas City, Mo.
70. Wheeler, Munger & Co., Los Angeles, Calif.
72. William C. McDonnell, New York, New York
Changes In List Of Participating Firms

Any other member or member organization of a national securities exchange or a national securities association registered with the Securities and Exchange Commission may become a Participating Firm if it files with the Commissioner of Internal Revenue, Washington, D. C. 20224 (Attention: CP) a letter signed by the member, a partner or an officer (i) requesting designation as a Participating Firm, (ii) agreeing to comply with the documentation, record-keeping and reporting requirements established by the Internal Revenue Service (whether established prior or subsequent to the date of the letter), (iii) agreeing that its books and records no matter where located may be examined by any employee of the Internal Revenue Service, and (iv) if the letter is filed with the Commissioner of Internal Revenue on or after August 15, 1967 stating that such documentation, record-keeping and reporting requirement procedures are operational. The Internal Revenue Service will from time to time publish the names of those members or member organizations which have become Participating Firms subsequent to July 15, 1967.

Any member or member organization which became a Participating Firm prior to August 15, 1967 shall cease to be a Participating Firm unless on or before August 15, 1967 it files with the Commissioner of Internal Revenue a letter signed by the member, a partner, or an officer setting forth each of the items (i) to (iv), inclusive, of the preceding paragraph. A Participating Firm may terminate its
status as such by filing a request with the Commissioner of Internal Revenue. In addition, if the Commissioner of Internal Revenue has reasonable cause to believe that a Participating Firm is not complying with such statutory provisions, or with the documentation, record-keeping and reporting requirements, or any part thereof, he may cause the removal of such firm from the list of Participating Firms.

The effective date on which a member or member organization shall become or cease to be a Participating Firm shall be the date specified in a notice issued by the Internal Revenue Service, which date shall not be prior to the date following the date on which the notice was made available to financial publications and wire services.

Establishment of Exemption For Prior American Ownership and Compliance

The Treasury recommended that the amendments to H. R. 6098 authorize the following procedures, effective July 15, 1967, for the establishment of the exemption for prior American ownership and compliance:

1. If a United States person acquiring stock of a foreign issuer or a debt obligation of a foreign obligor directly from or through a Participating Firm receives in good faith from the Participating Firm an "IET Clean Confirmation" (meeting the requirements described below) applicable to the particular stock or debt obligation acquired, the exemption for prior American ownership and compliance shall be deemed to have been established.
2. If a United States person acquiring stock
of a foreign issuer or a debt obligation of a
foreign obligor receives in good faith copies 1
and 2 of a Validation Certificate issued by the
Internal Revenue Service to the seller or to
himself applicable to the particular stock or debt
obligation acquired and, in the case where the
Validation Certificate was issued to the seller,
completes and files copy 2 of the certificate with
the Internal Revenue Service, the exemption for
prior American ownership and compliance shall be
deemed to have been established.

3. If a United States person acquiring stock
of a foreign issuer or a debt obligation of a
foreign obligor establishes that there is reason-
able cause for an inability to establish prior
American ownership and compliance in accordance
with one of the foregoing, prior American owner-
ship and compliance may be established by other
evidence which satisfies the Internal Revenue
Service that the person from whom such acquisi-
tion was made was a complying United States person
not ineligible to sell as a United States person.
The Treasury further recommended that the amendments to H. R. 6098 provide that Participating Firms are required to sell stock of a foreign issuer or a debt obligation of a foreign obligor as stock or a debt obligation not exempt from the interest equalization tax by reason of the exemption for prior American ownership and compliance except in the following cases:

1. The Participating Firm (i) held in its custody at the close of business on July 14, 1967 for the account of the seller the stock or debt obligation being sold, (ii) has in its possession and relies in good faith on a certificate of American ownership with respect to the stock or debt obligation being sold, or a blanket certificate of American ownership with respect to such account, and (iii) included the stock or debt obligation in the Transition Inventory of the Participating Firm duly filed with the Internal Revenue Service as hereinafter provided.
2. The Participating Firm purchased on or after July 15, 1967 for, or sold to, the seller the stock or debt obligation being sold if the exemption for prior American ownership and compliance applied to the seller's acquisition and if the Participating Firm continuously held in its custody such stock or debt obligation or received from the seller the identical stock certificates or evidence of indebtedness which it had previously delivered to the seller in respect of the purchase.

3. The Participating Firm received the stock or debt obligation being sold from another Participating Firm or from a Participating Custodian with a Transfer of Custody Certificate meeting the requirements described below.

4. The Participating Firm has received from the seller copies 1 and 2 of a Validation Certificate issued by the Internal Revenue Service applicable to the stock or debt obligation being sold and on the date of the sale or the next business day completes and files copy 2 of the certificate with the Internal Revenue Service.
5. The Participating Firm withholds the amount of Interest Equalization Tax which would be imposed had the seller purchased in a taxable acquisition the stock or debt obligation being sold on the day of the sale. Information on withholding procedures will be published shortly.

**IET Clean Confirmation**

A Participating Firm is authorized to issue an "IET Clean Confirmation" to a customer with respect to stock or a debt obligation of a foreign issuer or obligor in the following circumstances:

1. In a case where the Participating Firm purchased the stock or debt obligation as broker for the customer from or through another Participating Firm in the regular market (in the case of a purchase on a national securities exchange referred to in Section 4918(c) of the Internal Revenue Code) or received a clean comparison from another Participating Firm under the procedures referred to in Section 4918(d) of the Internal Revenue Code.

2. It sold the stock or debt obligation as dealer to the customer and it was a complying United States person not ineligible to sell as a United States person.
Each IET Clean Confirmation shall state the date of acquisition, the number of shares or the face amount of obligations purchased, the description of the stock or debt obligations, the price paid and the name of the broker representing the seller and the market on or through which the purchase was effected. Only an original document may constitute an IET Clean Confirmation and each copy or duplicate shall be marked as such. All other confirmations issued by Participating Firms with respect to stock or debt obligations of foreign issuers or obligors shall be clearly and indelibly marked so as to be distinguishable from IET Clean Confirmations.

Issuance of Validation Certificates

Validation Certificates will be issued by all District Directors of Internal Revenue commencing Monday, July 17, 1967, upon proof that the United States person on whose behalf the Validation Certificate is requested has complied with his interest equalization tax obligations with respect to the securities to be covered by the Validation Certificate. The Internal Revenue Service will shortly announce the procedures for obtaining Validation Certificates. Each District Director will reissue Validation Certificates in different denominations upon request.
Transition Inventory

The Transition Inventory shall be filed with the Commissioner of Internal Revenue no later than August 15, 1967. Each Participating Firm and each Participating Custodian filing a Transition Inventory (Participating Custodians are described below) shall list those stocks and debt obligations of foreign issuers and obligors held at the close of business July 14, 1967, and shall indicate those held for the accounts of United States persons and those held for the accounts of other persons.

Participating Custodians

During the period beginning July 15, 1967 and until a notice or notices to the contrary are published by the Internal Revenue Service, the Participating Custodians are the Federal Reserve Member Banks which are classified as reserve city banks.

A bank or trust company insured by the Federal Deposit Insurance Corporation may become a Participating Custodian if it files with the Commissioner of Internal Revenue, Washington, D. C. 20224 (Attention: CP) a letter signed by an officer (i) requesting designation as a Participating
Custodian, (ii) agreeing to comply with the documentation, record-keeping and reporting requirements established by the Internal Revenue Service (whether established prior or subsequent to the date of the letter), (iii) agreeing that its books and records no matter where located may be examined by any employee of the Internal Revenue Service, and (iv) if the letter is filed with the Commissioner of Internal Revenue on or after August 15, 1967 stating that such documentation, record-keeping and reporting requirement procedures are operational. The Internal Revenue Service will from time to time publish the names of those members or member organizations which have become Participating Custodians subsequent to July 15, 1967.

Any bank or trust company which became a Participating Custodian prior to August 15, 1967 shall cease to be a Participating Custodian unless on or before August 15, 1967 it files with the Commissioner of Internal Revenue a letter signed by an officer setting forth each of the items (i) to (iv), inclusive, of the preceding paragraph. A Participating Custodian may terminate its status as such by filing a request with the Commissioner of Internal Revenue. In addition, if the Commissioner of Internal Revenue has reasonable cause to believe that a Participating Custodian is not complying with the statutory provisions related to the interest
equalization tax applicable to it, or with the documentation, record-keeping and reporting requirements, or any part there-of, he may cause the removal of such firm from the list of Participating Custodians.

The effective date on which a bank or trust company shall become or cease to be a Participating Custodian shall be the date specified in a notice issued by the Internal Revenue Service, which date shall not be prior to the date following the date on which the notice was made available to financial publications and wire services.

Transfer of Custody Certificates

Transfer of Custody Certificates shall be issued only by Participating Firms and Participating Custodians and only in connection with a transfer from the account of a customer of a Participating Firm or Participating Custodian to the account of the same customer with a different Participating Firm or Participating Custodian in the following circumstances:

1. The Participating Firm or Participating Custodian held in its custody on July 14, 1967 for the account of the customer the stock or debt obligation referred to in the Transfer of Custody Certificate and acquired and holds in good faith a certificate of American ownership with respect to
such stock or debt obligation or a blanket certificate of American ownership with respect to such account, if it included such stock or debt obligation in the Transition Inventory duly filed by it with the Commissioner of Internal Revenue.

2. The Participating Firm or Participating Custodian received the stock or debt obligation referred to in a Transfer of Custody Certificate from another Participating Firm or Participating Custodian accompanied by a Transfer of Custody Certificate.

3. The Participating Firm purchased for the customer the stock or debt obligation referred to in the Transfer of Custody Certificate and in connection with the purchase either received (i) a Validation Certificate issued by the Internal Revenue Service, or (ii) was authorized to issue an IET Clean Confirmation and in either case continuously held in its custody the stock or debt obligation so purchased or received back from the purchaser the identical securities or evidence of indebtedness previously delivered to the purchaser.
Record Keeping Requirements

The record-keeping requirements for Participating Firms are, until further notice, identical to the record-keeping requirements for broker-dealers issued pursuant to the Securities Exchange Act of 1934 with the following required modifications:

1. Records of original entry (in most cases the purchase and sale blotter) shall be prepared and maintained separately for all purchases and sales of stock and debt obligations of foreign issuers and obligors. All entries shall clearly designate those transactions which involved foreign-owned securities. All entries reflecting a purchase of securities, the acquisition of which is exempt from the tax under the exemption for prior American ownership and compliance, shall clearly designate the documentation received establishing such exemption. All entries reflecting a sale of securities regular way on a national securities exchange referred to in Section 4918(c) of the Internal Revenue Code or under the clean comparison procedure established by Section 4918(d) of the Code shall clearly designate the documentation authorizing such sale.
2. The securities record or ledger reflecting separately for each stock or debt obligation of a foreign issuer or obligor all "long" or "short" positions (including such securities in safekeeping) carried by such firm or custodian for its account or for the account of customers (commonly known as stock record sheets) shall be prepared and maintained apart from those prepared and maintained for all other securities. All entries in such record or ledger, and in each customer's account, shall clearly designate those of such securities with respect to which the firm or custodian can issue a Transfer of Custody Certificate without obtaining further documentation.

3. The ledger account itemizing separately the accounts of such firm or custodian reflecting all purchases, sales, receipts, and deliveries of stock or debt obligations of a foreign issuer or obligor for the firm's own investment and trading accounts shall be prepared and maintained apart from those prepared and maintained for all other securities. All entries shall clearly designate those transactions which involve securities on which the firm or custodian can issue a Transfer of Custody Certificate.
Appropriate files for each of said dealer-owned foreign securities shall be maintained, in readily accessible form, to hold all relevant information and evidence to substantiate tax free nature of the acquisitions pursuant to which such securities were acquired or, if acquired in a taxable transaction, the retained copies of the tax returns filed with respect to such acquisitions.

4. Separate files shall be maintained for all interest equalization tax reports filed with the Internal Revenue Service (both for information and tax paying purposes) including copies of all documents filed with the Internal Revenue Service and summaries and supporting schedules. In addition, such files shall contain substantiation of the Transition Inventory filed with the Commissioner of Internal Revenue.

**Certain Debt Obligations**

The foregoing procedures would not apply to those debt obligations of foreign obligors which are neither convertible nor listed or traded in domestic or foreign markets. In such cases, the exemption for prior American ownership and compliance will, until other procedures are announced, be
established if the United States person acquiring the obligation receives in good faith a letter from the seller certifying to the exemption together with a copy thereof and files the copy with the Internal Revenue Service.