Mr Eccles

COPY

August 4, 1948

To: Board of Governors

From: Mr. Vest

SUBJECT: Constitutional power of Congress as to reserves of nonmember banks.

When Chairman McCabe was testifying before the House Banking and Currency Committee on August 2, 1948, he was requested to have a memorandum prepared on the constitutional power of Congress to make reserve requirements applicable to nonmember banks. We have prepared such a memorandum and I have submitted a copy to the House Banking and Currency Committee. A copy is attached for the Board's information.

G.B.V.

Attachment

Mr. Eccles

POWER OF CONGRESS TO REQUIRE BANKS WHICH ARE NOT MEMBERS OF THE FEDERAL RESERVE SYSTEM TO MAINTAIN CERTAIN RESERVES

As a measure to aid in protecting interstate commerce and the nation's monetary, banking and financial structure against the dangers arising from further inflationary pressures, it has been proposed that Congress enact legislation requiring all commercial banks to maintain certain reserves in the form of balances with Federal Reserve Banks. This proposal encompasses banks which are not members as well as those which are members of the Federal Reserve System because, as has been pointed out, the proposal would be both ineffective and unfair if the reserve requirements in question were made applicable only to those banks that happen to be members of the Federal Reserve System.

A question has been raised as to the authority of Congress to enact such legislation requiring nonmember banks to comply with such reserve requirements, and the purpose of this memorandum is to show in brief compass the clear authority which Congress has in the matter.

Previous Legislation Applicable to Nonmember Banks

Before discussing the legal considerations and the decisions of the Federal courts which clearly sustain this authority on the part of Congress, it should be pointed out that Congress has heretofore enacted legislation which subjects banks to certain requirements regardless of whether or not they are members of the Federal Reserve System.

In the Banking Act of 1933, Congress included a provision

(section 21 of that Act) which provides that it shall be unlawful for any person engaged in underwriting securities to engage at the same time in receiving deposits. In other words, banks were required by that Act to give up any underwriting business in which they were then engaged. That provision applied to all persons engaged in the banking business, regardless of whether or not members of the Federal Reserve System. Likewise in 1934, in the Securities Exchange Act of that year, Congress authorized the Board of Governors of the Federal Reserve System to issue regulations prescribing the amount of credit which could be extended for the purpose of purchasing or carrying registered stocks, and the Board, pursuant to that authority, has for years had in effect a regulation which applies to all banks, whether or not members of the Federal Reserve System. Moreover, it goes without saying that Congress could, as a condition of insurance of deposits of banks by the Federal Deposit Insurance Corporation, make any reserve or other requirements of such banks which it deemed appropriate. But as will be demonstrated below, the decisions make clear the power of Congress to enact the proposed legislation regardless of whether the banks affected by it are insured by the FDIC or are members of the Federal Reserve System.

The first part of the discussion which follows relates to the power of Congress to take the proposed action under its authority over interstate commerce, and this power alone is fully sufficient to authorize the proposed legislation. In addition, however, there is discussed the authority of Congress to take this action in order to protect the banking system which Congress has established and in order to protect the nation's monetary system. All these grounds are related, but it is convenient to consider

them separately.

Authority of Congress

Power over Interstate Commerce. - The power of Congress to enact the legislation in question is sustained by the plenary authority granted to Congress by Section 8 of Article I of the Constitution, "To regulate Commerce with foreign Nations, and among the several States, * * *", and "To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers * * *." (U. S. Code, p. XXXIX, 1946 Ed.) That banking--whether chartered by the Federal or State governments--is an activity within the reach of this Congressional authority has been decided specifically by court decisions under both the National Labor Relations Act and the Fair Labor Standards Act which, of course, were enacted in pursuance of the "commerce power".

In National Labor Relations Board v. Bank of America National Trust & Savings Association, 130 F(2d) 624 (C.C.A. 9th, 1942), a petition for enforcement of a Board order based on violations of the National Labor Relations Act, the Bank contended in defense that it was not "engaged in commerce" and that its operations did not "affect commerce" within the meaning and intendment of that Act.

In sustaining the order and, therefore, overruling the Bank's contentions, the Court reviewed the Bank's activities, including, among others, the financing of business operations, both interstate and intrastate in character; the collection of commercial paper, much of which

covered interstate shipments of goods; the interstate transfers of funds; and the facilitation of the sale and shipment of goods in the channels of commerce through the discounting of trade acceptances, the issuance of letters of credit, bank drafts, etc. The Court said that the Bank's operations had an "undeniable effect * * * upon commerce among the States," lending "vital support to the commercial life of the nation." Furthermore, the Court said that the Bank was "itself directly and every hour of the business day engaged in interstate activities not describable otherwise than as commerce * * * 'within the meaning of the Constitution'." The United States Supreme Court denied certiorari and rehearing (318 U.S. 791-792; 319 U.S. 782).

A similar case is that of Bozant v. Bank of New York, 156 F(2d) 787 (C.C.A. 2d, 1946), which held that the Bank was subject to the Fair Labor Standards Act because of the relationship of the Bank's activities to interstate commerce. The close relationship of credit activities to interstate commerce is further illustrated by United States v. General Motors Corporation, 121 F(2d) 376 (C.C.A. 7th, 1941), cert. and rehearing den. 314 U. S. 579, 618, 710, holding that the local retail and wholesale financing of products moving in interstate commerce is a matter within the power of Congress under the "commerce power" as expressed in the Federal anti-trust laws.

The above decisions demonstrate fully the application to banking of the principle, established by the courts in dealing with other but analogous situations, that the regulation of commerce may extend properly to the regulation of all aspects of commerce and of all instrumentalities upon which the carrying on of commerce depends. This general principle was reiterated in United States v. Darby, 312 U.S. 100, 118 (1940), wherein the Court, in holding a local manufacturer subject to the Fair Labor Standards Act, said that "The power of Congress over interstate commerce * * * extends to those activities intrastate which so affects interstate commerce or the exercise of the power of Congress over it as to make regulation of them appropriate means to the attainment of a legitimate end, the exercise of the granted power of Congress to regulate interstate commerce." For earlier examples, it has long since been settled that stockyards, although engaged in dealing locally in livestock, are subject to Federal control, because they are essential cogs in the machinery of interstate commerce. Stafford v. Wallace, 258 U.S. 495 (1922). The same is true of a local grain exchange. Board of Trade of City of Chicago v. Olsen, 262 U.S. 1 (1923). The issuance of fraudulent bills of lading is punishable under Federal statute, although they cover no interstate shipment. United States v. Forger, 250 U. S. 199 (1919). Indeed, the Supreme Court has frequently rejected arguments which, by the application of "artificial" or "mechanical" concepts, would disregard the "economic continuity" of either individual or collective processes or activity and, hence, ignoring actuality, seek to limit or impair the Constitutional power of Congress over interstate

commerce. Mandeville Island Farms, Inc. v. American Crystal Sugar Co., 68 S. Ct. 996 (1948). See also United States v. Sullivan, 68 S. Ct. 331 (1948).

While no useful purpose would be served by referring to the many court decisions cumulative of the foregoing, no discussion of the "commerce power" would be complete without mention of United States v. South-Eastern Underwriters Association, 322 U.S. 533 (1944), holding that the business of insurance, notwithstanding local regulation, constitutes commerce and, hence, is subject to the Federal anti-trust laws. See also Darr v. Mutual Life Insurance Co. of New York, 17 L.W. 2035 (C.C.A., 2d, July 8, 1948), holding that "insurance policies are goods produced for commerce" within the coverage of the Fair Labor Standards Act; and Smolowe v. Delendo Corporation, 136 F (2d) 231 (C.C.A., 2d, 1943), cert den. 320 U.S. 751, holding that, as "private sales" on national security exchanges affect stock quotations thereon, such sales are not purely intrastate activities, but are subject to Congressional regulation as interstate commerce under the Securities Exchange Act of 1934.

In conclusion on this point may be noted Wickard v. Filburn, 317 U.S. 111 (1942), in which the Court sustained as validly within the "commerce power" of Congress, the wheat marketing quota and attendant penalty provisions of the Agricultural Adjustment Act of 1938, as amended, although the facts before the Court involved wheat not intended in any part for commerce but wholly for consumption on the farm where grown.

In so holding, the Court observed that the general scheme of the Act was "to control the volume" of wheat "moving in interstate and foreign commerce in order to avoid surpluses and shortages and the consequent

abnormally low or high wheat prices and obstructions to commerce." In overruling the argument that the Act was unconstitutional as an interference with local matters, i.e., "production" and "consumption", which, at most, would have only an "indirect" effect on interstate commerce, the Court said:

> "But even if appellee's activity be local and though it may not be regarded as commerce, it may still, whatever its nature, be reached by Congress if it exerts a substantial economic effect on interstate commerce, and this irrespective of whether such effect is what might at some earlier time have been defined as 'direct' or 'indirect' * * *. That appellee's own contribution to the demand for wheat may be trivial by itself is not enough to remove him from the scope of federal regulation where, as here, his contribution, taken together with that of many others similarly situated, is far from trivial * * *. * * * Congress may properly have considered that wheat consumed on the farm where grown, if wholly outside the scheme of regulation, would have a substantial effect in defeating and obstructing its purpose to stimulate trade therein * * *."

The Wickard case is particularly apposite to the question here. If it is constitutional to regulate as interstate commerce wheat grown locally and in a "trivial" amount for home consumption, as held in the Wickard case, so also is local banking subject to such regulation even though, in a given case, it might be considered to be of equally "trivial" proportions in interstate commerce. Here, as in the legislation involved there, Congress may properly consider that any such banking, no less than local farming, if left outside the scheme of regulation, "would have a substantial effect in defeating and obstructing" its lawful purpose and, therefore, apply its regulation to all banks, large and small alike, and whether nonmembers or members of the Federal Reserve System.

Protection of the Banking and Monetary Systems. - Although, as indicated above, the "commerce power" is ample authorization for the proposed legislation, the Congress also has authority for such action under its power to protect the banking system and the nation's monetary system.

The authority of Congress to protect the national banking system and the Federal Reserve System has been reaffirmed many times since the famous case of McCulloch v. Maryland, 4 Wheat (U.S.) 316 (1819), which held that a bank chartered by Congress could not be taxed by a State because such taxation would interfere with the power of Congress. In that case, Chief Justice Marshall stated (p. 426) the basic doctrine that "a power to create implies a power to preserve".

The authority of Congress to authorize national banks to act in certain circumstances as trustees, executors and administrators, as against the contention that such action infringed State authority, was sustained in First National Bank v. Union Trust Co., 244 U. S. 416 (1917), on the ground that Congress could lawfully authorize national banks to act in such capacities in order to enable them to compete with State corporations having such power. And, in State of Missouri v. Duncan, 265 U.S. 17 (1924), the Court held, in effect, that, although the local law did not authorize national banks to act as executors, a State probate court could not discriminate against national banks by refusing to appoint them executors and thereby deprive such banks of "their power to compete that Congress is authorized to sustain."

The banks to which Congress can lawfully extend protection, however, need not be Federally chartered. Thus, in Westfall v. United States, 274

U. S. 256 (1927), a defendant was indicted for aiding and procuring a branch manager of a member bank of the Federal Reserve System to misapply bank funds in violation of Federal statute. The application of the statute to the defendant, although not a bank official, was sustained on the ground that it was proper to prevent the weakening of the System. The authority of Congress similarly to protect nonmember banks whose deposits are insured by the Federal Deposit Insurance Corporation also has been upheld. Doherty v. United States, 94 F. (2d) 495 (C.C.A., 8th, 1938) and Weir v. United States, 92 F. (2d) 634 (C.C.A., 7th, 1937), cert. den. 302 U. S. 761.

The authority of Congress to protect the nation's monetary system was long ago held to authorize measures far more sweeping than the legislative proposal in question. Veazie Bank v. Fenno, 8 Wall (U.S.) 533 (1869), sustained a 10 per cent Federal tax imposed on the circulating notes of State banks. Although clearly recognizing that the tax was intended to, and did, bring to an end the practice of State banks of issuing such notes, the Court stated the monetary authority for such action as follows:

> "Having undertaken to provide a currency for the whole country, it can not be questioned that Congress may, constitutionally, secure the benefit of it to the people by appropriate legislation. To this end, * * * Congress may restrain, by suitable enactments, the circulation as money of any notes not issued under its own authority."

It will be noted that the statute sustained by the court in the Veazie Bank case singled out State banks and applied the burden

of the control exclusively to them. That statute, by comparison, illustrates the far milder effect which the present proposal would have on State banks. Instead of laying special burdens on State banks as was done in the Veazie Bank case, the present proposal would merely have all banks, member and nonmember alike, conform to the requirements which would be ineffective and unfair if applied only to members of the Federal Reserve System, and which are necessary for aid in the protection of interstate commerce and the banking and monetary systems established by Congress.

The Congressional powers to protect the banking and monetary systems are, of course, clearly related. They stem not only from several specific provisions of the Constitution but from a blending thereof and from its general purposes.

Norman v. B. & O. R.R. Co, 294 U. S. 240 (1935) is one of many cases illustrating the broad sweep of these powers. There the Court sustained the power of Congress to strike down "gold clauses" not only in contracts made by individuals, but also in contracts of States and their subdivisions. The Court not only quoted with approval from the Veazie Bank case, above, but clearly stated and reaffirmed the comprehensive character of such powers:

> "The Constitution grants to the Congress power 'To coin money, regulate the value thereof, and of foreign coin.' Art. I, sec. 8, par. 5. But the Court in the legal tender cases [12 Wall. 457] did

> not derive from that express grant alone the full authority of the Congress in relation to the currency. The Court found the source of that authority in all the related powers conferred upon the Congress and appropriated to achieve 'the great objects for which the government was framed,'--'a national government, with sovereign powers.' McCulloch v. Maryland, 4 Wheat. 316, 404-407; Knox v. Lee, supra, pp. 532, 536; Juilliard v. Greenman, supra, p. 438. The broad and comprehensive national authority over the subjects of revenue, finance and currency is derived from the aggregate of the powers granted to the Congress, embracing the powers to lay and collect taxes, to borrow money, to regulate commerce with foreign nations and among the several States, to coin money, regulate the value thereof, and of foreign coin, and fix the standards of weights and measures, and the added express power 'to make all laws which shall be necessary and proper for carrying into execution' the other enumerated powers."

Clearly the legislative proposal in question, which would operate prospectively and which would be merely regulatory rather than prohibitory, is nothing like as drastic as the Congressional action sustained by the court in the Norman and Veazie Bank cases. Thus, if the Congressional power can be lawfully used as demonstrated by these cases to adjust matters of vital national interest, there can be no room for doubt as to the validity of the Congressional action now proposed.

Submitted by George B. Vest, General Counsel,
Board of Governors of the Federal Reserve System.

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