



FEDERAL RESERVE BANK  
OF DALLAS

Circular No. 34

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**Subject:--ELIGIBILITY FOR REDISCOUNT OF PAPER OWNED BY COTTON FACTORS.**

TO THE MEMBER BANK ADDRESSED:—

On November 1, 1919, the Federal Reserve Board issued a ruling (see Federal Reserve Bulletin November, 1919, page 1054), in which it is held that the note of a cotton factor (even though secured by warehouse receipts), discounted by a member bank is ineligible for rediscount by a Federal Reserve Bank, if the proceeds of the note had been, or were to be used by the borrower for the purpose of making loans to customers.

The Federal Reserve Board also ruled, under date of February 1, 1920 (see Federal Reserve Bulletin, February, 1920, page 162), that a draft drawn upon a member bank by a cotton factor and secured at the time of presentation for acceptance by warehouse receipts covering cotton consigned to the factor, for the purpose of sale, is not eligible for acceptance by the member bank, and, therefore, not eligible for rediscount or purchase by a Federal Reserve Bank, after acceptance, if the proceeds are to be used by the factor, not for a commercial purpose, but rather for the purpose of lending to his customers.

It will be perfectly evident from these two rulings that, while a member bank may (subject to the limitations of Section 5200 of the National Bank Act) discount the paper of a cotton factor, the proceeds of which are to be used for relending to his customers, such paper cannot be properly offered for rediscount to a Federal Reserve Bank. It is also evident that, under the circumstances described, a member bank has not the right to create a banker's acceptance, the proceeds of which are to be used by the cotton factor for loans to customers. The question remains, therefore,—is it possible for a cotton grower or a merchant who has acquired cotton in the regular course of his business to lodge the cotton with a cotton factor for sale and to obtain a loan, the instrument representing which will be eligible for rediscount by a Federal Reserve Bank? There are two forms in which this can be done:—

(1)—If a cotton grower wishes to deliver his cotton to a cotton factor for sale and to obtain an advance upon the cotton pending the sale, and intends to use the proceeds of the loan for agricultural purposes; or if a merchant who has taken cotton from a cotton grower in satisfaction of advances, wishes to deliver his cotton for sale in like manner to a cotton factor and obtain a loan on the cotton pending the sale, the proceeds of which loan he intends to use for commercial purposes,—in either case the owner of the cotton can give his note for the amount of the advance to the cotton factor, the cotton factor can discount the note with a member bank and the member bank can rediscount the note, if it is otherwise acceptable, with a Federal Reserve Bank. The Federal Reserve Bank, however, is limited to an amount of such paper bearing the endorsement of any one cotton factor to 10% of the capital and surplus of the member bank offering same for rediscount.

(2)—If a cotton factor in the regular course of his business makes a sale of cotton to a consumer or to a merchant, or to any person who is in the business of buying or selling cotton and draws his draft upon the purchaser for the amount of the sale, and the draft is accepted by the purchaser of the cotton, such draft when discounted by a member bank and endorsed by it is eligible for rediscount at its Federal Reserve Bank; and since it is also a bill of exchange drawn against actually existing values the amount of such paper rediscounted is not subject to the statutory limitations.

If the proceeds of notes referred to in (1) have been or are to be used by the cotton grower for agricultural purposes, the time limit is six months, exclusive of days of grace. If the proceeds of notes referred to in (1) have been or are to be used by the merchant for commercial purposes the time limit is ninety days, exclusive of days of grace. The time limit of drafts referred to in number (2) is ninety days, exclusive of days of grace. It should be borne in mind, however, by member banks discounting any such paper, with the intention of offering it for rediscount to a Federal Reserve Bank that, regardless of the time limit set by law, the notes and drafts referred to in (1) and (2) should not be drawn for a longer time than may be reasonably necessary to complete the transaction. For example, if a cotton producer lodges his cotton for sale with a cotton factor, gives his note to him intending to use the proceeds of the note for agricultural purposes, the note should be drawn to mature in a reasonable time, during which the factor will have an opportunity to sell, deliver and collect for the cotton lodged with him for sale. The Federal Reserve Bank of Dallas will take into consideration, with respect to any such paper offered to it for rediscount, whether or not the time allowed is reasonable.

In all of the above cases it should be borne in mind that paper offered to a Federal Reserve Bank must be acceptable as well as eligible. It is, therefore, advisable in every case to furnish the Federal Reserve Bank with a statement of the assets and liabilities of the cotton factor, and where possible of the cotton grower in case (1), and of the cotton buyer in case (2). Cases may easily arise in which the Federal Reserve Bank would be unwilling to rediscount such a note without having both statements in its possession. Cases will arise in which the Federal Reserve Bank will have to refer to the statement of the maker of the note or the drawer of the draft in order to determine its eligibility.

It should also be remembered that the member bank offering any of the above described paper for rediscount to a Federal Reserve Bank is presumed to know whether or not it complies with all conditions of eligibility. As a matter of fact the officer of a member bank who offers to a Federal Reserve Bank any paper for rediscount is required to sign a regular rediscount application, which application embodies a certificate of eligibility with respect to all paper embraced in the offering and described in the application.

Respectfully,

  
Governor.