Minutes for July 19, 1963

To: Members of the Board

From: Office of the Secretary

Attached is a copy of the minutes of the Board of Governors of the Federal Reserve System on the above date.

It is not proposed to include a statement with respect to any of the entries in this set of minutes in the record of policy actions required to be maintained pursuant to section 10 of the Federal Reserve Act.

Should you have any question with regard to the minutes, it will be appreciated if you will advise the Secretary's Office. Otherwise, please initial below. If you were present at the meeting, your initials will indicate approval of the minutes. If you were not present, your initials will indicate only that you have seen the minutes.

Chm. Martin _____

Gov. Mills _____

Gov. Robertson _____

Gov. Balderston _____

Gov. Shepardson _____

Gov. King _____

Gov. Mitchell _____

Minutes of the Board of Governors of the Federal Reserve System on Friday, July 19, 1963. The Board met in the Board Room at 10:00 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Balderston, Vice Chairman
Mr. Robertson
Mr. Shepardson

Mr. Sherman, Secretary
Mr. Young, Adviser to the Board and Director, Division of International Finance
Mr. Cardon, Legislative Counsel
Mr. Fauver, Assistant to the Board
Mr. Noyes, Director, Division of Research and Statistics
Mr. Koch, Associate Director, Division of Research and Statistics
Mr. Holland, Adviser, Division of Research and Statistics
Mr. Furth, Adviser, Division of International Finance
Mr. Katz, Associate Adviser, Division of International Finance
Mr. Landry, Assistant to the Secretary
Mr. Eckert, Chief, Banking Section, Division of Research and Statistics
Mr. Yager, Chief, Government Finance Section, Division of Research and Statistics
Mr. Keir, Senior Economist, Division of Research and Statistics
Mr. Bernard, Economist, Division of Research and Statistics
Mr. Goldstein, Economist, Division of International Finance

Money market review. Tables were distributed summarizing monetary developments during the preceding four weeks and member bank reserve positions on statement weeks in May, June, and July of 1963 along with a chart showing comparative yield curves on Government securities for recent dates. Mr. Bernard described developments in the money market, including reference to the Government's cash budget

position for fiscal 1963. Mr. Koch then commented on the situation with respect to bank reserves, the money supply, and liquidity, following which Mr. Goldstein reported on the foreign exchange market.

At the conclusion of these reports all members of the staff except Messrs. Sherman, Fauver, and Landry withdrew and the following entered the room:

Mr. Farrell, Director, Division of Bank Operations
Mr. Solomon, Director, Division of Examinations
Mr. Conkling, Assistant Director, Division of Bank Operations
Mr. Benner, Assistant Director, Division of Examinations

Discount rates. The establishment without change by the Federal Reserve Bank of New York on July 18, 1963, of the rates on discounts and advances in its existing schedule was approved unanimously with the understanding that appropriate advice would be sent to that Bank.

Currency shipments across district lines (Item No. 1). Reference was made in a distributed memorandum from the Division of Bank Operations dated July 16, 1963, to advice received from Chairman Irons of the Presidents' Conference in a letter dated July 2 that the Conference agreed at its meeting on June 17, 1963, that the present System policy of permitting shipments of currency across district lines only at the request of a member bank was too restrictive and should be broadened to permit such shipments on the initiative of the Reserve Banks concerned.

The memorandum noted that the question was discussed by the Presidents' Conference at the suggestion of President Scanlon of the Chicago Reserve Bank, who had ascertained that one of the common carriers (Brink's Inc.) was able to provide service at a more reasonable rate out of Minneapolis than out of Chicago to certain areas of the Chicago District, principally western Iowa. Mr. Scanlon had expressed the view that with the passage of time the most efficient and economical way to deliver currency and coin would be to permit some crossing of district lines in the manner indicated. Attached to the memorandum was a draft of letter to the Presidents of all Reserve Banks advising that the Board would interpose no objection to the shipment of currency across district lines on the initiative of the Reserve Banks concerned and on a mutually agreeable basis, with the understanding that the Board would be advised of any such arrangements and the names of the cities in other districts to which a Reserve Bank might agree to make such shipments at the request of another Reserve Bank.

At the invitation of the Board Mr. Farrell commented on the memorandum. In reply to a question from Governor Robertson, he stated that, although it was not essential that the Board be advised of arrangements worked out by the Reserve Banks for currency and coin shipments across district lines, it seemed advisable for the Board to be kept informed of such developments.

Following discussion, unanimous approval was given to a letter to all Reserve Bank Presidents interposing no objection to the

initiation by the Reserve Banks of currency shipments to member banks in other districts on such basis as was mutually agreeable to the Reserve Banks concerned. A copy of the letter is attached as Item No. 1.

Messrs. Hexter and O'Connell, Assistant General Counsel, and Mr. Stone, Law Clerk, joined the meeting at this point.

Proposed Investment Securities Regulation of the Comptroller of the Currency (Item No. 2). On June 21, 1963, the Comptroller of the Currency published in the Federal Register for comment within thirty days a proposed revision of the Investment Securities Regulation that would purport to govern "purchase, sale, underwriting, and holding of investment securities" by national banks and member State banks. In a distributed memorandum dated July 17, 1963, from the Legal Division it was noted that the comments of the Reserve Banks on the proposed revision, which had been grouped by topic in an appendix to the memorandum, had been incorporated to the extent deemed appropriate in an attached draft of letter to the Comptroller of the Currency.

The memorandum noted that the proposed revision would introduce a number of new features into the Regulation that for the most part were discussed in an enclosure that would accompany the draft letter. In one respect, however, the Regulation would purport to deal with a matter that was believed to go beyond the authority of the Comptroller to regulate, and would do so in a manner that apparently would conflict with applicable Federal statutory provisions. This was the question of underwriting and dealing in securities, to which the memorandum was

principally devoted, since it was believed that the other subjects requiring comment were covered sufficiently in the proposed communication to the Comptroller.

The statutory provision upon which the Comptroller relied for his authority to adopt the proposed Regulation was paragraph seventh of section 5136 of the Revised Statutes (12 U.S.C. 24), as amended by the Banking Acts of 1933 and 1935, in which was stated a fundamental distinction between investing in securities and underwriting and dealing in securities. With respect to securities investment the statute, which vested regulatory authority in the Comptroller, provided that a bank may not hold "investment securities of any one obligor or maker" in an amount exceeding 10 per cent of the bank's capital and surplus. Limitations were prescribed in the statute with respect to bank underwriting and dealing in securities restricting such activity to transactions for the account of customers and prohibiting banks from underwriting any issue of securities or stock. The chief exception to this general prohibition related to obligations of the United States or general obligations of any State or of any political subdivision thereof. As noted in the memorandum, since the 1930's when the provisions relating to underwriting and dealing in securities were added to Revised Statutes 5136, the exception had been construed uniformly as applicable only to obligations of governmental organizations possessing the general power of property taxation and only where the obligations were supported by this power. Over the past decade a number of bills had been introduced

into Congress for the purpose of amending the statute to permit banks to underwrite and deal in government revenue bonds, to a limited extent. It was the view of the Legal Division that under the proposed Regulation a State or other public body would be in a position to make every obligation a "general obligation," eligible for bank underwriting and investment without limitation upon amount, simply by creating an "authority" or other public organization for a particular purpose. In such instances the basic distinction drawn between revenue bonds and general obligations by Congress in Revised Statutes 5136 could be nullified by changes in form having no relationship to the substantive investment characteristics of the securities involved.

The memorandum went on to state that even should the proposed Regulation be made applicable only to national banks, the Board would be concerned both indirectly and directly: indirectly, because of the unauthorized administrative relaxation of legislative restrictions and directly, because section 9 of the Federal Reserve Act provides that State member banks are subject to the same limitations and conditions with respect to underwriting, etc., "as are applicable in the case of national banks." In this connection, a letter had been addressed to the Board by Bankers Trust Company, New York City, inquiring

> "whether the Board concurs in the provision of the proposed regulations to the effect that such regulations are applicable to state member banks. If the Board does not concur in this provision, we would appreciate knowing whether or not the Board will issue similar regulations. In this respect we would also appreciate knowing whether the Board considers

that there is any difference between investment securities which national and state member banks may purchase for their own accounts and securities which national and state member banks may deal in or underwrite."

It was the Legal Division's opinion that, should the Board take a position similar to that proposed in the draft letter to the Comptroller of the Currency, and should the Comptroller nevertheless promulgate the Regulation substantially in its proposed form, it would seem necessary for the Board to inform all member State banks that the Comptroller lacked authority to enlarge the underwriting powers of member banks and that, despite the language of the new Regulation, member State banks might not underwrite and deal in securities except to the extent permitted by the provisions of Revised Statutes 5136.

Following comment by Mr. Hexter on the Legal Division's memorandum, Chairman Martin inquired whether Counsel at the Reserve Banks took the same view of the question as the Legal Division. In reply, Mr. Hexter said that all of the Reserve Banks that analyzed the proposed revision reached the same conclusion as the Board's Legal Division.

A lengthy discussion then ensued in the course of which it became apparent that the Board members present favored sending to the Comptroller of the Currency a letter substantially the same as that attached to the Legal Division memorandum. At the conclusion of the discussion, the letter was approved unanimously in the form attached as Item No. 2.

With respect to the manner in which member State banks might be informed of the Board's views on the proposed Regulation should it be adopted by the Comptroller of the Currency, it was understood that there would be no such advice until the Board had given consideration to alternative approaches that might be taken.

Meeting with proponents of commercial bank revenue bond financing. Chairman Martin said that a group of proponents of public revenue bond financing headed by Mr. Hardin Hawes, Senior Vice President, Harris Trust and Savings Bank, Chicago, Illinois, would be in Washington next Wednesday to confer with the Treasury Department and had requested an opportunity to meet with the Board to present their views. Noting that copies had been distributed of a pamphlet on the subject by Mr. John K. Langum, the Chairman inquired whether the Board would be agreeable to meeting with Mr. Hawes and his group on Wednesday afternoon, July 24. There being agreement expressed with the proposal, it was understood that appropriate arrangements would be made.

The meeting then adjourned.

Secretary's Notes: Governor Shepardson today approved on behalf of the Board the following actions relating to the Board's staff:

Salary increase

James R. Turner, Offset Press Operator (Multilith), Division of Administrative Services, from $4,909 to $4,930 per annum, effective July 21, 1963.

Transfer

Concetta M. Nobilio, from the position of Clerk-Typist in the Division of Personnel Administration to the position of Clerk-Typist in the Division of Bank Operations, with no change in basic annual salary at the rate of $3,820, effective July 21, 1963.

Outside activity

Wilbert J. Hart, Messenger, Division of Administrative Services, to work on a part-time basis for Aldo Cafe.

Governor Shepardson also approved today on behalf of the Board a letter to Mr. Fernando Rivera, Assistant Director of the Center for Latin American Monetary Studies, Mexico City, Mexico, regarding arrangements for the annual visit to the Board's offices of the Center's trainees during the week of September 3, 1963. (It was understood that the costs of the program would include a luncheon, translating facilities, a conducted tour of Washington, and certain minor expenditures, provision for all of these items having been made in the budget of the Secretary's Office.)

Secretary

2363

Item No. 1
7/19/63
S-1880

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON 25, D. C.

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

July 22, 1963.

Dear Sir:

This letter supersedes the Board's letter of April 7, 1938 (S-84, F.R.L.L.S. #3064) which interposed no objection to a Federal Reserve Bank entering into an arrangement, under certain circumstances, whereby shipment of currency might be made by a Reserve Bank to member banks in adjacent districts.

The Board has been informed that, at their June 17, 1963 meeting, the Presidents agreed that the policy set forth in the 1938 letter of permitting shipments of currency across district lines only at the request of a member bank was too restrictive and should be broadened to permit such shipments on the initiative of the Reserve Banks concerned.

The Board will interpose no objection to mutually agreeable arrangements between Federal Reserve Banks for the shipment of currency to an adjacent district, without expense to the member banks involved, such arrangements to be entered into either on the initiative of the Reserve Banks concerned or at the request of a member bank to its own Federal Reserve Bank.

Please advise the Board whenever your Bank enters into any arrangement for the shipment of currency to a member bank in another district and the names of the cities to which such shipments are made.

Very truly yours,

Merritt Sherman,
Secretary.

TO THE PRESIDENTS OF ALL FEDERAL RESERVE BANKS

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

Item No. 2
7/19/63

OFFICE OF THE CHAIRMAN

July 19, 1963.

The Honorable James J. Saxon,
Comptroller of the Currency,
Treasury Department,
Washington 25, D. C.

Dear Jim:

On June 21, 1963, the Federal Register contained a notice that the Comptroller of the Currency was considering the adoption of a revision of the Investment Securities Regulation (12 CFR Part 1). It was stated that consideration would be given to comments submitted to the Comptroller within 30 days.

In the opinion of the Board of Governors, certain of the proposed changes in the Regulation would be beneficial. However, the proposed revision appears to be questionable in some respects. A number of apparent defects are enumerated and commented upon in the enclosure. Some of these are of considerable substantive importance; others are inconsistencies or ambiguities that can be corrected readily to reflect the actual intent of the Regulation.

The Board's most serious concern relates to those provisions of the proposed Regulation that would purport to govern the authority of national banks and member State banks to underwrite and deal in securities, and to invest in certain classes of securities without limitation on amount. In the McFadden Act of 1927 and the Banking Acts of 1933 and 1935, Congress amended the Federal banking laws with respect to the authority of banks (1) to invest in securities and (2) to underwrite and deal in securities. With respect to banks' investments, the Comptroller of the Currency was empowered to define the term "investment securities" and to prescribe "limitations and restrictions". However, no regulatory authority was conferred upon the Comptroller regarding underwriting and dealing in securities. Those subjects are covered by a provision of R. S. 5136 that (1) permits banks to deal in securities only "without recourse, solely upon the order, and for the account of, customers, and in no case for its own account", and (2) forbids banks to "underwrite any issue of securities". A subsequent sentence of section 5136, however, provides that

"The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof," or certain other enumerated classes of securities. (Securities of the kinds described in that sentence are referred to, generally, as "exempt securities".)

In the opinion of the Board of Governors, the Federal banking laws do not authorize the Comptroller of the Currency to expand or contract the coverage of the underwriting, dealing, or investing powers conferred by this provision; and this has been the consistent position of the Office of the Comptroller of the Currency and the Federal Reserve System.

Accordingly, the Board recommends excluding from the proposed Regulation any provisions purporting either (1) to regulate the extent to which banks may underwrite, deal in, or purchase for their own accounts, so-called "exempt securities", which are governed by the provision of section 5136 that is quoted above, or (2) to confer upon banks powers relating to underwriting and dealing in securities, as distinguished from investing in securities.

The objections to the proposals regarding "public securities" are not based solely, or even principally, on their being embodied in regulatory provisions that are not authorized by law. If the provisions of the proposed Regulation on this subject constituted permissible interpretations of the applicable statutes, their inclusion in the Regulation would be merely misleading in that they would appear to constitute regulations with the force and effect of law rather than interpretations of legislative provisions. However, these proposed provisions involve a serious departure from the uniform, consistent, and clearly correct interpretation of the relevant statutory provisions. Therefore, their adoption by your Office, whether in the form of regulation or interpretation, would amount to an unauthorized attempt to change or to nullify Congressional policy expressed in existing law.

The distinction between (1) "general obligations" exempted by section 5136 from the limitations and restrictions applicable to other securities, and (2) other governmental obligations, generally called "revenue bonds", which are not so exempt, is firmly established in both law and practice, although occasionally security issues must be analyzed carefully to determine in which category they belong. With respect to the group of securities exempted from the limitations of R. S. 5136 by the statutory phrase "general obligations of any State or of any political subdivision thereof", the following excerpt from the Digest of Opinions of the Office of the Comptroller of the Currency states the applicable principles:

> "The term 'political subdivision,' as used in R.S. 5136, includes only such governmental units as have the power of general property taxation, together with the incidental power to compel payment, as distinguished from governmental units which have lesser taxing powers or which may merely levy charges for voluntary use of their property or facilities. In order to qualify as 'general obligations' of a political subdivision, securities must be backed by its full faith and credit." (Paragraph 520)

As far as the Board of Governors is aware, this interpretation has been accepted by banks and has been enforced by Federal bank supervisors without exception. Since the relevant statutory provisions were adopted, banks have regularly participated in underwriting general obligations of political subdivisions of States, as described in the above quotation from the Digest of Opinions, and at no time have banks underwritten securities of governmental units that were not supported, directly or indirectly, by the power of general property taxation. This distinction has also been maintained scrupulously by banks in their activities as dealers in municipal securities.

As you know, over the past decade a number of bills have been introduced into Congress for the purpose of amending R. S. 5136 to permit banks to underwrite and deal in governmental revenue bonds (to a limited extent) in addition to general obligations of States and political subdivisions. These efforts by the national banks and member State banks most active as underwriters and dealers reflect their understanding that a statutory amendment would be necessary to empower them to underwrite revenue securities.

Under the proposed Regulation a bank would be permitted to underwrite and deal in any security of a "public authority" or "any publicly owned entity which is an instrumentality of the state or of a municipal corporation", provided the security was "supported by the full faith and credit of the obligor". In effect, this would mean that banks could underwrite and deal in any security as to which a public authority or publicly owned corporation was generally liable, even though the obligor did not possess any power of taxation or have access to funds derived from taxation. In other words, securities of a turnpike authority or bridge authority, or a public corporation operating parking facilities or public beaches, would be eligible for bank underwriting, even though the principal and interest on such securities were payable solely from the net income, if any, derived by such authority or corporation from voluntary use by the public of its facilities.

Under such an interpretation of paragraph Seventh of R. S. 5136, a State or other public body would be in a position, generally speaking, to make every obligation a "general obligation", eligible for bank underwriting and investment without any limitation upon amount, simply by creating an authority or other public organization for a particular limited purpose. The consequence would be that the basic distinction drawn by Congress in R. S. 5136 could be nullified at will, by changes in form having no relationship to the actual strength or the substantive investment characteristics of the securities involved.

It is noteworthy in this connection that when Congress, in 1959, specifically authorized banks to underwrite and deal in obligations issued by the Tennessee Valley Authority, it specifically prohibited any national bank or member State bank from holding obligations of that Authority "as a result of underwriting, dealing, or purchasing for its own account...in a total amount exceeding at any one time 10 per centum" of the bank's capital stock and surplus. Bonds of other Federal governmental authorities and corporations are subject to all the prohibitions and restrictions prescribed by R. S. 5136 with respect to security investments generally. In contrast, the proposed Regulation would purport to authorize banks to underwrite, deal in, and purchase for their own account, securities of a local bridge authority or public parking-facilities corporation, for example, without any limitation whatever upon amount. It would be difficult to bring out more sharply the extent to which the proposed Regulation would contravene the Congressional prohibition with respect to underwriting and dealing in, and the limitation as to purchasing for investment, municipal securities other than "general obligations", as that term has been consistently interpreted and applied.

Attention is directed also to the provisions of section 21 of the Banking Act of 1933 (12 U.S.C. 378).

This matter has been discussed at length because the Board of Governors is seriously concerned over the proposal to depart from the Congressional policy and principles embodied in the provisions of R. S. 5136 that have been mentioned herein. The Board reiterates its earnest recommendation that the proposed Regulation be amended by excluding any provisions regarding underwriting and dealing in securities, or purporting to expand the category of "exempt securities" established by R. S. 5136, since such provisions are beyond the powers conferred by Congress upon the Comptroller

of the Currency and would contravene statutory provisions that the Comptroller is not authorized to disregard or modify. The Board's staff is prepared to assist in revising the Regulation along these lines and to discuss any aspect of the matter that has not been sufficiently clarified.

Sincerely yours,

(Signed) Wm. McC. Martin, Jr.

Wm. McC. Martin, Jr.

Enclosure

Comments on proposed revision of Investment Securities Regulation published in Federal Register of June 21, 1963

1. Legal validity. This matter is discussed in the letter from the Board of Governors to the Comptroller, with which this memorandum will be enclosed. If the Board's recommendation is followed by the Comptroller, several provisions of the proposed Regulation would be deleted; in that case, some of the comments listed below would no longer be applicable.

2. In § 1.3(d), "a state" probably should be "the State".

3. In the second sentence of § 1.4, "In the case of" probably should be "Prior to purchase of".

4. Section 1.4 requires a specified determination prior to purchase of "an obligation of a State or political subdivision thereof". It is not clear why this requirement, if advisable in such cases, would not be equally desirable with respect to other "public securities". Limiting this requirement to the groups specified might seem to imply a view that the obligations of States and political subdivisions tend to be of somewhat lower quality than other public securities and require stronger justification.

5. In the same sentence, the second "source" should be "sources".

6. Varying criteria. Sections 1.4, 1.5(a), and 1.5(b) require certain determinations as prerequisites to the purchase of certain kinds of securities. The three criteria are different from each other, and the reasons for the differences are not apparent. For example, § 1.5(a) requires a determination "that there is adequate evidence" of the obligor's ability to perform, whereas § 1.5(b) requires a similar determination, except that it is required to be "based upon reliable estimates". If the clause in § 1.5(a) were changed to read "when in its prudent banking judgment, based upon adequate evidence", the intended difference between the two might be somewhat clearer.

More important, in this connection, is the fact that an entirely different criterion is prescribed by § 1.4. It appears that the criterion specified in § 1.5(a) would be equally applicable to the § 1.4 situation, and uniformity in this respect would avoid the puzzling question as to what different objective, if any, was intended by the difference in language.

7. Use of new and undefined terms. The Regulation includes a number of novel terms. Those are not defined, and their meanings are not clear from the terms themselves. Perhaps the most important is

the term "qualified investment department" in § 1.5(b). This provision probably would lead to conflicts between banks and supervisors, since the latter will be required to determine, whenever securities are purchased under the provisions of § 1.5(b), whether the purchasing bank possesses a "qualified investment department". Presumably, this term is not intended to include only large and formally organized departments, since a smaller institution may have an officer and assistants who are as capable as a larger bank's organization to evaluate securities. Consequently, if the "qualified investment department" standard is to have any effect whatever, bank examiners will find it necessary to grade each bank's "investment department" as "qualified" or "unqualified". The undesirability of such an arrangement seems clear.

Another example of an undefined term that could give rise to difficulties is "based upon reliable estimates", in § 1.5(b). Presumably, these will be estimates of firms of traffic engineers, and so on. Is it advisable, or practical, to require bank examiners to evaluate the reliability of professional estimates?

8. It is inferred that § 1.5(a) is intended to cover only securities of obligors that have a financial history, whereas § 1.5(b) is intended to apply only to the securities of obligors engaged in a new and unproved enterprise. It might be advisable to indicate this by a brief sentence in § 1.5(b), since "estimates" could be made regarding the prospects of established enterprises as well as new ones.

9. In § 1.5(c), "a published ruling of the Comptroller" should be changed to "a ruling published by the Comptroller". This would avoid any inference that a ruling sent to an individual bank, and published by it, would constitute a basis for eligibility under § 1.5(c), which presumably is not intended.

10. (For purposes of this comment, it is assumed that the Comptroller has legal authority to promulgate a list of individual eligible securities in the nature of a "legal list".) A ruling as to eligibility for purchase necessarily rests on the relevant circumstances at the time of the ruling. The quality of a security may change from time to time; securities that are of bank-investment quality in 1963 may deteriorate and become ineligible a year or two later. However, § 1.5(c) appears to provide that, if a security is "ruled eligible for purchase" by the Comptroller at any time, it will continue to be eligible at all times thereafter. Obviously, this would be an undesirable arrangement, since it would permit banks to purchase weak, speculative, or defaulted securities simply because the Comptroller had ruled those securities "eligible" in the past, when their quality was better.

The solution to this difficulty is not apparent, unless the Comptroller intends to maintain an organization in his office that will keep up-to-date on the investment quality of all securities theretofore

"ruled eligible", and to "de-list" securities that have deteriorated in quality to such an extent as to make them unsuitable for bank investment.

11. Section 1.6(a) contains a general prohibition against a bank's holding "investment securities of any one obligor in a total amount in excess of 10% of the bank's capital and surplus". The term "investment security" is defined in § 1.3(b) to include securities that are exempted by R. S. 5136 from the 10% limitation. Accordingly, § 1.6(a) should begin "Except as otherwise provided by R. S. 5136, a bank may not hold", etc.

12. For the purpose of applying the statutory 10% limitation, § 1.6(a) provides that the amount of a bank's investment "is to be determined on the basis of the par or face value of the security". In view of the purpose of the 10% limit prescribed by Section 5136--to compel diversification and to limit the amount of a bank's funds at risk in the securities of any one obligor--it is questionable whether the use of "face value" as the measure is either legally valid or practically advisable. Since bonds frequently sell far above face value, this provision of § 1.6(a) would mean that a bank with a capital and surplus of $1,000,000, for example, could invest $150,000 or $200,000 (i.e., 15% or 20%) in the securities of one corporation. Accordingly, the second sentence of § 1.6(a) should specify "the amount paid for the security" rather than "the par or face value of the security".

13. Section 1.6(b) presumably intends to set a maximum limit on the aggregate amount of <u>all</u> "securities purchased pursuant to paragraph (b) of § 1.5". However, some readers of the proposed Regulation, even though experienced in this field, actually have misinterpreted this provision as fixing a limit on holdings of securities of <u>any one obligor</u>. To prevent this misinterpretation, there should be inserted after "dollar amount" a phrase such as ", for all such securities,".

14. Sections 1.6(b) and 1.6(c) prohibit a bank from <u>holding</u> certain securities in excess of amounts specified or to be specified. This provision might compel liquidation in circumstances where this is not intended and would not be desirable. For example, assume that a bank purchases "§ 1.5(b) securities" in a total amount equal to the 5% aggregate limit prescribed by § 1.6(b). Thereafter the percentage increases to more than the permissible 5% (either by sale or redemption of other securities, decrease in value of other securities, or increase in the value of the § 1.5(b) securities). The language of § 1.6(b) would seem to require, in those circumstances, a sale of enough of the § 1.5(b) securities to reduce the aggregate to the prescribed 5% maximum.

This undesirable interpretation (and a similar interpretation of § 1.6(c) could be avoided by eliminating the word "hold" and, in lieu thereof, including something along these lines:

"...may not purchase investment securities pursuant to paragraph (b) of § 1.5 if, after such purchase, the aggregate amount of the bank's holdings of such securities would exceed 5% of the bank's investment account."

Definition of "investment account", in this context, would seem advisable.

15. Section 1.6(b) prescribes an aggregate limitation on the amount of securities that may be "purchased pursuant to paragraph (b) of § 1.5". However, § 1.5(b) is designed to permit banks to purchase securities of new enterprises, without financial histories. Over the years, after such securities have been purchased pursuant to § 1.5(b), the obligor usually will establish a satisfactory financial record, and thereafter there would exist the "adequate evidence" that permits purchase under § 1.5(a). In those circumstances, it appears unreasonable to require banks to continue to take such seasoned issued of securities into account in applying the 5% limitation prescribed by § 1.6(b). Nevertheless, that seems to be the effect of § 1.6(b) in its present form.

(In the parallel provisions of § 1.6(b) and § 1.6(c), it is noted that the wordings are "may not hold at any time" and "may not at any time thereafter hold". Because of the parallel nature of the provisions, it might be advisable to use similar wording, to avoid any possible inference that the two expressions are intended to have different meanings.)

16. It is assumed that the Comptroller does not contemplate making rulings, under § 1.6(c), with respect to any securities that are "exempt" under R. S. 5136, since such securities are expressly excluded from the limitations and restrictions under that section.

17. Section 1.9 provides that banks may request the Comptroller for rulings on the "application of the Regulation or paragraph Seventh of 12 U.S.C. 24". The term "bank" is defined in § 1.3(a) to include State member banks. Accordingly, § 1.9 is an invitation to member State banks to seek interpretations of the Regulation or of the statutory provision from the Comptroller. The following comments are made:

(a) The entire provision (§ 1.9) seems unnecessary; no regulatory authorization is required to enable banks to request supervisors to interpret applicable statutes or regulations, and specific "authorization" of such requests on this subject might seem to suggest that interpretations will not be made on other subjects. Accordingly, § 1.9 might well be deleted.

(b) If such a provision is retained, its application should be confined to national banks. As the Board recently

informed the Comptroller, it is the Board's responsibility to interpret Federal laws and regulations as they apply to member State banks, and inviting those banks to seek such interpretations from the Comptroller might lead to unnecessary conflicts and complications. (This comment does not relate to securities included in a "legal list" promulgated by the Comptroller pursuant to the proposed § 1.5(c).)

18. Convertible securities. Section 1.10 would permit banks to purchase securities that are convertible into stock, provided the bank immediately charged off the portion of the purchase price that exceeded the "investment value of the security considered independently of the conversion feature", etc.

This provision (1) would contravene a provision of R. S. 5136 and (2) would be substantively undesirable. A considerable number of convertible debentures sell at prices far in excess of their "investment value", solely because of the conversion feature, and the purchase of such securities is equivalent, in effect, to purchase of the stock into which they are convertible. A check of a broad sample of higher-priced convertible debentures traded on the New York Stock Exchange (at prices ranging up to $3,380 for a $1,000 debenture) discloses that, without exception, the price of the bond is within a few dollars of the value of the stock into which it is convertible.

The Federal banking statutes forbid banks to invest in corporate stocks. As mentioned, however, the purchase of convertible securities at prices greatly in excess of face value is tantamount to investment in the stock itself. This is demonstrated by (a) the relationship between the prices of the stock and the convertible bonds in such instances and (b) the manner in which the prices of both fluctuate to the same extent, substantially. In these circumstances, it has been considered that bank purchase of such convertible securities would be an attempt to evade the statutory prohibition of stock investments, and it has not been permitted by the Federal supervisory authorities.

This position is reflected in § 1.3(f) of the present Investment Securities Regulation of the Comptroller of the Currency, and paragraph 330 of the Comptroller's Digest of Opinions points out that

> "A convertible bond selling at a price considerably higher than other issues of comparable quality and yield must be recognized as reflecting in this matter the speculative value of the conversion privilege"--that is, the value of the stock that the convertible bond actually represents.

Inclusion in the Regulation of a provision such as § 1.10, therefore, might encourage banks to make highly speculative investments contrary to the principle stated in the proposed § 1.3(b) and also contrary to sound banking practices, and in addition would appear to approve attempted evasion of the statutory prohibition against stock investments by indirection, through purchase of convertible securities whose price clearly is based almost exclusively on their value as equity securities. Accordingly, the Board of Governors urges deletion of the objectionable features of § 1.10.

19. In view of the fact that the redemption price of an issue of securities frequently changes with the passage of time, it is recommended that the last clause of § 1.11 be amended to read: "at which the obligor may currently redeem such security".

(The difference between the procedures prescribed by § 1.10 and § 1.11 for amortization of premiums evidences tacit recognition of the stock-investment character of purchases of convertible securities at prices greatly in excess of their "investment value".)

20. Section 1.10 contains an expression that is difficult to analyze: "a price level representing a yield which reflects the investment value", etc. It is suggested that the intent might be better expressed if the words "representing a yield" were deleted.

21. Section 1.12 provides that securities acquired "d.p.c." are not subject to the restrictions and limitations of the Regulation. Unless this provision is modified, it would seem to disregard those restrictions and limitations unnecessarily and inadvisably. For example, assume that a bank acquires, through foreclosure, eligible investment securities of one obligor equal to 6% of the bank's capital and surplus. If that holding were excluded from the limitations of the Regulation, the bank would be at liberty, under § 1.6(a), to purchase additional securities of that obligor to the extent of 10% of the bank's capital and surplus. In effect, this would permit the bank to invest in the securities of one obligor, voluntarily, in excess of the statutory 10% limitation. (A similar difficulty would exist, under § 1.12, with respect to banks' investments in securities that were held by the Comptroller to be "eligible for purchase subject to a specified limitation", pursuant to § 1.6(c).)