TO ALL MEMBER BANKS:

For your information there is quoted below letter received from the Federal Reserve Board, at Washington, under date of February 28th, on the subject of DOMESTIC ACCEPTANCES:

"From the accompanying file it appear that some confusion of thought exists in the minds of certain officers of Federal reserve banks and member banks as to the Board's interpretation of those provisions of Section 13 of the Federal Reserve Act which relate

(1) To the power of member banks to accept drafts drawn in domestic transactions;

(2) To the eligibility for rediscount by Federal reserve banks of member bank acceptances.

"The understanding of this office of the provisions in question as interpreted by the Board is as follows:

POWER OF MEMBER BANKS TO ACCEPT DRAFTS DRAWN IN DOMESTIC TRANSACTIONS.

"Subject to the limitations prescribed by the Act, member banks are authorized -

(a) To accept drafts or bills of exchange which grow out of transactions involving the domestic shipment of goods, provided shipping documents conveying or securing title are attached at the time of acceptance.

(b) To accept drafts or bills of exchange which are secured at the time of acceptance by warehouse receipts or other such documents conveying or securing title covering readily marketable staples.

"All drafts accepted in domestic transactions must therefore be secured at the time of acceptance either by shipping documents or warehouse receipts or other such documents, as specified in the law. If the aggregate amount of drafts accepted for one person, firm or corporation exceeds a sum equal to ten per cent. of the capital and surplus of the accepting bank, such drafts, whether in a foreign or domestic transaction, must remain secured throughout the life of the draft since the Act provides that -
"No member bank shall accept, whether in a foreign or domestic transaction, for any one person, to an amount equal at any time in the aggregate to more than ten per centum of its paid up and unimpaired capital stock and surplus, unless the bank is secured either by attached documents or by some other actual security growing out of the same transaction as the acceptance.

"To give this language any meaning it must be assumed that the accepting bank may, if it chooses, release the security in any case in which the total amount accepted for any one customer does not exceed ten per cent. of its capital stock and surplus. Unless this interpretation is placed upon the statute, the provision just quoted would be meaningless in so far as it relates to domestic transactions since all drafts accepted in domestic transactions must be secured at the time of acceptance.

"In any case, however, where the total amount accepted for any one customer exceeds ten per cent. of the capital stock and surplus of the accepting bank the security legally cannot be released unless some other actual security growing out of the same transaction as the acceptance is substituted therefor. This immediately raises the question as to whether or not the ordinary trust receipt substituted for shipping documents, warehouse receipts, etc., constitutes as actual security such as is required by this provision of the act. In an opinion filed by this office on October 12, 1917, and printed on page 881 of the November, 1917, Bulletin, it was stated -

"'that a trust receipt which permits the purchaser of the goods to obtain control of those goods either for milling or other purposes is not an actual security within the meaning of the act, and that, therefore, acceptances secured by such trust receipts come within the 10 per cent limitation imposed by section 13.

"'A different situation results, of course, in any case where the trust receipt is of such a character as not to permit the purchaser to gain control of the goods, as where they are held for the account of the acceptor by some person, warehouse, or corporation independent of the borrower.'

"The view expressed in this opinion has been followed by the Federal Reserve Board in various rulings relating not only to the Purchaser in a transaction involving a sale, but also to any customer for whom a draft is accepted regardless of whether or not there is an actual sale of the goods covered by the documents attached to the draft.

ELIGIBILITY FOR REDISCOUNT OF MEMBER BANK ACCEPTANCES.

"Under the terms of section 13 any draft or bill of exchange which a member bank has the power to accept under the provisions of that section is technically eligible for rediscount by a Federal reserve bank. This does not mean, however, that Federal reserve banks are required by law to rediscount every such acceptance tendered to them for that purpose. In developing a general market for acceptances the Federal reserve banks are necessarily called upon to carry a large amount of this class of paper, but it is important that the Federal Reserve Board and the Federal Reserve Banks should take all
necessary steps to insure conservatism in the exercise of the acceptance power by member banks. The policy of the Board, therefore, as reflected in its various rulings, has been to caution Federal reserve banks that in rediscounting drafts accepted in domestic transactions they should consider and in many cases investigate, the circumstances under which the draft was accepted in order to determine whether or not the particular transaction complies with the spirit as well as the letter of the statute.

"It was in view of this policy that the Federal Reserve Board has consistently refrained from encouraging Federal reserve banks to rediscount or purchase warehouse acceptances after the warehouse receipts have been released though there is nothing in the law which prohibits the rediscount of such acceptances. It is recognized, however, that an unrestricted policy of rediscounting or purchasing such acceptances after the warehouse receipts have been released might very probably lead to an abuse of the domestic acceptance privilege by facilitating the use of the warehouse receipt as a mere cloak for a straight loan in violation of the provisions of Section 5200. It can not be stated, of course, as a hard and fast rule that the acceptance of a draft secured by a warehouse receipt was not a bona fide transaction merely and solely because the warehouse receipt has been surrendered before the acceptance is presented to the Federal reserve bank for rediscount. It should, however, put the bank on notice and should suggest extreme caution in order to determine whether in fact the acceptance complies in every way with both the letter and spirit of the law. When Congress granted the power to accept drafts in domestic transaction, it clearly intended to facilitate domestic commerce and did not contemplate that this power should be used for the purpose of extending unreasonable lines of credit to individual borrowers in substantial violation of the limitations of Section 5200 of the Revised Statutes. If Congress has intended to give greater latitude to banks under its jurisdiction in the matter of loans of this character a much more direct method would have been to remove or to broaden the limitations of Section 5200.

"The Board has recognized the fact, however, that in the ordinary course of business, shipping documents securing accepted drafts must be released in order that the customer for whom the draft was accepted may procure the goods represented by such documents. It also recognizes the fact that where such drafts are secured by warehouse receipts it is probable that at some period during the life of the draft it may be necessary for the receipt to be surrendered to the customer for whom the draft is accepted in order that the transaction involved may be consummated. In the case of shipping documents it is ordinarily necessary to release the documents at an earlier period than in the case of warehouse receipts.

"In neither case, as a matter of policy the security should not be surrendered by the accepting bank until this becomes necessary in order for the transaction to be consummated, and even when surrendered, bank prudence requires that the bank protect itself by procuring either a trust receipt or a definite agreement on the part of the customer to whom the security is surrendered that the proceeds derived from the sale of the goods represented by the shipping documents or warehouse receipts will be deposited with the accepting bank when available to pay the draft at maturity and will not be used by the customer for other purposes. It should be re-
membered, however, as previously stated, that in any case where a trust receipt is substituted the ten per cent limit applies if the trust receipt is such as to give control over the goods to the borrowers or the customer for whom the draft was accepted.

Respectfully,

(Signed) M. C. ELLIOTT,

General Counsel."

It is hoped that the above will be of service to our member banks in the study of acceptance credits and the practical application of the principle to modern banking.

Respectfully,

Governor.