

Minutes for July 13, 1966

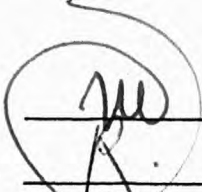
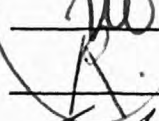


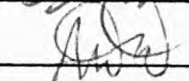
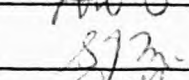
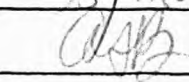
To: Members of the Board

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	<u></u>
Gov. Robertson	<u></u>
Gov. Shepardson	<u></u>
Gov. Mitchell	<u></u>
Gov. Daane	<u></u>
Gov. Maisel	<u></u>
Gov. Brimmer	<u></u>

Minutes of the Board of Governors of the Federal Reserve System on Wednesday, July 13, 1966. The Board met in the Board Room at 10:00 a.m.

PRESENT: Mr. Robertson, Vice Chairman
Mr. Shepardson
Mr. Daane 1/
Mr. Maisel
Mr. Brimmer

Mr. Sherman, Secretary
Mr. Kenyon, Assistant Secretary
Mr. Bakke, Assistant Secretary
Mr. Young, Senior Adviser to the Board and
Director, Division of International Finance
Mr. Solomon, Adviser to the Board
Mr. Molony, Assistant to the Board
Mr. Cardon, Legislative Counsel
Mr. Fauver, Assistant to the Board
Mr. Hackley, General Counsel
Mr. Farrell, Director, Division of Bank Operations
Mr. Solomon, Director, Division of Examinations
Mr. Harris, Coordinator of Defense Planning
Mr. Hexter, Associate General Counsel
Mr. Shay, Assistant General Counsel
Mr. Hooff, Assistant General Counsel
Mr. Partee, Associate Director, Division of
Research and Statistics
Mr. Daniels, Assistant Director, Division of
Bank Operations
Messrs. Forrestal and Sanders, Senior Attorneys,
Legal Division
Mr. Ring, Technical Assistant, Division of Bank
Operations

Due bills (Item No. 1). Unanimous approval was given to a letter to The First National Bank of Chicago, Chicago, Illinois, in response to its inquiry whether due bills that the bank issued in connection with certain sales of securities would constitute deposits for purposes of Regulations D and Q as a result of the recent amendments

1/ Attended only that part of meeting indicated in minutes.

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to those regulations relating to inclusion of certain promissory notes and similar instruments as deposits. A copy of the letter is attached as Item No. 1; the substance of the letter was sent to all Federal Reserve Banks.

Communications and Records Center (Item No. 2). In a letter of June 24, 1966, the Federal Reserve Bank of Richmond requested authorization to call for bids for the construction of the proposed Communications and Records Center at Culpeper, Virginia. In a distributed memorandum dated July 5, 1966, the Division of Bank Operations recommended that the Bank be authorized to call for bids on the basis of the final plans and specifications subject to the following modifications: (1) inclusion of the proposed "guard tower" as an alternate in the bidding documents, and (2) inclusion of Steelcrete reinforcement for the vault ceiling and walls, with the possible exception of the back wall. The Division also recommended that the Bank be asked to consider redesigning the guard station at the entrance gate to reduce its cost and to make it more in keeping with the functional purpose of a gatehouse.

In reviewing the matter, Mr. Farrell said that the recommendation for Steelcrete reinforcement of the vault ceiling and walls reflected, among other things, review of the building plans by a representative of the Secret Service. He also said that the Division of Bank Operations wished to withdraw its objection to the proposed guard tower. However, it continued to believe that the guard station at the entrance gate should be redesigned.

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After discussion of the purposes to be served by the proposed facility and the points to which the Division of Bank Operations had called particular attention, the Division's present recommendations were approved unanimously. Attached as Item No. 2 is a copy of the telegram sent to the Richmond Reserve Bank pursuant to this action. It was understood that the plans for the project would include a modification, for reasons explained by Mr. Harris, relating to the placement of certain communications connections, and that this would be worked out with the Richmond Bank.

Establishment of "operations" subsidiaries (Items 3-6). There had been distributed a memorandum from the Legal Division dated July 7, 1966, discussing several inquiries that had been received by the Board involving the establishment of "operations" subsidiaries by member banks. The conclusion reached was that the Federal statutes should be interpreted as prohibiting member banks from purchasing the stock of other corporations formed to conduct a segment of the bank's operations. It was recommended that the Board adhere to this position even though such action would continue the existing conflict with the position of the Comptroller of the Currency.

The memorandum also indicated that the Legal Division was inclined to agree with a suggestion of the Federal Reserve Bank of New York that the Board consider recommending to the Congress legislation to authorize State member banks to establish or acquire "operations"

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subsidiaries, subject to such conditions and limitations as the Board deemed desirable. The Division believed, however, that before legislation was recommended the question of the advisability of a more permissive legislative policy with respect to affiliates should be taken up with the Reserve Banks, the other Federal bank supervisors, and perhaps representatives of the State bank supervisors also.

Submitted with the memorandum were draft letters to appropriate parties reaffirming the Board's position that, except as otherwise permitted by law, section 5136 of the Revised Statutes and section 9 of the Federal Reserve Act prohibit national banks and State member banks from purchasing stock of corporations established by such banks for the purpose of performing certain functions for the bank. The draft letters also stated that the Board was considering the advisability of recommending legislation to amend section 5136 in this respect.

The memorandum recommended that the Board's position be published in the Federal Register and the Federal Reserve Bulletin.

After comments by Mr. Hexter in summarization of the memorandum and the recommendations therein, Mr. Hackley said he agreed with the stated conclusion. This was an important question because, if the Board interpreted the law as permitting a member bank to acquire the stock of a company engaged in business in which the bank could engage directly, the possibility existed that subsidiaries could be used to evade many of the laws relating to banking in the absence of appropriate safeguards.

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The question of recommending legislation would require thorough study. However, it seemed appropriate to indicate, without going into details, that the Board was considering the desirability of recommending such legislation.

Mr. Sanders, who held a minority view within the Legal Division, expressed the belief that since the Comptroller's position was not clearly erroneous, it would be better, on balance, to follow in this instance the general theory that the restrictions imposed on State member banks by paragraph 20 of section 9 of the Federal Reserve Act should be equivalent to those imposed upon national banks. He pointed out that the Comptroller's position had been announced for some time, a number of national banks were operating on the basis of it, the Comptroller had replied to questions raised by the Congress concerning his interpretation, and the Congress had taken no action.

Mr. Solomon (Examinations) expressed the view that there was much to be said for not restricting State member banks in quite so severe a fashion as recommended by the Legal Division. The question admittedly was a close one. It might be more realistic, in his opinion, to say that if a corporation was wholly owned by a bank and was doing nothing except what the bank itself could do, there really was no essential conflict with sound banking practice or with the statutes. He would not go so far as to agree with the Comptroller that a bank in New York City could buy stock of a bank in Buffalo; this would amount to allowing the bank to do something that it could not do in its own right,

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namely, to establish a branch in Buffalo. This would be different from saying that the bank could engage in a leasing business through a separate corporation, because in that case the subsidiary would be doing nothing that the bank itself could not do. He saw little harm in permitting that kind of thing.

Mr. Hackley observed that even though it might be regarded as desirable, as a matter of policy, to permit a member bank to incorporate certain departments of the bank and establish operating subsidiaries, nevertheless it was necessary to look at the language of the law, which in this case involved interpreting the sentence of section 5136 stating that "Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by (a national bank) for its own account of any shares of stock of any corporation." The history of the section clearly indicated that in the past the courts, as well as the Congress, had taken the position that the law prohibited a member bank from purchasing any corporate stock except as permitted by law or necessary to carry out its functions.

Mr. Hexter commented that from his experience in the bank supervisory area over the years he was satisfied that whereas a member bank itself would not do certain things, if it had a wholly-owned subsidiary there was a tendency to think of that as a separate institution with its own life and powers and seek to do things through the subsidiary that would not otherwise have been done. He also said that if the

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establishment of operations subsidiaries was regarded as desirable from some points of view, he felt it would be advisable to have legislation enacted that would permit this under specific regulations of the Board, which regulations would more effectively prevent the types of operations that might jeopardize the integrity of the bank involved.

As the discussion proceeded, Governor Shepardson inquired about the possibility of obtaining a judicial determination concerning the Comptroller's interpretation. Mr. Hackley explained why it would be difficult for the Board to initiate such a procedure. He felt that it would almost be necessary to rely on a bank bringing litigation of this kind. Also, the process of obtaining a final judicial determination probably would involve a period of years.

Mr. Hackley went on to say that he considered fallacious the argument that it would be appropriate for the Board to take a position, in the absence of appropriate legislation, that a member bank could acquire stock in a corporation that could do only what the bank itself could do. This was illustrated by the Comptroller's position that a national bank could purchase the stock of another bank. As long as there was no legislation vesting authority to make such interpretations in a single agency, it was always possible that the Board and the Comptroller would interpret the law differently.

Governor Maisel observed that a member bank in New York, for example, might be permitted to engage in leasing. However, if it were

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held that a wholly-owned subsidiary should be allowed to do the same type of business that the bank itself could do, there might be the possibility of establishing a subsidiary that would set up operations in other States.

Mr. Hexter agreed, noting that legislation was pending in New York to permit State banks to do this. A State bank could then conduct such business at its offices in New York, but it was hardly likely to attempt to open offices in other States. If the bank owned a leasing company, however, there would be more likelihood that such a corporation might set up offices in other States. Experience had shown that subsidiaries were likely to do such things and fight effectively against supervisory control.

In further discussion Governor Brimmer said he would not wish to say that the Comptroller was correct in maintaining that banks ought to be allowed to pursue various innovations and ways therefore should be found to interpret the law in such manner as to accommodate this philosophy. At the same time he was troubled about the possibility, over the longer run, of unwarranted restrictions that hampered the efficiency of the banking system. On the question under consideration today, if the Board simply reiterated its position without at least calling for legislation, there would be this danger. He would be willing to adopt the recommendation of the Legal Division, but he would like to see a more substantive comment included in the proposed letters about an intention to consider seeking legislation.

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Governor Shepardson said he was unhappy about the situation in which the Board found itself. He wished there was some way of resolving the conflicting positions of the two agencies. Nevertheless, he believed the recommendation made by the Legal Division was warranted. He would be willing to support it, but he hoped that the matter of developing a legislative proposal would be pursued actively by the staff.

Governor Maisel also indicated that he would go along with the recommendation in the circumstances. He added, however, that he would like to see legislation enacted that would make it clear that it was the duty of the Comptroller to interpret the provisions of the National Bank Act, thus relieving the Board from the responsibility.

The recommendation of the Legal Division was then approved unanimously subject to the understanding that the possibility of recommending legislation in this area would be placed under active study. Attached as Item No. 3 is a copy of the interpretation subsequently sent to the Federal Register for publication pursuant to the Board's action. Attached as Items 4-6 are copies of the letters sent to the appropriate parties.

Treatment of Christmas Club accounts and related questions. A distributed memorandum from the Legal Division dated July 11, 1966, noted that several Federal Reserve Banks had raised the question whether Christmas Club accounts should be classified as savings deposits or as

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other time deposits in determining reserve requirements under the Board's June 27, 1966, amendment to the Supplement to Regulation D, Reserves of Member Banks. The same question arose under Regulation Q, Payment of Interest on Deposits, although the status of such accounts for purposes of interest rate ceilings was not of such practical importance since it was doubtful whether any bank paid more than 4 per cent on such accounts. The memorandum suggested providing the Reserve Banks an answer to the question by July 14, when the new reserve requirements would become effective for reserve city banks.

Under the present regulations, the memorandum pointed out, it seemed clear the Christmas Club accounts, as well as vacation club accounts, must be regarded as other time deposits. However, it might be argued that deposits representing funds gradually accumulated by individuals for anticipated expenses constituted the clearest form of savings deposits. For reasons described in the memorandum, this led to the question whether any deposit with a fixed maturity could be classified as a savings deposit. This question had arisen at various times over the past decade but had never been settled. The matter involved two distinct aspects: (1) whether the present regulations prohibited a deposit with a fixed maturity from being classified as a savings deposit, and (2) whether the matter should be clarified one way or the other, either by interpretation or by specific amendments to the regulations. On the first aspect, a majority of the Legal

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Division had consistently taken the position that the present Regulation Q should be construed as prohibiting savings deposits with fixed maturities. Further, it was believed on balance that it would be preferable for the Board to take the position, as a matter of policy, that savings deposits could not be represented by instruments with fixed maturities.

The memorandum presented for consideration the following possible alternative courses of action: (1) simply advise the Reserve Banks that under the present regulations Christmas Club (and similar) accounts must be treated as time deposits, open account; (2) amend the regulations by redefining savings deposits to include such accounts; (3) also amend the regulations to exclude from savings deposits any deposits with fixed maturities other than Christmas Club accounts or publish an interpretation taking the position that deposits with fixed maturities could not be classified as savings deposits; (4) specifically include Christmas Club accounts in the definition of savings deposits and also limit savings deposits to those as to which a bank reserved the right to require not less than 30 days' written notice of withdrawal. A majority of the Legal Division recommended the fourth alternative.

Following a review of the matter by Mr. Hackley, based generally on the contents of the distributed memorandum, Governor Brimmer indicated that he would like to have additional time to analyze the problems involved. Accordingly, it was agreed that the subject would be held over for further discussion at another meeting.

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At this point Governor Daane joined the meeting and all members of the staff except Messrs. Sherman and Hackley withdrew.

Governor Robertson reported briefly on possible legislation regarding maximum rates of interest along the lines he had mentioned at yesterday's meeting of the Board, and he then withdrew from the meeting in order to keep another engagement. Following a general discussion of the interest rate question, Governor Daane reported on discussions that he had had at the Treasury yesterday afternoon.

The meeting then recessed and reconvened at 12:40 p.m. with Vice Chairman Robertson and Governors Shepardson, Maisel, and Brimmer present, along with Messrs. Kenyon and Hackley of the staff.

The Vice Chairman stated that he would like to report to the members of the Board the substance of a conversation with the Secretary of the Treasury. He had told the Secretary of the Board's intention to lower the maximum rate payable by member banks on time deposits with multiple maturities, and also of the Board's intent to request legislation broadening the rate regulatory powers of the Board, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board. On the matter of the proposed legislation, the Secretary stated that in the absence of Board action he had already discussed with members of the Congress a legislative proposal that would place a temporary statutory ceiling on rates that banks could pay on certificates of deposit up to \$100,000, and would also provide discretionary authority for the

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Board and the Federal Deposit Insurance Corporation to fix different rate ceilings for different kinds of deposits, along with authority for the Home Loan Bank Board to fix rate ceilings on dividends paid by savings and loan associations. Governor Robertson said he had told the Secretary that he would nevertheless like to talk with the Chairman of the Federal Deposit Insurance Corporation and the Chairman of the Home Loan Bank Board about the type of legislation the Board was ready to propose. The Secretary expressed no disagreement with such a procedure, indicating that it might be desirable for the Congress to have alternative proposals before it for consideration. The Secretary added that he doubted whether savings and loans could compete with banks on an even basis at 5 per cent, but that this would be for the supervisory agencies to decide.

As to the discount rate, Governor Robertson said the Secretary related that the matter of an increase in the rate had been discussed with him by President Hayes of the New York Reserve Bank. The Secretary observed that bank credit had expanded more since December than before, that the result of monetary policy had been primarily to move interest rates up, and that, as he had told Mr. Hayes, he was fundamentally opposed to any further increase in the discount rate. The Secretary said such an increase would interfere with plans for the appropriate use of fiscal policy if the occasion should arise and that it might even curb efforts currently being made on the Hill to restrict Government spending.

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The Vice Chairman then said that he had expressed to the Secretary a personal view on the matter of the discount rate, making it clear that he did not know whether any other Board members would go along with that view. Mr. Hayes had presented the matter on the basis of an increase of $1/2$ of 1 per cent, but Governor Robertson felt that this would merely prolong the uncertainty about an additional increase. Therefore, his thinking would be to move the discount rate to $5-1/2$ per cent, through determination of such rate by the Board of Governors if necessary. In the announcement of the new rate, he would state that it was designed to curb the expansion of credit and to make borrowing from the Reserve Banks more difficult. He would also state in the announcement that the Board did not contemplate raising Regulation Q ceilings. The Secretary, Governor Robertson said, observed that this placed the matter in a different light and asked what chance there would be of getting the members of the Board to agree on the issuance of such a statement. Governor Robertson had replied that he had no idea. The Secretary then said that he did not want to express a firm opinion at the moment and that he would call back later. The Secretary added, however, that if the Board could prevent speculation about interest rates going higher, and if it could curb the expansion of credit, that was one thing; on the other hand, if a discount rate increase were to be made simply to bring the rate into line with market rates, he felt that that would be waste motion.

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In response to a question, Governor Robertson said the Secretary had indicated that he would be glad to see the Board act to lower the maximum rate payable on time deposits with multiple maturities, even though this would not go as far as he (the Secretary) would like, for it would not deal with the rate on single-maturity time deposits in denominations up to \$100,000.

There followed a brief discussion based on the conversation related by the Vice Chairman, following which Governor Robertson indicated, in reply to a question by Mr. Hackley, that he intended to talk with the Chairman of the Federal Deposit Insurance Corporation tomorrow morning about the proposed action on time deposits with multiple maturities and that draft material on the subject therefore need not be forwarded to the Corporation today.

Mr. Hackley then withdrew from the meeting.

Pay bill. Governor Shepardson noted the probability that the President would sign within the next few days a bill providing pay increases for Federal Government employees retroactive to the first of July. This raised the question whether the Board's payroll should be prepared on the assumption that this legislation would have been signed by the time of the next payroll distribution and action taken by the Board to extend its applicability to Board employees.

The matter was discussed briefly in terms of possible alternative procedures, and it was agreed that no action should be taken until the bill had actually been signed by the President.

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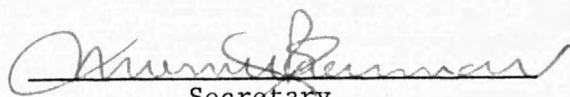
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Governor Shepardson also raised a question with regard to the treatment of salaries of the Board's official staff if the terms of the pay bill were made applicable to other Board employees. No decision was reached, and it was understood that the matter would be considered further by the Board at another meeting.

The meeting then adjourned.

Secretary's Notes: Governor Shepardson today approved on behalf of the Board a recommendation from the Division of Administrative Services that Karl J. Steger be employed as Operating Engineer on a temporary contractual basis at the rate of \$2.66 per hour to operate the air conditioning system of the Federal Reserve Building during evening hours and on Saturdays.

A letter was sent today to First National City Bank, New York, New York, acknowledging advice of its intent to establish an additional branch in Argentina, to be located in the Villa Urquiza section of Buenos Aires. The letter noted that the proposed branch would be established from funds available in Argentina and that no additional remittance of funds would be required from New York.


Secretary

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

Item No. 1
7/13/66



ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

July 14, 1966

Mr. George B. Rogers,
Vice President and General Counsel,
The First National Bank of Chicago,
Chicago, Illinois. 60690

Dear Mr. Rogers:

This is in response to your inquiry of July 1, 1966, whether "due bills" that your bank issues in connection with certain sales of securities will constitute deposits for purposes of Federal Reserve Regulations D and Q as a result of the recent amendments to those regulations relating to inclusion of certain promissory notes and similar instruments as deposits.

You state that your bank contemplates issuing due bills in two types of situations: (1) where the security sold is owned by the bank but is not immediately available for delivery against payment because of its physical location and (2) where the security sold is not yet owned by the bank.

Under the amendments, classification of a due bill as a deposit will depend on whether it is issued by the bank "principally as a means of obtaining funds to be used in its banking business". If the due bill is issued in connection with a "genuine" securities transaction with respect to which the bank is not in a position to make same-day delivery against payment, it should not be classified as a deposit. If, however, the purpose of the transaction actually is not the sale of securities, but that form of transaction is used to effect what is essentially a funds transaction, the due bill will be required to be classified as a deposit.

Ultimately, whether a particular due bill is issued "principally as a means of obtaining funds" depends on the intent of the parties to the transaction. You state the issuance of the due bills to which your inquiry relates will arise in the ordinary

Mr. George B. Rogers

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course of the operations of your bank's bond trading desk and that the instruments will not be outstanding for more than two business days, except in emergency situations beyond the control of the bank.

It is assumed that no interest will accrue to the customer for the delay in delivery of the securities purchased and that securities will, in fact, be delivered.

Such circumstances tend to indicate that the due bills will not be issued by the bank "principally as a means of obtaining funds", even though funds incidentally will be obtained thereby and used by the bank in its banking business.

Very truly yours,

(Signed) Merritt Sherman

Merritt Sherman,
Secretary.

T E L E G R A M
LEASED WIRE SERVICE

Item No. 2

7/13/66

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON

July 13, 1966.

WAYNE - RICHMOND

Board authorizes calling for bids for construction of the proposed Communications and Records Center at Culpeper on the basis of plans and specifications referred to in your letter of June 24, 1966, subject to modification by inclusion of Steelcrete reinforcement for the vault ceiling and walls with the exception perhaps of the back wall. The Board feels that the guard station at the entrance gate, as it is now designed, is a rather expensive structure and that consideration should be given to redesigning it to make it more in keeping with the functional purpose of a gatehouse.

(Signed) Merritt Sherman

SHERMAN

TITLE 12 - BANKS AND BANKING

Item No. 3

CHAPTER II - FEDERAL RESERVE SYSTEM

7/13/66

SUBCHAPTER A - BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

[Reg. H]

PART 208 - MEMBERSHIP OF STATE BANKING INSTITUTIONS
IN THE FEDERAL RESERVE SYSTEM

Purchase of Stock

§ 208.119 Member bank purchase of stock of "operations subsidiaries".

(a) In response to several inquiries, the Board of Governors has re-examined the question whether member banks may establish and purchase the stock of "operations subsidiaries" - that is, organizations designed to serve, in effect, as separately-incorporated departments of the bank, performing functions that the bank is empowered to perform directly. That question involves the interpretation of the following provision of section 5136 of the Revised Statutes (12 U.S.C. 24), the so-called "stock-purchase prohibition":

"Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by [a national bank] for its own account of any shares of stock of any corporation."

(b) the Board's re-examination has confirmed its previous position that the stock-purchase prohibition, which is made applicable to member State banks by the twentieth paragraph of section 9 of the Federal Reserve Act (12 U.S.C. 335), forbids the purchase by a member State bank "for its own account of any shares of stock of any corporation" (the statutory language), except as specifically permitted by provisions of Federal law or as comprised within the concept of "such

incidental powers as shall be necessary to carry on the business of banking", referred to in the first sentence of paragraph "Seventh" of R.S. 5136.

(c) The Federal banking statutes explicitly permit the purchase of stock of a number of kinds of corporations, including stock of Federal Reserve Banks, bank premises subsidiaries, safe deposit companies, "Edge" and "Agreement" corporations, small business investment companies, bank service corporations, and certain foreign banks. In addition, it has been held that, in the process of collecting defaulted loans that were contracted in good faith, the "incidental powers" of national banks include the power to purchase corporate stock where that action constitutes a reasonable and appropriate step toward the collection of indebtedness.

(d) In one proposal presented to the Board, the stock to be purchased would have been that of one or more corporations engaged in the business of leasing personalty to customers of the member bank and in the business of selling money orders. The Federal statutes contain no express permission for the purchase of stock of corporations of these kinds, and the Board of Governors concluded that the power to purchase the stock of such corporations may not properly be regarded as comprised within "such incidental powers as shall be necessary to carry on the business of banking", within the meaning of section 5136.

(e) One of the inquiring member banks contended that the above-cited provisions of the National Bank Act and Federal Reserve Act

"were intended to restrict member banks in dealing in securities and stock in the sense of trading therein or in the sense of the purchase of the stock of a going concern and, perhaps, further to restrict national and member [State] banks from engaging through subsidiaries in activities in which such banks were not directly empowered to engage, but not in the sense of holding the entire stock of an operating corporation created by the bank."

Along the same lines, the contention has been advanced that the stock-purchase prohibition was intended by Congress only to prevent banks from investing depositors' funds in corporate stock for income and appreciation, in the way that banks invest in debt obligations of the Federal Government, municipalities, and private corporations.

(f) The Board did not adopt either of these constructions of the statutory provisions. Although the prevention of such investment in stocks undoubtedly was a major Congressional purpose, it appeared to the Board that the stock-purchase prohibition was intended generally to prevent the purchase of the stock of corporations, including those created to perform functions that could be performed by the bank itself. The provisions have been so interpreted and applied by the Board (and by the Comptroller of the Currency until recently) since their enactment in the Banking Act of 1933.

(g) One of the banking problems that principally concerned Congress in the early 1930s and that led to the enactment of the Banking Acts of 1933 and 1935 was the "affiliate system", including member banks' ownership of other corporations. Among the objectives of the Banking Act of 1933, as expressed by the Senate Banking

Act of 1933, the stock-purchase prohibition of R.S. 5136 served the purpose of confining the bank-affiliate system by preventing banks from purchasing the stock of other corporations, except to the limited extent specified in that general prohibition. 1/

(h) The Board also considered, among other contentions, the assertion that, despite the apparent intent of the terms of the pertinent statute and its legislative history, it should not be interpreted to prevent the separate incorporation of a banking department engaged in a legitimate activity. The supporting argument would be that, if a proposed course of action cannot possibly produce the evil effect at which a statutory provision was directed, a construction of the provision that would prevent such action would be unrealistic, and, by emphasizing statutory language rather than underlying purpose, would injure rather than safeguard the public interest.

(i) The Board agreed that, if a proposed course of action could not result in any evil at which a statute is aimed, interpretation of the statute to prohibit such action should be avoided, if possible. However, it appeared to the Board that this principle does not apply to the situation presented by the inquiries. Experience in the supervision of banks has revealed that the likelihood of unsafe and unsound practices, violations of law, and other developments contrary to the public interest is significantly greater when banks operate through subsidiary corporations. There appears to be an

1/ Corrected paragraph (g), as subsequently published in Register, is attached.

inevitable tendency for some banks, in time, to regard their subsidiary corporations as separate enterprises and thereupon to conduct their operations in a way that is unsuitable for a part of a banking enterprise, to disregard pertinent restrictions and requirements, and, in particular, to venture through their subsidiaries into activities that are beyond the powers of the parent bank. It is reasonable to infer that Congress, having in mind the pre-depression affiliate system, concluded that the American banking system and the general welfare would be benefited by limiting the authority of member banks to conduct their operations through separately-incorporated organizations.

(12 U.S.C. 248(i). Interprets 12 U.S.C. 24 and 335.)

Dated at Washington, D. C., this 14th day of July, 1966.

By order of the Board of Governors.

(Signed) Merritt Sherman

Merritt Sherman,
Secretary.

(SEAL)

CHAPTER II - FEDERAL RESERVE SYSTEM

SUBCHAPTER A - BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

[Reg. H]

PART 208--MEMBERSHIP OF STATE BANKING INSTITUTIONS
IN THE FEDERAL RESERVE SYSTEM

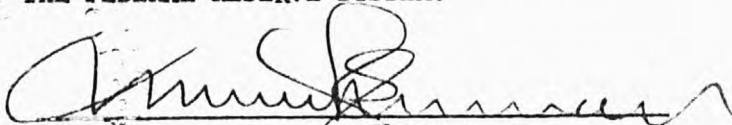
Purchase of Stock

Federal Register Document 66-8029, published at page 10021 in the issue dated Saturday, July 23, 1966, is corrected by changing paragraph (g) to read as follows:

"(g) One of the banking problems that principally concerned Congress in the early 1930s and that led to the enactment of the Banking Acts of 1933 and 1935 was the 'affiliate system', including member banks' ownership of other corporations. Among the objectives of the Banking Act of 1933, as expressed by the Senate Banking Committee, was 'To separate as far as possible national and member banks from affiliates of all kinds.' (S. Rep. No. 77, 73rd Congress, p. 10) Together with a number of other provisions of the Banking Act of 1933, the stock-purchase prohibition of R.S. 5136 served the purpose of confining the bank-affiliate system by preventing banks from purchasing the stock of other corporations, except to the limited extent specified in that general prohibition."

Dated at Washington, D. C., this 26th day of July, 1966.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.


Merritt Sherman,
Secretary.

7/13/66

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

July 15, 1966

Mr. Frank Wille,
Superintendent of Banks,
State of New York Banking Department,
100 Church Street,
New York, New York. 10007

Dear Mr. Wille:

Your letters dated April 15, 1966, to the members of the Board of Governors recommended "a public clarification by the Board of its views with respect to the right of state member banks to conduct portions of their domestic banking business through subsidiary corporations." You expressed the view that the Board "can and should interpret the 'incidental powers' clause of Section 5136 [of the Revised Statutes] in such manner as to permit State member banks" to do so. You also indicated that, in your opinion, "a different interpretation by the Board of Governors would result in the most serious consequences for state banking systems throughout the country" and "could easily influence a bank's decision to convert from State to national charter", in view of the permissive interpretation that has been adopted by the Comptroller of the Currency.

As you point out, the interpretative problem in this case relates principally to the following provision - the so-called "stock-purchase prohibition" - of section 5136:

"Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by [a national bank] for its own account of any shares of stock of any corporation."

The twentieth paragraph of section 9 of the Federal Reserve Act provides that "State member banks shall be subject to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as are applicable in the case of national banks under paragraph 'Seventh' of section 5136".

On a number of occasions during the three decades since the enactment of the stock-purchase prohibition, the Board of Governors has considered whether member State banks may establish and purchase the stock of "operations subsidiaries" - that is, organizations designed to serve, in effect, as separately-incorporated departments or adjuncts of the bank, performing functions that the bank is empowered to perform directly. Nevertheless, the subject has now been re-examined by the Legal Department of the Federal Reserve Bank of New York, by the Legal Division of the Board of Governors, and by the Board itself.

Such re-examination has confirmed the Board's previous position that the above-quoted provisions of R.S. 5136 and section 9 of the Federal Reserve Act forbid the purchase by a member State bank "for its own account of any shares of stock of any corporation", except to the extent permitted by specific provisions of Federal law or comprised within the concept of "such incidental powers as shall be necessary to carry on the business of banking", referred to in the first sentence of paragraph "Seventh" of R.S. 5136.

Specific provisions of the Federal banking statutes permit the purchase of stock of a number of kinds of corporations, including stock of Federal Reserve Banks, bank premises subsidiaries, safe deposit companies, "Edge" and "Agreement" corporations, small business investment companies, bank service corporations, and certain foreign banks. In addition, it has been held that, in the process of collecting defaulted loans that were contracted in good faith, the incidental powers of national banks include the power to purchase corporate stock where that action constitutes a reasonable and appropriate step toward the collection of the indebtedness.

The Federal statutes contain specific provisions that permit national banks (and member State banks) "to conduct portions of their domestic business through subsidiary corporations" only in the areas enumerated in the preceding paragraph, and the Board of Governors is compelled to conclude that general power to purchase the stock of "operations" subsidiaries may not properly be regarded as comprised within "such incidental powers as shall be necessary to carry on the business of banking". In accordance with your recommendation, there will be published in the Federal Register and in the Federal Reserve Bulletin an interpretation reaffirming the Board's position on this matter, and the text of that interpretation is enclosed.

As you point out, "Congress intended the rights of State member banks to be the same as the rights of national banks in this

area, assuming the state bank has authority under state law to invest in subsidiaries." Congress certainly did not anticipate divergent interpretations by Federal bank supervisory agencies, and the Board is deeply concerned that the legislative objective of a uniform Federal rule for all member banks, in this respect, is not being effectuated at present. The possibility of such divergent interpretations cannot be avoided, unfortunately, under the existing arrangement, which divides Federal bank supervisory authority among three agencies. In the circumstances, the Board considers that its paramount obligation is to effectuate the substantive legislative purpose in its supervision of member State banks, rather than to accept and apply, in the interest of a uniform rule, an interpretation that does not carry out the intent of Congress.

Your letter persuasively describes certain "advantages of permitting banks to conduct portions of their business through subsidiary corporations." As indicated in the enclosed interpretation, such use of subsidiaries may also involve certain detrimental features. Such considerations, of course, bear upon the advisability of a recommendation to Congress that member banks be permitted to establish subsidiaries to engage in activities that such banks may carry on directly. As you may be aware, the Federal Reserve Bank of New York favors the use of such operations subsidiaries, subject to appropriate conditions and limitations, and the Board of Governors is presently considering whether to recommend enactment of Federal legislation to authorize member banks to establish such subsidiaries and to purchase their stock, under regulations to be prescribed by the Federal supervisory authorities.

Very truly yours,

(Signed) Merritt Sherman

Merritt Sherman,
Secretary.

Enclosure

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

Item No. 5

7/13/66

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD



July 15, 1966

Chemical Bank New York Trust Company,
20 Pine Street,
New York, New York. 10015

Gentlemen:

This is in response to the letter of Mr. Howard W. McCall, Jr., dated November 22, 1965 (and the accompanying memorandum of law prepared by Cravath, Swaine & Moore), wherein your Bank requested "a ruling that (1) paragraph Seventh of 12 U.S.C. § 24 does not prohibit the limited corporate act of creating a subsidiary corporation to engage in a business in which our Bank is expressly empowered so to engage, and (2) we may form a subsidiary or subsidiaries for such purposes." The Board has also received a letter from Cravath, Swaine & Moore, dated May 11, 1966, and a copy of a letter from that firm to the Federal Reserve Bank of New York, dated December 17, 1965.

On a number of occasions since the enactment in 1933 of the so-called "stock-purchase prohibition" of section 5136 of the Revised Statutes (12 U.S.C. 24), the Board of Governors has considered the question whether member State banks may establish and purchase the stock of "operations subsidiaries" - that is, organizations designed to serve, in effect, as separately-incorporated departments of the bank, performing functions that the bank is empowered to perform directly. Nevertheless, the subject has been re-examined, in view of your inquiry, by the Legal Department of the Federal Reserve Bank of New York, by the Legal Division of the Board of Governors, and by the Board itself.

Such re-examination has confirmed the Board's previous position that the stock-purchase prohibition, which is made applicable to member State banks by the twentieth paragraph of section 9 of the Federal Reserve Act (12 U.S.C. 335), forbids the purchase by a member State bank "for its own account of any shares of stock of any corporation", except to the extent permitted by specific provisions of Federal law or comprised within the concept of "such incidental powers as shall be necessary to carry on the business of banking", referred to in the first sentence of paragraph "Seventh" of R.S. 5136.

Specific provisions of the Federal banking statutes permit the purchase of stock of a number of kinds of corporations, including stock of Federal Reserve Banks, bank premises subsidiaries, safe deposit companies, "Edge" and "Agreement" corporations, small business investment companies, bank service corporations, and certain foreign banks. In addition, it has been held that, in the process of collecting defaulted loans that were contracted in good faith, the incidental powers of national banks include the power to purchase corporate stock where that action constitutes a reasonable and appropriate step toward the collection of the indebtedness.

In the program presented by your Bank, the stock to be purchased would be that of one or more corporations that would engage in the business of leasing personalty to customers of the Bank and in the business of selling money orders. The Federal statutes contain no express permission for the purchase of stock of corporations of these kinds, and the Board of Governors is compelled to conclude that the power to purchase the stock of such corporations may not properly be regarded as comprised within "such incidental powers as shall be necessary to carry on the business of banking".

Your letter of November 22, 1965, takes the position that the above-cited provisions of the National Bank Act and Federal Reserve Act

"were intended to restrict member banks in dealing in securities and stock in the sense of trading therein or in the sense of the purchase of the stock of a going concern and, perhaps, further to restrict national and member [State] banks from engaging through subsidiaries in activities in which such banks were not directly empowered to engage, but not in the sense of holding the entire stock of an operating corporation created by the bank."

The Board is unable to agree with that construction of the statutory provisions. One of the banking problems that principally concerned Congress in the early 1930s and that led to the enactment of the Banking Acts of 1933 and 1935 was the "affiliate system", including member banks' ownership of other corporations. Among the objectives of the Banking Act of 1933, as expressed by the Senate Banking Committee, was "To separate as far as possible national and member banks from affiliates of all kinds." (S. Rep. No. 77, 73rd Congress, p. 10) Together with a number of other provisions of the Banking Act of 1933, the stock-purchase prohibition of R.S. 5136 served the purpose of confining the bank-affiliate system by preventing banks from purchasing the stock of other corporations, except within the narrow limits prescribed by the prohibition.

It has been contended that, despite the apparent intent of the terms of the pertinent statute and its legislative history, it should not be interpreted to prevent the separate incorporation of a banking department engaged in a legitimate activity. The supporting argument would be that, if a proposed course of action cannot possibly produce the evil effect at which a statutory provision was directed, a construction of the provision that would prevent such action would be unrealistic, and, by emphasizing statutory language rather than underlying purpose, would injure rather than safeguard the public interest.

The Board agrees that, if a proposed course of action could not result in any evil at which a statute is aimed, interpretation of the statute to prohibit such action should be avoided, if possible. However, the Board does not believe that this principle applies to the situation presented by your inquiry. Experience in the supervision of banks has revealed that the likelihood of unsafe and unsound practices, violations of law, and other developments contrary to the public interest is significantly greater when banks operate through subsidiary corporations. There appears to be an inevitable tendency for some banks, in time, to regard their subsidiary corporations as separate enterprises, to conduct their operations in a way that is unsuitable for a part of a banking enterprise, to disregard pertinent restrictions and requirements, and, in particular, to venture through their subsidiaries into activities that are beyond the powers of the parent bank. It is reasonable to infer that Congress, having in mind the pre-depression affiliate system, concluded that the American banking system and the general welfare would be benefited by limiting the authority of member banks to conduct operations through separately-incorporated organizations.

The foregoing discussion touches upon one aspect of this problem, which was emphasized in your inquiry. As you know, the question presents numerous other aspects, both legal and practical, which have been carefully re-examined.

The Federal Reserve Bank of New York has expressed the view that, as a matter of policy, member banks should be permitted to establish subsidiaries to engage in activities that such banks may carry on directly, subject to appropriate conditions and limitations. Accordingly, the Board is presently considering the advisability of recommending to Congress the enactment of legislation to authorize member banks to establish such "operations" subsidiaries and to purchase their stock, under regulations to be prescribed by the Federal supervisory authorities.

Very truly yours,

(Signed) Merritt Sherman

Merritt Sherman,
Secretary.



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

Item No. 6

7/13/66

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

July 15, 1966

Northwest Bancorporation,
Minneapolis, Minnesota. 55440

Gentlemen:

This is in response to your letter of March 16, 1966, requesting the opinion of the Board as to whether Northwest Bancorporation, a bank holding company, may acquire the stock of a "mortgage company" of the kind described therein, and whether a national bank subsidiary of Northwest Bancorporation may do so.

Your inquiry is based principally upon two provisions of the Federal banking laws. Section 5136 of the Revised Statutes (12 U.S.C. 24) contains the following sentence (the so-called "stock-purchase prohibition"):

"Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by [a national bank] for its own account of any shares of stock of any corporation."

Section 4(c)(5) (formerly section 4(c)(4)) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843) provides that the general prohibition against acquisition by a holding company of "voting shares of any company which is not a bank" (section 4(a)(1)) shall not apply to "shares which are of the kinds and amounts eligible for investment by national banking associations under the provisions of section 5136".

As you are aware, the twentieth paragraph of section 9 of the Federal Reserve Act (12 U.S.C. 335) subjects member State banks "to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as are applicable in the case of national banks under paragraph 'Seventh' of section 5136". In connection with its supervision of member State banks, the Board has considered

the last-quoted provision on a number of occasions, and such consideration necessarily has involved the interpretation of the stock-purchase prohibition of R.S. 5136. See, for example, 1937 Federal Reserve Bulletin 715, 1964 id. 1000. However, in view of your inquiry that subject has been re-examined by the Legal Division of the Board of Governors and by the Board itself.

Such re-examination has confirmed the Board's previous position that the stock-purchase prohibition forbids the purchase by a national bank or member State bank "for its own account of any shares of stock of any corporation", except to the extent permitted by specific provisions of Federal law or comprised within the concept of "such incidental powers as shall be necessary to carry on the business of banking", referred to in the first sentence of paragraph "Seventh" of R.S. 5136.

Specific provisions of the Federal banking statutes permit the purchase of stock of a number of kinds of corporations, including stock of Federal Reserve Banks, bank premises subsidiaries, safe deposit companies, "Edge" and "Agreement" corporations, small business investment companies, bank service corporations, and certain foreign banks. In addition, it has been held that, in the process of collecting defaulted loans that were contracted in good faith, the incidental powers of a national bank include the power to purchase corporate stock where that action constitutes a reasonable and appropriate step toward the collection of the indebtedness.

In the program described in your inquiry, the stock to be purchased is that of a corporation that would

"purchase mortgage loans . . . , . . . originate loans, . . . hold and assemble into blocks acceptable to large investors the loans so acquired and then sell them, servicing them . . . after such sale."

The Federal statutes contain no express permission for purchase of stock of corporations of this kind by national banks, and the Board of Governors is compelled to conclude that the power to purchase the stock of such corporations may not properly be regarded as comprised within "such incidental powers as shall be necessary to carry on the business of banking".

The suggestion has been advanced that, as a matter of policy, member banks should be permitted to establish subsidiaries to engage in activities that such banks may carry on directly, subject to appropriate conditions and limitations. Accordingly, the Board is presently considering the advisability of recommending to

Congress the enactment of legislation to authorize member banks to establish such "operations" subsidiaries and to purchase their stock, under regulations to be prescribed by the Federal supervisory authorities.

In view of the Board's conclusion that national banks and member State banks may not lawfully purchase stock of mortgage servicing corporations, it necessarily follows that a bank holding company is not authorized to do so by the provision of section 4(c)(5) of the Bank Holding Company Act regarding "shares which are of the kinds and amounts eligible for investment by national banking associations". The Board wishes to point out, however, that even if a national bank were empowered to purchase the stock of such a corporation, it may be questioned whether section 4(c)(5) would permit a bank holding company to do so.

Upon initial analysis, it might appear that if a national bank may purchase shares of a mortgage servicing corporation, section 4(c)(5) permits a holding company to purchase shares of that "kind" - that is, shares of a mortgage servicing corporation. Upon further analysis, however, it might be concluded that this would be a questionable interpretation of the word "kinds" in section 4(c)(5), especially in view of the resulting conflict with one of the major objectives of the Holding Company Act. It may be forcefully contended that the term "kind" should be read in this connection as referring, not to stock of a mortgage servicing corporation (or other functional category), but to stock of a corporation organized to perform functions that the parent corporation may perform directly. Since a bank holding company is not empowered to conduct such a mortgage servicing business directly, on this reasoning shares of a mortgage servicing corporation would not be shares "of the kinds" eligible for investment by national banks, within the meaning of the second clause of section 4(c)(5). Although a ruling on this point is not necessary in order to respond to your inquiry, it is pointed out that the interpretation described in the preceding sentence would effectuate the intent of the Holding Company Act to restrict within narrow limits the nonbanking interests of holding companies, whereas the opposite interpretation would tend to defeat that intent.

The foregoing discussion relates only to the effect of section 4(c)(5) of the Bank Holding Company Act upon your program. The Board has not considered other questions that might arise in this connection, such as whether purchase of voting shares of a mortgage servicing corporation would be permissible in accordance with the terms of section 4(c)(8), formerly section 4(c)(6).

Very truly yours,

(Signed) Merritt Sherman

Merritt Sherman,
Secretary.