Minutes for July 22, 1965

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. Robertson ______

Gov. Balderston ______

Gov. Shepardson ______

Gov. Mitchell ______

Gov. Daane ______

Gov. Maisel ______

Minutes of the Board of Governors of the Federal Reserve System on Thursday, July 22, 1965. The Board met in the Board Room at 10:00 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Robertson
Mr. Mitchell
Mr. Maisel

Mr. Sherman, Secretary
Mr. Bakke, Assistant Secretary
Mr. Molony, Assistant to the Board
Mr. Cardon, Legislative Counsel
Mr. Fauver, Assistant to the Board
Mr. Hackley, General Counsel
Mr. Solomon, Director, Division of Examinations
Mr. Kiley, Assistant Director, Division of Bank Operations
Mr. Smith, Assistant Director, Division of Examinations
Miss Hart, Senior Attorney, Legal Division
Mr. Shuter, Attorney, Legal Division

Discount rates. The establishment without change by the Federal Reserve Bank of Minneapolis on July 21, 1965, 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.

Request of Union Bond & Mortgage Company (Item No. 1). Unanimous approval was given to a letter to the Federal Reserve Bank of San Francisco declining the request of Union Bond & Mortgage Company, Port Angeles, Washington (a registered bank holding company), for the Board's assistance in obtaining an amendment to the provisions of the Internal Revenue Code that impose a penalty tax on personal holding companies. A copy of the letter is attached to these minutes as Item No. 1.

Interpretation of Regulation T (Item No. 2). There had been distributed a memorandum from the Legal Division, dated July 20, 1965, to

which was appended a draft of letter to the Securities and Exchange Commission responding to a request for the Board's interpretation of section 220.4(c)(5) of the Board's Regulation T (Credit by Brokers, Dealers, and Members of National Securities Exchanges) in light of certain factual circumstances described in a communication from that agency.

At the Board's request, Mr. Shuter summarized the substance of the July 20 memorandum and the accompanying draft of letter.

An individual, in conjunction with a national bank, ordered stock from a registered broker-dealer to be delivered to the bank in the name of its nominee. While the individual made prompt payment to the bank, the bank refused to pay the broker-dealer until the stock was registered in the name of its nominee, which delayed completion of the transaction beyond the normal 7-day consummation rule applicable to a special cash account.

The broker-dealer apparently permitted this delay in payment in reliance on section 220.4(c)(5) of Regulation T, which provides that if a creditor [here, the broker-dealer], acting in good faith, purchases a security for, or sells a security to, a special cash account customer, with the understanding that he is to deliver the security promptly to the customer, and full cash payment is to be made by the customer against such delivery, the creditor may elect to allow 35 days for payment rather than the usual 7 days.

In 1940, the Board had interpreted the "prompt delivery" referred to in the above-cited provision as being delivery of the securities by the creditor as soon as he reasonably could in view of the mechanics of the securities business and the bona fide usages of the trade. As an example, there was cited the case of a large institutional investor ordering a quantity of stock greater than the market could provide in an orderly fashion within the normal 7-day period, but the investor wanted the stock delivered as a single unit to avoid duplication of clerical operations (1940 Federal Reserve Bulletin 1172).

Mr. Shuter commented that while superficially there was little difference between the foregoing example and the case at hand, because of the time required in the mechanics of transferring ownership on the books of the corporation involved and the preparation of a new stock certificate in the nominee's name, the Legal Division was of the opinion that section 220.4(c)(5) should not be held applicable. The bank had alternative methods of consummating the transaction within the 7-day period that would have protected it as fully as delivery of the stock in the name of the nominee. To allow section 220.4(c)(5) to be invoked notwithstanding this fact would mean that whenever a customer requested stock to be registered in his name, pursuant to a C.O.D. transaction, the creditor could treat the permissible time for payment as 35 days, thereby enabling virtually any customer to circumvent the ordinary rule of prompt payment in a special cash account by merely making such a

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request. In contrast, the situation before the Board in 1940 was not one that presented the possibility of serving as a precedent for general circumvention of the 7-day rule, because the ordinary customer does not enter an order of such magnitude that it cannot feasibly be filled within 7 days.

The substance of the foregoing line of reasoning had been incorporated into the draft of letter to the Securities and Exchange Commission.

Governor Mitchell commented that he was not entirely happy with the conclusion that section 220.4(c)(5) was not applicable to the case at hand, because so to hold seemed highly technical. Nevertheless, he recognized that to rule otherwise might open a potential loophole in Regulation T.

Governor Maisel stated that he, too, had reservations about the proposed interpretation. To him, the course followed by the bank was in the nature of a business judgment, and it seemed rather harsh to say that merely because other avenues were open to it in consummating the transaction the one chosen should not have been followed.

Governor Mitchell added that so long as the purchasing customer made payment to the bank within the required 7-day period, he could see no particular objection to the bank taking advantage of section 220.4(c)(5). This was perhaps one way in which the bank might recover its administrative costs incident to the transaction, rather than charging the customer a fee.

Following further discussion during which Governor Robertson observed that section 220.4(c)(5) was an exception to the general rule of 7-day settlement in special cash accounts under Regulation T and, as such, should be strictly construed, a consensus was reached to adopt the Legal Division's view that the transaction in question was not within the purview of that section. Accordingly, transmittal of the proposed letter to the Securities and Exchange Commission was unanimously approved. A copy of the letter is attached to these minutes as Item No. 2.

Commingled investment funds (Item No. 3). Pursuant the Board's request at its meeting on July 16, 1965, there had been distributed a memorandum from the Legal Division, dated July 19, attached to which were (1) a draft of letter to counsel for First National City Bank, New York, New York, regarding that bank's proposal to establish a "Commingled Investment Account," and (2) a draft of letter to the Department of Justice referring for its consideration the question whether the criminal sanctions of section 21 of the Banking Act of 1933 would be applicable to the proposed activity. Also distributed was a letter to the Board from the Comptroller of the Currency, dated July 15, 1965, noting that the case had been submitted to the Board for a determination whether the plan would be prohibited by section 32 of the Banking Act of 1933, and offering the services of his staff to the Board for consultation if it would assist in disposition of that question.

Governor Robertson commented that he now felt that it would be preferable to have First National City Bank, rather than the Board,

raise the question with the Department of Justice whether section 21 of the Banking Act of 1933 would apply to the proposal. He felt this would not only be logical, but it would be fairer to the bank, since its submission could include advocacy of arguments why section 21 should not be held applicable. The Board, on the other hand, could properly do no more than refer the bare question.

Governor Mitchell expressed doubt as to whether the Department of Justice would be willing to render an opinion at the behest of the commercial bank, and Governor Robertson stated that the bank was not entitled to a ruling as a matter of right, but, for that matter, neither was the Board.

In amplification of Governor Robertson's comment, Mr. Hackley observed that a distinction should be borne in mind between the Board's statutory obligation to refer apparent violations of Federal banking laws to the Department for such action as the Attorney General sees fit, on the one hand, and the Board's lack of standing to require advisory opinions regarding the interpretation of Federal statutes from the Attorney General, on the other hand. Only the Executive Departments have the statutory right to receive such advisory opinions, and for this reason the Board had, in the past, been reluctant to ask the Department of Justice to interpret banking statutes. Mr. Hackley was of the opinion that it would be preferable to adhere to this precedent, particularly since the Comptroller of the Currency had already given his approval to First National City Bank's proposed plan.

Chairman Martin observed that he had no strong feelings either for or against the Board taking the initiative in presenting to the Department of Justice the question whether section 21 of the Banking Act of 1933 would apply to the Commingled Investment Account plan, but he wondered what posture the Board would be left in if the bank elected to proceed with its proposal, ignoring the Board's reference to the section 21 question on the strength of the Comptroller's prior approval.

The discussion engendered by this question developed a consensus that since the pending issue involved a national bank, even if that institution did not present the matter to the Department of Justice the Board could appropriately wait to secure the Department's interpretation of the statute in question until such time as a similar investment plan was proposed by a member State bank. In the instant case, it was believed that the Board's responsibility in the area of bank supervision would be satisfactorily discharged by merely citing in its letter to counsel for First National City Bank the fact that the Commingled Investment Account proposal might be prohibited by section 21 of the Banking Act of 1933.

Accordingly, transmittal of the letter to counsel for First National City Bank, in revised form to reflect the foregoing consensus, was approved unanimously, with the understanding that a copy would also be sent to the Comptroller of the Currency. A copy of the letter sent to First National City Bank is attached to these minutes as Item No. 3.

Outside audits of insured banks (Item No. 4). There had been distributed a revised draft of letter, dated July 21, 1965, to Chairman Patman of the House Banking and Currency Committee, reporting on H.R. 40 and H.R. 123, bills that would require outside audits of all insured banks. This matter had been discussed at the Board meeting on July 21, at which time the staff had been requested to prepare a revision of the draft report there considered to reflect the substance of various changes suggested.

Governor Mitchell commented that while he agreed with the conclusion stated in the July 21 redraft, he felt a somewhat different approach to the supporting arguments would be desirable, and read the text of a substitute letter that he had prepared for the Board's consideration.

It was agreed that Governor Mitchell's proposed letter was preferable, and transmittal thereof was approved unanimously, subject to minor editorial changes. A copy of the letter in the form sent to Chairman Patman is attached to these minutes as Item No. 4.

Mr. Cardon then withdrew from the meeting.

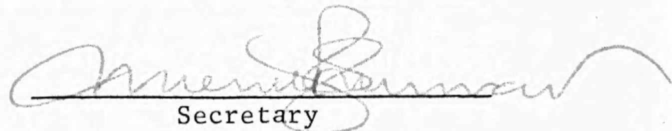
Examination of Kansas City Reserve Bank. There had been circulated to the Board the report of examination of the Federal Reserve Bank of Kansas City made by the Board's field examining staff as of April 16, 1965.

At the Board's invitation, Mr. Smith reviewed the salient features of the report, observing that nothing therein appeared to call for Board

action. He discussed the Reserve Bank's discount activity during the period covered by the examination, contemplated building plans for the Reserve Bank and its Denver Branch, and certain personnel matters.

With respect to the comments made concerning the Reserve Bank's discount activities, Governor Mitchell noted that because of the economic characteristics of the Tenth Federal Reserve District, the Kansas City Reserve Bank consistently had more Federal Reserve credit outstanding than did the other districts. He expressed a sympathetic understanding of the underlying reasons and observed that perhaps as a matter of operating philosophy the Reserve Banks serving agricultural areas where inadequate sources of credit existed should encourage greater use of the discount window. However, at present there was wide variation among such districts in the use of Federal Reserve credit, and he expressed the hope that the proposed study of the discount mechanism might throw light on the subject.

The meeting then adjourned.



Secretary

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

Item No. 1
7/22/65

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

July 22, 1965.

Mr. Eliot J. Swan, President,
Federal Reserve Bank of San Francisco,
San Francisco, California. 94120

Dear Mr. Swan:

This refers to your letter of January 19, 1965, with which you enclosed a copy of a letter of December 18, 1964, from Mr. J. E. Phillips, President, First National Bank in Port Angeles, Port Angeles, Washington, and a copy of your reply of January 19, 1965. Mr. Phillips asked that you submit to the Board a request by Union Bond & Mortgage Company, Port Angeles, Washington ("Union"), a registered bank holding company, for assistance "in an attempt to have bank holding companies subject to the Bank Holding Company Act of 1956 ['the Act'] . . . exempted from the terms of the Personal Holding Company regulations."

Section 541 of the Internal Revenue Code of 1954 imposes, in addition to all other taxes imposed by Chapter 1 of the Code ("Normal Taxes and Surtaxes"), a tax of 70 per cent on so-called "undistributed personal holding company income". Section 542 defines a personal holding company, as amended by the Revenue Act of 1964, as a corporation (with certain exceptions not relevant here) that meets two tests, (1) as to income, at least 60 per cent of its "adjusted ordinary gross income" for the taxable year must be "personal holding company income", and (2) as to stock ownership, at some time during the last half of the taxable year, more than 50 per cent in value of its outstanding stock must be owned, directly or indirectly, by or for not more than five individuals.

Mr. Phillips states that under the somewhat less rigorous income tests obtaining before the 1964 amendments, Union Bond & Mortgage was not a personal holding company. However, since the amended income test seems to apply, and since it appears that the stock ownership test also applies, he feels "that we are now probably subject to the personal holding company law".

It is understood that Union Bond & Mortgage has avoided incidence of the penalty tax for the year just past, as permitted by the Code, by paying out all of its undistributed personal holding company

income in dividends. However, Mr. Phillips urges that "this makes it impossible for us to build up any reserve for possible purchase of additional shares of bank stock if we are required to increase capital at any of the banks. It also makes it impossible for the holding company to buy back any of its own capital stock, in case it is advisable for payment of estate taxes or for the retirement of any of our preferred stock." He points out that corporations not subject to the Act may invest in assets producing sufficient income that is not "personal holding company income" to prevent the tax from applying, but that the divestment requirements of the Act prevent a bank holding company from following this course.

The Board has considered the request submitted by Mr. Phillips, but agrees with the view stated in your letter of January 19, 1965, that the tax status of Union does not seem to be a proper subject for System intervention, and believes that under the circumstances, Mr. Phillips should seek whatever legislative relief he believes appropriate.

It would be appreciated if you would convey the substance of this letter to Mr. Phillips.

Very truly yours,

(Signed) Merritt Sherman

Merritt Sherman,
Secretary.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

Item No. 2
7/22/65

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

July 23, 1965.

Mr. Robert Block, Chief Counsel,
Division of Trading and Markets,
Securities and Exchange Commission,
Washington, D. C. 20549

Dear Mr. Block:

This is in response to your letter of May 18, 1965, in which you request an opinion of the Board as to whether section 220.4(c)(5) of Regulation T permits a delay of payment beyond the ordinary seven days allowed in a special cash account in the situation described as follows. A customer of a bank, presumably through the trust department, orders securities, with the concurrence of the bank, from a registered broker-dealer. The customer "promptly" pays the bank, but the bank refuses to pay the broker until it receives the securities registered in the name of the bank's nominee. The registration procedure takes several weeks to complete.

As you know, the general rule, contained in section 220.4(c)(1) of Regulation T, requires that a customer "promptly make full cash payment" for any security purchased in a special cash account, and section 220.4(c)(2) provides that if payment does not occur within seven days the broker must cancel or otherwise liquidate the transaction. Section 220.4(c)(5) extends the period to 35 days if payment is to be on delivery of the securities. However, this exception is limited to a situation where the delay is required by the mechanics of the securities business and bona fide usages of the trade; it is not the purpose of the section to allow additional time to customers to make payment (1940 Federal Reserve Bulletin 1172).

In the present case, the delay is caused by the insistence of the bank on having the stock registered in the name of its nominee. The transaction could be completed by delivery in street name, or by deposit of the security with the transfer agent and delivery of the transfer claim ticket to the bank. Therefore, it is not the operation of the market that causes the delay, but merely the desire of the bank or the customer to complete a transaction in a particular form.

In the case you describe, the customer makes prompt payment to the bank, and there seems to be no attempt to evade the general rule of section 220.4(c) requiring that payment be made promptly in a special cash account. Nevertheless, if section 220.4(c)(5) were construed to cover this practice, the basis for the exception would be shifted from the requirements of the market itself to the personal preference of the customer. Any customer could demand registration in his name prior to delivery, and in effect extend the time for payment whenever his broker agreed.

Accordingly, the Board is of the opinion that section 220.4(c)(5) does not permit payment for securities purchased in a special cash account to be delayed beyond seven days where the purchaser, whether a bank or an individual, refuses to pay the broker until it receives the securities registered in the purchaser's name.

Very truly yours,

(Signed) Merritt Sherman

Merritt Sherman,
Secretary.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

Item No. 3
7/22/65

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

July 22, 1965.

Mr. William Everdell, III,
Debevoise, Plimpton, Lyons & Gates,
320 Park Avenue,
New York 22, New York.

Dear Mr. Everdell:

This refers to your letter of March 16, 1965, and enclosures, in which you ask, as counsel for First National City Bank of New York ("First"), for the Board's views on the question whether establishment of a proposed "commingled investment account" ("Fund") by First would involve a violation of section 32 of the Banking Act of 1933 ("section 32"), and to subsequent correspondence and conversations between members of your firm and the Board's staff, concerning this request.

From the information submitted, it is understood that Fund would comprise a commingled account, to be operated under the effective control of First, for the collective investment of sums of money that might otherwise be handled individually by the bank as managing agent. The Comptroller of the Currency has ruled, in a letter of May 10, 1965, that Fund would be an eligible operation for a national bank under his Regulation 9, "Fiduciary Powers of National Banks and Collective Investment Funds." You have informed the Board that the Securities and Exchange Commission is of the opinion that Fund would be a "regulated investment company" within the meaning of the Investment Company Act of 1940, and that participating interests in Fund would be "securities" subject to the registration requirements of the Securities Act of 1933.

The minimum individual participation permitted in Fund would be $10,000, while the maximum acceptable individual investment would be half a million dollars. There would be no "load" or payment by customers for the privilege of investing in Fund. You have stated that -

> "The availability of the Commingled Account would not be given publicity by the Bank except in connection with the promotion of its fiduciary services in general and the Bank would not advertise or publicize the Commingled Account as such. Participations in the Commingled Account are to be made available only on the premises of the Bank (including its branches), or to persons who are already customers of the Bank in other connections, or in response to unsolicited requests."

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The information supplied indicates further that participations would be received by First as agent, under a broad authorization signed by the customer, substantially equivalent to the power of attorney under which customers currently deposit their funds for individual investment. You state that the participations would not be received "in trust".

Fund would be required to comply with certain requirements of the Federal securities laws that are not applicable to an ordinary common trust fund operated by a bank. In particular, supervision of Fund would be in the hands of a committee to be initially appointed by First, but subsequently elected by participants having a majority of the units of participation in Fund. At least one member of the committee would be entirely independent of First, but it is expected that the remaining members would be officers in the trust department of First.

The committee would make a management agreement with First under which First would be responsible for managing Fund's investments, have custody of its assets, maintain its records, and keep its books. The management agreement would be renewed annually if approved by the committee, including a "majority" of the independent members, or by a vote of participants having a majority of the units of participation. The agreement would be terminable on sixty days' notice by the committee, by such a majority of the participants, or by First, and would terminate automatically if assigned by First.

It is understood also that First would receive as annual compensation for its services one-half of one per cent of Fund's average net assets (calculated quarterly). Fund would also pay for its own independent professional services, including legal, auditing, and accounting services, as well as the cost of maintaining its registration and qualification under the Securities Acts.

Initially, the assets of Fund would be divided into units of participation of an arbitrary value, and each customer would be credited with a number of units proportionate to his investment. Subsequently, the assets of Fund would be valued at regular intervals, and divided by the number of units outstanding. New investors would receive units at their current value, determined in this way, according to the amount invested. Each customer would receive a receipt evidencing the number of units to which he was entitled. The receipts themselves would be nontransferable, but it would be possible for a customer to arrange with Fund for the transfer of his units to someone else. A customer could terminate his participation at any time and withdraw the current value of his units.

Section 32 of the Banking Act of 1933 provides in relevant part that -

> "No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve the same time [sic] as an officer, director, or employee of any member bank . . . ."

The Board has concluded, based on its understanding of the proposal and the general principles that have been developed in respect to the application of section 32, that First and Fund would constitute a single entity for purposes of section 32, at least so long as the operation of Fund conforms to the representations made by First and outlined above. Accordingly, section 32 would not forbid officers of First to serve on Fund's committee, since Fund would be regarded as nothing more than an arm or department of First.

The Board, however, wishes to call attention to section 21 of the Banking Act of 1933, which, briefly, forbids a securities firm or organization to engage in the business of receiving deposits subject to certain exceptions. Since section 21 is a criminal statute, the Board has followed the policy of not expressing views as to its meaning (1934 Federal Reserve Bulletin 534), and therefore, takes no position with respect to whether the section might be held applicable to establishment and operation of the proposed "commingled investment account". The Board does believe, however, that there is sufficient question concerning section 21 so that you may wish to consult the Department of Justice before proceeding with the matter. Because of the possibility that other banks, including State member banks, may wish to follow your lead and institute similar plans, the Board would appreciate being informed as to any response you may receive from the Department.

Very truly yours,

(Signed) Merritt Sherman

Merritt Sherman,
Secretary.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

Item No. 4
7/22/65

OFFICE OF THE CHAIRMAN

July 28, 1965

The Honorable Wright Patman,
Chairman,
Committee on Banking and Currency,
House of Representatives,
Washington, D. C. 20515

Dear Mr. Chairman:

This refers to your requests for reports on H.R. 40 and H.R. 123, which would require outside audits of all insured banks. The principal difference between the two bills is that H.R. 40 would require the audits triennially, while H.R. 123 would require them annually.

The Board believes that it is desirable to improve bank audit and control procedures and has continuously encouraged steps in this direction. Two interests are served by improved auditing procedures: those of stockholders and those of depositors. With respect to the former, the Board believes that the public disclosure regulations recently issued by it and the Federal Deposit Insurance Corporation under the 1964 Amendments to the Securities Exchange Act were adequate for market analyses of the securities issued by banks.

In formulating those regulations the Board, together with the Federal Deposit Insurance Corporation, carefully considered the possibility of requiring outside audits of the banks as an integral part of the informational requirements. But it was concluded that mandatory outside audits of all banks covered by the regulation were unnecessary.

The interests of depositors are more difficult to secure and more dependent upon statutory or regulatory requirements. Our view is that the best auditing protection for depositors is achieved by an adequate system of internal auditing safeguards. Only when these do not exist or when some special circumstances indicate they may have broken down is the necessity for a full outside audit

indicated. Many banks--their depositors, managements, and stockholders--are likely to benefit from an outsider's periodic review of their accounting and auditing controls, although it must be emphasized that the frequency and thoroughness of such reviews is a matter of judgment.

These considerations impel us to conclude that mandatory periodic outside audits of all insured banks are not necessary. But the Board feels there would be real merit in legislation specifically authorizing the respective Federal bank supervisory agencies to require outside audits in appropriate cases such as where internal controls are inadequate or have broken down.

Sincerely yours,

(Signed) Wm. McC. Martin, Jr.

Wm. McC. Martin, Jr.