

A meeting of the Board of Governors of the Federal Reserve System was held in Washington on Thursday, September 8, 1938, at 12:15 P. m.

PRESENT: Mr. Szymczak
Mr. Davis
Mr. Draper

Mr. Bethea, Assistant Secretary
Mr. Carpenter, Assistant Secretary

The action stated with respect to each of the matters hereinafter referred to was taken by the Board:

Letter to Mr. J. Harvie Wilkinson, Jr., Vice President, State-Planters Bank and Trust Co., Richmond, Virginia, reading as follows:

"Reference is made to your letter of July 25, 1938, requesting an interpretation of section II(6) of the Comptroller's Investment Securities Regulation.

"As stated in our letter of August 3, 1938, the question presented in your letter was taken up with the office of the Comptroller of the Currency. We have now received a reply from the Acting Comptroller, a copy of which is inclosed herewith.

"It is hoped that the inclosed letter will answer all of the questions which you have in mind. If, however, you should have any additional questions, it is suggested that you communicate with the Federal Reserve Bank of Richmond. If the Federal Reserve Bank is not in a position to answer such questions it will submit them to the Board of Governors for further consideration."

Approved unanimously, together with a letter to the Presidents of all Federal reserve banks, reading as follows:

"The Board of Governors recently received from a State member bank a request for an interpretation of section II(6) of the Investment Securities Regulation issued by the Comptroller of the Currency. This section reads as follows:

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"Purchase of securities convertible into stock at the option of the holder or with stock purchase warrants attached is prohibited if the price paid for such security is in excess of the investment value of the security itself, considered independently of the stock purchase warrants or conversion feature. If it is apparent that the price paid for an otherwise eligible security fairly reflects the investment value of the security itself and does not include any speculative value based upon the presence of a stock purchase warrant or conversion option the purchase of such a security is not prohibited."

"The pertinent portion of the letter from the State member bank reads as follows:

'Paragraph 6 of Section 2 states in part, "If it is apparent that the price paid for an otherwise eligible security fairly reflects the investment value of the security itself and does not include any speculative value based upon the presence of a stock purchase warrant or conversion option, the purchase of such a security is not prohibited." We will first assume, therefore, that any convertible bond to be eligible for purchase must be one in which the investment characteristics are not "distinctly or predominantly speculative". In short, the obligor's credit status must be such that its security cannot be said to be one in which the speculative characteristics are predominant. We presume that this is an interpretation on which you would agree?

'The point on which we would like to have clarification as to your intentions in examining procedure concerns that clause in Paragraph 6, Section 2, which states that the purchase of convertible or warrant bonds is prohibited "if the price paid for such security is in excess of the investment value of the security itself, considered independently of the stock purchase warrants or conversion feature." To be still more specific, what will be your procedure in determining whether the price of a security is

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"in excess of the investment value of the security itself, considered independently of the stock purchase warrants or conversion feature? Which of the following procedures or which other procedures will you adopt?

'1. Will the price paid for a convertible bond be deemed to reflect the presence of a conversion option when, and only when, the security (generally common stock) into which the bond is convertible has passed in market price the figure at which the bond is convertible (the parity figure)?

'By way of illustration, if a bond is convertible into common stock at 25 and the bond is purchased when the stock is selling at 24 7/8 or less, will the bond be eligible under this particular paragraph, assuming always, of course, that it is "otherwise eligible"?

'2. If a company has two issues of bonds outstanding under the same mortgage, one issue of which is convertible and one issue of which is not, will the convertible issue be deemed to be reflecting the presence of the conversion privilege if it sells to yield any smaller percentage return (that is, at a higher price) than the issue which is not convertible, however remote the conversion parity may be.

'Assume Series A and Series B bonds are issued under the same mortgage of a company whose obligations are "otherwise eligible". Assume Series B bonds are convertible into the stock at 50; assume Series A bonds are not convertible. Assume that the maturity dates and the coupon rates of both series are identical, both being 4% bonds, say, due 1946. If Series B, the convertible bond, sells at 80 and Series A sells at 75, and the common stock into which they are convertible is at 17 (33 points away from the conversion parity), will Series B bonds be eligible?

'3. Assume a somewhat similar situation as exists in 2 above, but further assume that there

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"is no comparable mortgage bond with which one can compare in order to ascertain what is the true investment merit. What will be the procedure for determining whether a bond does reflect the existence of a conversion privilege? In short, assume that there was a Series B bond but no Series A bond, what procedure would you use for determining whether the Series B bond reflected the existence of a conversion privilege?"

"Since the matter involved an interpretation of a regulation issued by the Comptroller of the Currency, a copy of the letter from the State member bank was furnished to the Acting Comptroller with a request for an expression of his views regarding the questions presented therein. Under date of August 29, 1938, the Board of Governors received from the Acting Comptroller a letter which stated the following (the references to paragraphs '1', '2', and '3' are to the above-quoted numbered paragraphs of the letter from the State member bank):

'Mr. _____ is correct in assuming that any convertible bond or bond with stock purchase warrants attached to be eligible for purchase must be one in which the investment characteristics are not distinctly or predominantly speculative; in short, the obligor's credit status, i.e., the credit status of the particular bond issue in question, must be such that the security cannot be said to be one in which the speculative characteristics are predominant.

'It is not believed that the illustration recited by Mr. _____ in his paragraph '1' at the top of page 2 of his letter could be used as the sole test in determining whether a bank had paid a price for such a security which was in excess of the investment value of the security itself, considered independently of the stock purchase warrants or conversion feature. If, with all the available facts before him, the Examiner deemed that a bank he was examining had paid a price for such a security which was in excess of the investment value of the security itself, considered independently of

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"the stock purchase warrants or conversion feature, he would report the security as having been illegally purchased by the bank.

'It would appear to be clear that in the illustration recited by Mr. _____ in his paragraph "2" on page 2 of his letter that the "Series B" bond would not be eligible as it would appear to be clear that the bank would have paid \$5 a hundred for the stock purchase warrants or conversion privilege.

'In answer to Mr. _____'s paragraph "3" on page 2, it can only be repeated that when an Examiner, with all the available facts before him, deems that the bank he is examining paid a price for such a security which was in excess of the investment value of the security itself, considered independently of the stock purchase warrants or conversion feature, he would report the security as having been illegally purchased by the bank.'"

Letter to the Presidents of all Federal reserve banks, reading as follows:

"Reference is made to the Board's letter of August 20, 1938 (R-295), calling a conference in Washington this fall, on a date to be subsequently announced, of the heads of the bank examination departments of the Federal reserve banks.

"You are accordingly notified that the conference will be held beginning Monday, October 17, 1938, at 10:00 a.m., in the Conference Room of the Board's Division of Examinations.

"A tentative draft of the program for the conference will be formulated as soon as the suggestions of the various Federal reserve banks have been received. You will recall that our letter of August 20 indicated the major questions to be discussed and requested that specific questions relating thereto and any other suggested topics for consideration at the conference be forwarded to Mr. Paulger by September 17."

Approved unanimously.

