FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 5839
July 26, 1966]

State Member Bank Purchase of Stock of "Operations Subsidiaries"

To the State Member Banks in the Second Federal Reserve District:

Printed below is an excerpt from the *Federal Register* of July 23, 1966, containing an interpretation, issued by the Board of Governors of the Federal Reserve System, on the question whether State member banks may establish and purchase stock of "operations subsidiaries."

Additional copies of this circular will be furnished upon request.

ALFRED HAYES,
President.

Title 12—BANKS AND BANKING

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

§ 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 reexamination 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 the 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

(OVER)

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 1930's 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.

(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 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 predepression 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.

[SEAL] MERRITT SHERMAN,
Secretary.

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