FEDERAL RESERVE BOARD

WASHINGTON X-3046

December 28th,
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Dear Sir:

The Federal Reserve Board has received your letter in which you request to be informed in some detail concerning the organization and operation of federally incorporated international financial corporations authorized under the provisions of the so-called Edge Act.

The Edge Act makes provision for the incorporation under Federal law and subject to Federal supervision of international financial corporations organized, as the first paragraph of the Act expresses it, "for the purpose of engaging in international or foreign banking or other international or foreign financial operations, or in banking or other financial operations in a dependency or insular possession of the United States, either directly or through the agency, ownership or control of local institutions in foreign countries, or in such dependencies or insular possessions." The Act gives to these corporations powers sufficiently broad to enable them to compete on terms of substantial equality with similar institutions incorporated under foreign laws or under the laws of any State of the United States and engaged in similar business.

It was the aim of Congress in passing this Act, as evidenced by the expressed purposes for which these corporations may be organized, to provide for two distinct kinds of international financial institutions, (1) international banking corporations organized for the purpose of granting ordinary short time commercial or banking credits and (2) international investment corporations organized for the purpose of granting credits for longer periods and engaged generally in the investment business. While the provisions of the Act specifically defining the powers of such corporations are techincally applicable to any corporation organized thereunder irrespective of whether organized for the purpose of engaging in international banking or for the purpose of engaging in the investment business, it will be noted that the Act expressly provides that such powers may be exercised only "under such rules and regulations as the Federal Reserve Board may prescribe," and, further, that "nothing contained in this section shall be construed to prohibit the Federal Reserve Board, under its power to prescribe rules and regulations, from limiting the aggregate amount of liabilities of any or all classes incurred by the corporation and outstanding at any one time."

Pursuant to these provisions of the Act and in order to

give effect to the purpose of Congress as outlined above, the Board in its Regulation K, Subdivision XIII, has provided that, except with the approval of the Federal Reserve Board, and subject to such limitations as it may prescribe, no corporation shall exercise the power to accept drafts or bills of exchange if at the time such drafts or bills are presented for acceptance it has outstanding any debentures, bonds, notes, or other obligations issued by it. In other words, if a corporation is organized for the purpose of issuing its debentures, it may not at the same time carry on an acceptance business except with the Board's express approval. On the other hand, a corporation which proposes to engage in the general business of international banking, including the making of bankers' acceptances, cannot issue its debentures unless it first obtains the Board's consent.

So far as the power to make acceptances is concerned, the Board's regulations provide that corporations organized under Section 25(a) may only accept drafts and bills which grow out of transactions involving the importation or exportation of goods (the term "importation and exportation" includes, however, an importation or exportation into or from any foreign country as well as into or from the United States), and drafts or bills which are drawn by banks or bankers in foreign countries for the purpose of furnishing dollar exchange, provided, however, that except with the approval of the Federal Reserve Board, no acceptance which grows out of a transaction involving the importation or exportation of goods shall have a maturity in excess of six months, and no acceptance which is drawn for the purpose of furnishing dollar exchange shall have a maturity in excess of three months. So far as acceptances of the first class are concerned, the Board feels that only unusual and extraordinary circumstances justify a banking corporation in accepting drafts in excess of six months. In unusual times, such as the period of the war through which we have just passed, and in certain countries, a draft of a longer maturity may perhaps be properly accepted. The necessity, however, for making bankers' acceptances with a maturity in excess of six months must appear very clear before the Board will authorize acceptances in excess of that period. Since the purpose for which a bankers' acceptance may properly be made should rarely require a maturity longer than six months, normally a transaction requiring a longer credit should be financed by means of a direct loan. The Board has, however, in one instance, permitted a corporation organized under Section 25(a) to make a limited amount of bankers' acceptances of nine and twelve months, but as a condition of granting its permission it required that no acceptances in excess of six months' maturity be for a longer period than the usual and customary credit extended for transactions similar to that being financed by the acceptances in question, that the customer for whom each acceptance is made agree that all payments on account of the transaction which is being financed by the acceptance shall be applied at once to the payment of the acceptance as and when received, and that a weekly report be made to the Federal Reserve Board of all acceptances made in excess of six months.

As for the opportunities afforded a corporation organized under Section 25(a) to realize upon its paper by rediscounting such paper with a Federal Reserve Bank, you will note that the Act itself expressly prohibits such a corporation from becoming a member of any Federal Reserve Bank and, it, therefore, cannot avail itself of the rediscount privileges afforded by the provisions of the Federal Reserve Act. Like any other non-member bank, however, such a corporation may offer for sale in the open market bankers' acceptances and bills of exchange which a Federal Reserve Bank may in its discretion purchase as an open-market operation under Section 14 of the Federal Reserve Act, provided that such acceptances or bills of exchange have a maturity at the time of purchase of not more than three months or ninety days respectively, exclusive of days of grace, and are in other respects eligible for purchase under the terms of the Act and the Board's regulations. In this connection it should be remembered, however, that under the Board's Regulation B, Series of 1920, bankers' acceptances, other than those accepted or endorsed by member banks are not eligible for purchase unless the acceptor furnishes a satisfactory statement of financial condition and agrees in writing with the Federal Reserve Bank to inform it upon request concerning the transaction underlying the acceptance.

One way has been suggested whereby acceptance credits running over a period of six months, and even longer where unforeseen events intervene, may be financed by means of acceptances which would at all times be eligible for purchase by Federal Reserve Banks. The particular credits referred to are known as "finishing" credits. They involve the exportation from the United States of raw or other materials to be used in the manufacture in foreign countries of finished products. If this exportation from the United States to the country of the foreign manufacturer normally takes not more than three months it may, of course, be financed by means of acceptances which are at all times eligible for purchase. If the foreign manufacturer purchasing these materials has, at the time of the maturity of the original drafts, bona fide contracts for the exportation of the finished products, the manufacture of those products and the exportation thereof from the foreign country may be financed by another acceptance credit, and if the period normally required for the consummation of the second export transaction is not in excess of three months the acceptances drawn under this credit may be eligible at all times. If there is some unforeseen delay in completion of either of the exportation transactions, a renewal of the acceptances based upon the transaction might be justified under the principles heretofore announced by the Board with reference to renewals. The second export transaction need not necessarily involve the return of the finished products to the United States, for the Board has ruled that a transaction involving the exportation of goods from one foreign country to another may be the basis of an acceptance granted by a member bank. In this way the entire transaction, including the exportation from the United States of the unfinished material, the manufacture in the foreign country of the finished products, and the final shipment to the United States or some other country may be financed by means of

eligible acceptances. This can only be so, of course, when there is a definite and bona fide contract providing for the exportation of the finished product from the country where it is manufactured. Otherwise, there is no export or import transaction upon which the second acceptance can be based.

The Board has taken no definite action upon these so-called finishing credits but is merely calling your attention to them because if, as seems possible, they may be brought within the principles of the Board's previous rulings, they would seem to be a desirable means of extending the credits required in order to finance the exportation of American products to foreign countries.

It is contemplated that the financial operations of corporations organized under Section 25(a) shall consist primarily of international or foreign business. In fact the domestic business which such a corporation may carry on within the United States is expressly limited to that which is, in the judgment of the Federal Reserve Board, incidental to its international or foreign business. The Board has not attempted to determine what domestic business is in its judgment incidental to the international or foreign business of such a corporation, but generally speaking, the Board takes the view that such business must arise out of or bear some direct relation to the international or foreign business of the corporation, such as receiving deposits within the United States as authorized in subdivision (a) of Section 25(a) or maintaining agencies for specific purposes necessarily incidental to the corporation's foreign business. However, where goods produced or manufactured in the United States are destined for export to a foreign country, and where there is in existence a specific and bona fide contract providing for the exportation of such goods at or within a specified and reasonable time, a draft drawn to finance such goods is a foreign draft rather than a domestic draft and the business of accepting such a draft would constitute international or foreign business within the meaning of Section 25(a) and consequently could be undertaken by a corporation organized under that section.

In this connection your attention is called to Subdivision XIV of the Board's Regulation K which provides that no corporation organized under Section 25(a) shall receive in the United States any deposits, except such as are incidental to or for the purpose of carrying out transactions in foreign countries. Deposits of any kind may be received outside the United States, provided, however, that if its debentures are outstanding it may receive abroad only such deposits as are incidental to the conduct of its export, discount or loan operations.

Agencies may be established abroad at such places as the Federal Reserve Board may approve. Agencies may also be established in the United States with the approval of the Federal Reserve Board, but for specific purposes only and not generally for the purpose of carrying on the business of the corporation. No branch, however, may be established under any circumstances within the United States, and branches may be established abroad only with the Board's approval.

Although it was realized that these international financial corporations must have sufficient authority to compete effectively with similar foreign institutions, ordinary principles of banking prudence made it appear inadvisable to allow such corporations, whose real function is to finance the movement of commodities, to engage in buying and selling commodities as well. Section 25(a) provides, therefore, that no corporation organized thereunder shall engage in commerce or trade in commodities, except such commodities as it is specifically authorized to deal in, such as gold and bullion. For much the same reason it is also specifically provided in Section 25(a) that a corporation organized under that section shall not own stock in another corporation if such other corporation is engaged in buying or selling commodities in the United States. It should be noted, however, that this latter provision does not prevent a corporation organized under Section 25(a) from owning a a limited amount of stock of a corporation dealing in commodities provied that such corporation is engaged solely in purchasing and selling commodities in a foreign country or purchasing in a foreign country and selling in another foreign country, and only transacts such business in the United States as is, in the judgment of the Federal Reserve Board, incidental to its international or foreign business.

However, while an Edge corporation may not itself engage in commerce or trade in commodities and while it may not own stock in corporations engaged in buying or selling commodities in the United States, Section 25(a) does not prevent a corporation organized thereunder from being closely allied with and to a certain extent subject to the control of the commercial corporation whose international business it finances. Nothing in this section, for instance, precludes an American or foreign exporter or importer, or a group of exporters or importers, from organizing an Edge corporation for the purpose of financing their international business, the stock of which may be largely owned by the corporation engaged in dealing in commodities. In fact one of the main advantages afforded by this section is the opportunity offered to exporters and importers to organize a corporation to finance their own international business and through stock ownership permit them to direct its policies to some extent and to have at least some voice in its management. Furthermore, while an Edge corporation cannot itself deal in commodities, there seems to be no reason why it should not through its foreign branches and agencies divert business to the commercial corporation whose interests are allied with it or even informally solicit business abroad and turn this business over to its parent corporation, provided that the actual business transacted is between the American producer and the foreign importer and provided, of course, that the Edge corporation does not either directly or indirectly thereby control or fix or attempt to control or fix the price of such commodities.

The necessary formalities incident to the organization of corporations under Section 25(a) are set forth in detail in the Board's Regulation K, Series of 1920. You will note that no corporation which issues its debentures or other similar obligations is permitted to use the word "bank" as part of its title and no corporation which has the

word "Federal" in its title is permitted to use the word "bank" in its title. No corporation may be organized with a capital stock of less than $2,000,000 and no corporation will be permitted to issue stock of no par value. You will also note that the annual meeting of the stockholders must be held at the home office of the corporation which must be in the United States, and that all the directors must be citizens of the United States.

After the Articles of Association and the Organization Certificate have been made and filed with the Board and after the Board has approved them, a preliminary permit to begin business will be issued, after which the association shall become and be a body corporate, but it cannot exercise any of its powers except such as are incidental and preliminary to its organization until after it has been authorized by a final permit issued by the Board generally to commence business. One of the prerequisites of this final permit is that at least 25% of the authorized capital stock shall be paid in cash, the remaining installments being paid in accordance with the provisions of the law. The Board requires that the by-laws of the corporation, the form of certificate of stock which it proposes to issue, and such similar documents be filed with it for its information. The Board, however, does not attempt to approve such by-laws or other documents in any manner but merely requires them to be filed with it as a matter of record.

Section 25(a) provides in part that a majority of the shares of the capital stock of a corporation organized thereunder shall at all times be held and owned by citizens of the United States, by corporations the controlling interests in which is owned by citizens of the United States, chartered under the laws of the United States or of a State of the United States, or by firms or companies, the controlling interests in which is owned by citizens of the United States. In this connection the Board wishes to call your attention especially to the provisions of Subdivision VII of Regulation K which must be strictly complied with in order to insure compliance at all times with the requirements of the Act. You will also note that the by-laws of the corporation must prescribe appropriate regulations for the registration of the shares of stock in accordance with the terms of the law and that the by-laws must also provide that the certificates of stock issued by the corporation shall contain provisions sufficient to put the holder on notice of the terms of the law and the Board's regulation defining the limitations upon the right of transfer.

The Board will be very glad to answer any further inquiries which may suggest themselves to you in connection with the organization and operation of these corporations.

Very truly yours,

Governor.