Minutes of actions taken by the Board of Governors of the Federal Reserve System on Friday, September 4, 1953. The Board met in the Board Room at 10:00 a.m.

PRESENT: Mr. Szymczak, Acting Chairman
Mr. Evans
Mr. Robertson

Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Vest, General Counsel
Mr. Young, Director, Division of Research and Statistics
Mr. Allen, Director, Division of Personnel Administration
Mr. Molony, Assistant to Mr. Thurston

There was presented a draft of letter prepared for the signature of the Acting Chairman to Mr. H. Eliot Kaplan, Chairman of the Committee on Retirement Policy for Federal Personnel, Executive Office of the President, Washington, D. C., reading as follows:

> Inasmuch as Chairman Martin is away from Washington at present on vacation, I am responding to your letter of August 28, 1953 requesting the cooperation of the Board of Governors in furnishing data to your Committee for a current valuation of the Civil Service Retirement System. Some of the Board's employees are members of the Civil Service Retirement System but none of them are covered under the Federal Insurance Contributions Act.
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> The Board will, of course, be glad to cooperate in the project to which you refer, and Mr. Dwight L. Allen, Director, Division of Personnel Administration, has been designated as the individual responsible for supplying the information requested.

Following a statement by Mr. Allen as to the reasons why the information requested was desired

by the Committee, the letter was approved unanimously.

At this point Messrs. Riefler, Assistant to the Chairman, and Thomas, Economic Adviser to the Board, entered the room.

Mr. Young presented a report on the Central Banking Seminar conducted by the Federal Reserve Bank of San Francisco, in which he participated earlier this week pursuant to the authorization of the Board on June 17, 1953.

There was a discussion of the extent to which such seminars, to which selected members of college faculties are invited, have been arranged by the Federal Reserve Banks to date, and the members of the Board who were present concurred in a statement by Governor Evans that the program of seminars was desirable and should be expanded.

There were presented telegrams to the Federal Reserve Banks of Boston, New York, Philadelphia, Chicago, St. Louis, and San Francisco stating that the Board approves the establishment without change by the Federal Reserve Banks of Boston and St. Louis on August 31, by the Federal Reserve Bank of San Francisco on September 1, and by the Federal Reserve Banks of New York, Philadelphia, and Chicago on September 3, 1953, of the rates of discount and purchase in their existing schedules.

Approved unanimously.

Messrs. Riefler, Thomas, and Young withdrew from the room at this point.

Reference was made by Mr. Sherman to a letter dated September 2, 1953, from Mr. Powell, President of the Federal Reserve Bank of Minneapolis, to Mr. Leonard, Director, Division of Bank Operations, advising Mr. Leonard that he had been named as an associate member of the Presidents' Conference Subcommittee on Paper Currency. Mr. Sherman stated that in accordance with the understanding at the meeting of the Board on September 1, he thereafter talked by telephone with President Powell, who is Chairman of the Special Committee which was appointed by the Presidents' Conference following the meeting of the Conference in June 1953 to study problems involved in the provision and destruction of all types of paper currency with a view to determining the position the Reserve Banks should take with respect to this matter in the future. He said he informed President Powell that in view of the Board's concern with the matters which the subcommittee was to study, both from the operating standpoint and from the legal standpoint, the Board would be pleased to have representation on the Subcommittee on Paper Currency, and that President Powell replied that he would be glad to name a member of the Board's staff as an associate member.

During a discussion of the assignment which it was understood had been given to the Subcommittee, Governor Robertson suggested that

since the terms of reference for the study assigned to the Special Committee by the Presidents' Conference seemed to involve primarily the position that the Federal Reserve Banks should take, it might be desirable for the Board to set up another committee to study the entire problem of the currency of the United States in all its aspects. Such a committee could be broadened into a System committee with legal, operating, and research personnel represented. He indicated that he would favor this procedure despite the fact that there might be some overlapping in the work of the two committees.

Following a discussion of Governor Robertson's proposal, it was understood that no action would be taken for the present with respect to Mr. Leonard's appointment as an associate member of the Subcommittee on Paper Currency, that Messrs. Vest and Leonard would explore the possibilities of a System study, including the field which might be covered by such a study, and that the matter would be considered again by the Board in advance of the next meeting of the Presidents' Conference with a view to determining the manner in which the position of the Board should be expressed to the Presidents.

Thereupon the meeting adjourned. During the day the following additional actions were taken by the Board with Governors Szymczak, Evans, and Robertson present:

Letter to the Presidents of all Federal Reserve Banks reading as follows:

There are enclosed two interpretations of the Board relating to Regulation T and Regulation U which will be published in early issues of the Federal Reserve Bulletin and the Federal Register.

As further assurance that interested parties are advised of the interpretations, you may wish to send copies to all banks and to all brokers and dealers in your district.

Approved unanimously. The interpretations referred to in the foregoing letter read as follows:

INTERPRETATION OF REGULATIONS T AND U

Arranging for Extensions of Credit to be Made by a Bank

The Board has recently had occasion to express opinions regarding the requirements which apply when a person subject to Regulation T--for convenience, called here simply a broker --arranges for a bank to extend credit.

The matter is treated generally in section 7(a) of Regulation T, and is also subject to the general rule of law that any person who aids or abets a violation of law by another is himself guilty of a violation. It may be stated as a general principle that any person who arranges for credit to be extended by someone else has a responsibility so to conduct his activities as not to be a participant in a violation of Regulation T which applies to brokers, or Regulation U, which applies to banks.

More specifically, in arranging an extension of credit that may be subject to Regulation U, a broker must act in good faith and, therefore, must question the accuracy of any non-purpose statement (i.e., a statement that the loan is not for the purpose of purchasing or carrying registered stocks) given in connection with the loan where the circumstances are such that the broker from any source knows or

has reason to know that the statement is incomplete or otherwise inaccurate as to the true purpose of the credit. The requirement of "good faith" is of vital importance. While the application of the requirement will necessarily vary with the facts of the particular case, the broker, like the bank for whom the loan is arranged to be made, must be alert to the circumstances surrounding the loan. Thus, for example, if a broker or dealer is to deliver registered stocks to secure the loan or is to receive the proceeds of the loan, the broker arranging the loan and the bank making it would be put on notice that the loan would probably be subject to Regulation U. In any such circumstances they could not in good faith accept or rely upon a statement to the contrary without obtaining a reliable and satisfactory explanation of the situation. The foregoing, of course, applies the principles published at page 27 of the 1947 Bulletin (12CFR,221.101).

In addition, when a broker is approached by another broker to arrange extensions of credit for customers of the approaching broker, the broker approached has a responsibility not to arrange any extension of credit which the approaching broker could not himself arrange. Accordingly, in such cases the statutes and regulations forbid the approached broker to arrange extensions of credit on unregistered securities for the purpose of purchasing or carrying either registered or unregistered securities. The approaching broker would also be violating the applicable requirements if he initiated or otherwise participated in any such forbidden transactions.

The above expression of views to the effect that certain specific transactions are forbidden, of course, should not in any way be understood to indicate approval of any other transactions which are not mentioned.

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INTERPRETATION OF REGULATION U

Reliance in "Good Faith" on Statement of Purpose of Loan

Certain situations have arisen from time to time under Regulation U wherein it appeared doubtful that, in the circumstances, the lending banks may have been entitled to rely

upon the statements accepted by them in determining whether the purposes of certain loans were such as to cause the loans to be not subject to the regulation.

The use by a lending bank of a statement in determining the purpose of a particular loan is, of course, provided for by section 3(a) of the regulation. However, under that section a lending bank may "rely" upon any such statement only if it is "accepted by the bank in good faith". As the Board stated in the interpretation published in the 1947 Federal Reserve Bulletin, p. 27 and at 12 C.F.R., 221.101, the "requirement of 'good faith' is of vital importance"; and, to fulfill such requirement, "it is clear that the bank must be alert to the circumstances surrounding the loan".

Obviously, such a statement would not be accepted by the bank in "good faith" if at the time the loan was made the bank had knowledge, from any source, of facts or circumstances which were contrary to the natural purport of the statement, or which were sufficient reasonably to put the bank on notice of the questionable reliability or completeness of the statement.

Furthermore, the same requirement of "good faith" is to be applied whether the statement accepted by the bank is signed by the borrower or by an officer of the bank. In either case, "good faith" requires the exercise of special diligence in any instance in which the borrower is not personally known to the bank or to the officer who processes the loan.

The interpretation mentioned above contains an example of the application of the "good faith" test. There it was stated that "if the loan is to be made to a customer who is not a broker or dealer in securities, but such a broker or dealer is to deliver registered stocks to secure the loan or is to receive the proceeds of the loan, the bank would be put on notice that the loan would probably be subject to the regulation. It could not accept in good faith a statement to the contrary without obtaining a reliable and satisfactory explanation of the situation".

Moreover, and as also stated by the aforementioned interpretation, the "purpose" of a loan, of course, "cannot be altered by some temporary application of the proceeds. For example, if a borrower is to purchase Government securities with the proceeds of a loan, but is soon thereafter to sell such securities and replace them with registered stocks, the loan is clearly for the purpose of purchasing or carrying registered stocks". The purpose of a loan, therefore, should not be determined upon a narrow analysis of the immediate use to which the proceeds of the loan are put. Accordingly, a bank acting in "good faith" should carefully scrutinize cases in which there is any indication that the borrower is concealing the true purpose of the loan, and there would be reason for special vigilance if registered stocks are substituted for bonds or unregistered stocks soon after the loan is made, or on more than one occasion.

Similarly, the fact that a loan made on the borrower's signature only, for example, becomes secured by registered stock shortly after the disbursement of the loan usually would afford reasonable grounds for questioning the bank's apparent reliance upon merely a statement that the purpose of the loan was not to purchase or carry registered stock.

These examples are, of course, by no means exhaustive. They simply illustrate the fundamental fact that no statement accepted by a bank is of any value for the purposes of the regulation unless "accepted by the bank in good faith", and that "good faith" requires, among other things, reasonable diligence to learn the truth.

Assistant Secretary