

FEDERAL RESERVE BANK OF NEW YORK

NEW YORK 45, N.Y.

RECTOR 2-5700

November 18, 1963

To Each State Member Bank in the
Second Federal Reserve District:

The following release was made public today by the Board of
Governors of the Federal Reserve System:

The Board of Governors has issued a statement regarding the recently revised Investment Securities Regulation of the Comptroller of the Currency, as it relates to State banks that are members of the Federal Reserve System. The Board held that the new Regulation does not enlarge the power of member State banks to underwrite or deal in securities. The Board also ruled that such banks may not invest in convertible debentures, or other securities that are convertible into stock, if such securities are selling at prices in excess of their value as corporate obligations.

A copy of the statement referred to in the release is enclosed.

ALFRED HAYES,
President.

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

APPLICATION OF INVESTMENT SECURITIES REGULATION TO MEMBER STATE BANKS

A revision of the Investment Securities Regulation (Code of Federal Regulations, Title 12, Part 1) was issued recently by the Comptroller of the Currency. Under section 9 of the Federal Reserve Act (12 U.S.C. 335) the Regulation is applicable to member State banks as well as to national banks, insofar as it conforms to to paragraph Seventh of section 5136 of the Revised Statutes (R. S. 5136; U. S. Code, Title 12, section 24).

Provisions of Regulation with respect to "exempt securities". Paragraph Seventh refers to two areas of securities transactions by a bank: (1) underwriting and dealing, which are grouped as "underwriting" herein, and (2) investing (called "purchasing for its own account" in the statute).

The statute contains a general prohibition against a member bank (1) underwriting securities or (2) investing more than 10 per cent of its capital and surplus in the securities of any one obligor. In addition to this 10 per cent limitation, the power of national banks and member State banks to purchase securities for investment is subject to "such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe". The term "investment securities" is defined in paragraph Seventh and is subject to "such further definition...as may by regulation be prescribed by the Comptroller".

The statute also provides, however, that "The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for [the bank's] 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 securities. In other words, national banks and member State banks are legally free (1) to underwrite such "exempt securities" and (2) to invest therein without regard to the 10 per cent limitation mentioned above.

The authority of the Comptroller of the Currency to issue investment regulations pursuant to R. S. 5136 does not include authority to exempt additional kinds of securities from the prohibition against underwriting or the prohibition against investing more than 10 per cent of capital and surplus in securities of any one obligor. Despite this, § 1.3 of the Comptroller's recent revision of the Investment Securities Regulation contains a definition of "public security" and § 1.4 states that "A bank may deal in, underwrite, purchase and sell for its own account a public security subject only to the exercise of prudent banking judgment." The term "public security" is so defined that, in effect,

the Regulation purports to authorize national banks and member State banks to underwrite, and to purchase without limitation on amount, securities that are not exempted by law from the statutory prohibition against underwriting and against investing in excess of the 10 per cent limitation. For example, the terms of the Regulation would authorize such banks to underwrite some securities of public corporations that are payable solely out of revenues derived from the operation of a tunnel, turnpike, bridge, or the like, despite the fact that the applicable statute does not exempt such securities from the general prohibition against underwriting by banks.

Since the Comptroller is not authorized by law to expand the category of exempt securities established and described in paragraph Seventh of R. S. 5136, the current Regulation does not have the force and effect of law insofar as it attempts to do this. Accordingly, member State banks are informed that, in the opinion of the Board of Governors, the only securities that are exempt from the limitations and restrictions of paragraph Seventh are those specified in section 5136. Unless a particular issue of securities is exempt by virtue of that provision of law, member State banks may not underwrite the issue, and the 10 per cent limit is applicable to investments therein. Since so-called "revenue obligations" of the kinds mentioned above, as well as other revenue obligations, are not exempt from the limitations and restrictions of R. S. 5136, it would be unlawful for a member State bank to underwrite such securities or to invest in them in excess of the 10 per cent limit.

Convertible securities. From time to time corporations issue debentures or similar securities that constitute an obligation to pay a specified dollar amount of principal (as well as interest) and in addition give the holder an option to convert the security into a specified number of shares of the corporation's stock. When the market value of the stock into which such a debenture is convertible is substantially less than the face value of the debenture, the debenture ordinarily will sell at a price that reflects principally its value as a corporate obligation, without regard to the conversion option. However, the market value of the stock sometimes increases to such an extent that the shares into which a debenture is convertible have a market value that is much greater than the face value of the debenture. For example, a number of convertible debentures traded on the New York Stock Exchange sell at prices of \$2,000, \$3,000, or more, for securities with a face value of \$1,000. These prices approximate very closely the current market value of the shares of stock for which the convertible may be exchanged at the holder's option.

A question has arisen as to the circumstances in which a member State bank may purchase convertible debentures for its investment portfolio under the provisions of the Investment Securities Regulation of the Comptroller of the Currency, as recently revised.

Section 1.3(b) of that Regulation defines "investment security" to exclude securities "which are predominantly speculative in nature", so that, under R. S. 5136 and the Regulation, the purchase of "predominantly speculative" securities is not permissible. When the market price of a convertible debenture is far in excess of its face value because of the conversion feature, and its price fluctuations parallel the fluctuations in the price of the stock into which it is convertible, the debenture is necessarily speculative. Market conditions may induce price fluctuations that may have no relationship to the quality of the debenture or even of the particular stock into which it can be converted.

Accordingly, it would appear that a bank is prohibited from purchasing convertible debentures in the circumstances described. However, uncertainty as to this matter could arise from the terms of § 1.10 of the Comptroller's Revised Regulation, which might be read as indicating that a bank may purchase convertible securities generally, provided that the cost of such a security is written down promptly "to an amount which represents the investment value of the security considered independently of the conversion feature".

Quite apart from questions of interpretation of the revised Regulation, however, it is to be noted that the law itself (paragraph Seventh of R. S. 5136) in effect forbids national banks and member State banks to purchase "any shares of stock of any corporation". When the market price of a convertible security reaches 200 per cent or 300 per cent of its face value due to a rise in the price of the related stock, purchase of the convertible security is, for practical purposes, equivalent to the purchase of the stock it represents.

In the light of these statutory and regulatory provisions, it is the position of the Board of Governors that a member State bank may not lawfully invest in a convertible security whose price exceeds, by more than an insignificant amount, the investment value of the obligation, considered independently of the conversion feature. Adherence to this principle will avoid violations of the statute and Regulation that would occur if a bank were to purchase convertible securities in such circumstances that the security necessarily would be "predominantly speculative in nature", for the reasons described, and the transaction would be tantamount to a purchase of corporate stock.

November 14, 1963.