

To: Federal Reserve Board.

July 2, 1923.

From: Law Committee.

Subject: Report on New Regulation.

The Law Committee has carefully considered the proposed new edition of the Board's regulations, the proof of which is attached hereto, and recommends that it be approved and adopted by the Board, except as to two points in Regulation H, which are referred to the Board without recommendation.

There is given below a brief description of the changes which have been made in the regulations, in the order in which they appear.

REGULATION A-Discounts under Sections 13 and 13 (a).

Section I. General Statutory Provisions. This section contains only a summary or paraphrase of the general statutory provisions effecting the rediscount of notes, drafts and bills of exchange, and the only changes made are such as are necessary to make this section conform to the law as amended to date.

Section II. General Character of Notes, Drafts and Bills of Exchange eligible. Subdivision (a) has been amended by inserting in the first line thereof immediately before the word "note" the word "negotiable", in order to incorporate in the regulations the well established ruling of the Board that only negotiable notes, drafts and bills of exchange are eligible for rediscount. At the end of this subdivision there has also been inserted a requirement that "the name of the party to such transaction must appear upon it as maker, drawer, acceptor or endorser." The purpose of this change is to incorporate in the regulation the substance of the ruling published in the Federal Reserve Bulletin for September, 1921, which announced a rule which is merely a

corollary to the rule previously stated in subdivision (a).

Subdivision (c) of the old regulation contained a statement of two different rules, (1) that paper offered for rediscount must not be paper the proceeds of which have been or are to be used for investments of a purely speculative character and (2) it must not be paper the proceeds of which have been used for the purpose of lending to some other borrower. This subdivision has been split into two subdivisions in order that exceptions might be made to the latter rule to cover two classes of paper which have been made eligible by the Agricultural Credits Act even though the proceeds have been used for the purpose of making loans to other borrowers, - i.e., paper of cooperative marketing associations of the kinds described in Section VI (b) and factors' paper of the kind described in Section VIII. This part of old subdivision (c), and the exceptions to the rule have been incorporated in new subdivision (b), and the remaining part of old subdivision (c) has been re-designated as subdivision (d).

New subdivisions (c) and (a) are identically the same as old subdivisions (b) and (d), respectively.

Section III. Applications for Discount. The language of this section has been changed somewhat in order to clarify it, but the substance remains the same except that the latter part, which relates to the amount of paper bearing the signature or endorsement of any one borrower which may be rediscounted for any one member bank has been changed so as to conform to the provisions of Section 9 of the Federal Reserve Act as amended by the Act of July 1, 1922.

Section IV. Promissory Notes. The second paragraph of subdivision (b) has not been changed in substance, but the phraseology has been changed

somewhat for the purpose of clarifying what was formerly a very ambiguous provision.

Sub-paragraph (1) of Section IV (b) has also been amended in substance by inserting after the word "storage" the words "by a valid prior lien on live stock which is being marketed or fattened for market." The effect of this amendment is to waive financial statements as to makers of notes which are secured by such a lien on live stock. It was made at the suggestion of several of the Western Federal Reserve Banks who stated that it had long been their custom to waive financial statements as to notes secured by chattel mortgages on live stock.

Section VI. Agricultural Paper. Subdivision (a) which consists of a definition of agricultural paper has been re-drafted so as to clarify the definition and broaden it so as to incorporate the latest and most liberal principles adopted by the Board in determining what constitutes agricultural paper and especially the principle that the marketing of agricultural products or the carrying of agricultural products by the growers thereof pending orderly marketing constitutes an agricultural purpose. This definition has also been changed by the substitution of the new nine months' maturity clause in place of the old six months' maturity clause, to conform to an amendment contained in the Agricultural Credits Act.

Subdivision (b) is entirely new and was inserted for the purpose of incorporating the provisions contained in the Agricultural Credits Act which make certain classes of paper of cooperative marketing associations eligible for rediscount as agricultural paper. All of this subdivision except the last paragraph thereof is simply a paraphrase

or analysis of the law. The last paragraph is a corollary to the rule that paper the proceeds of which have been used for permanent or fixed investments or for any other capital purpose is ineligible for rediscount. It is inserted in this part of the regulation in order to obviate the necessity of answering many inquiries as to the eligibility of the class of paper described which clearly is ineligible even under the law as amended by the Agricultural Credits Act.

Subdivision (c) is exactly the same as the corresponding portion of the old regulation, except that the words "six months" which previously appeared immediately before the words "agricultural paper" have been stricken out.

Subdivision (d) is entirely new and covers the rediscount of agricultural paper for Federal Intermediate Credit Banks as permitted under the second paragraph of Section 13 (a) of the Federal Reserve Act as amended by the Agricultural Credits Act.

Section VII. Sight Drafts secured by Bills of Lading. This section is entirely new and was inserted for the purpose of covering a new provision inserted in Section 13 of the Federal Reserve Act by the Agricultural Credits Act. It is merely a paraphrase or analysis of the law except in one respect in which an interpretation of the law has been attempted, i.e., the law says that all such bills shall be forwarded promptly for collection and "demand for payment shall be made with reasonable promptness after the arrival of such staples at their destination." In the regulation this is interpreted to mean that all such bills of exchange shall be forwarded promptly for collection and demand for payment shall be made promptly, unless the drawer instructs

that they be held until arrival of car, in which event they must be presented for payment within a reasonable time after notice of arrival of such staples at their destination has been received. This is believed to be a correct and practical interpretation of the law and one which fairly carries out the intention of Congress.

Section VIII. Factors' Paper. This section is entirely new and is merely a paraphrase of the law, except that one ambiguous phrase has been interpreted. The law says that "notes, drafts and bills of exchange of factors issued as such making advances exclusively to producers of staple agricultural products in their raw state shall be eligible for such discount." This might be construed as making eligible only the paper of such factors as make advances exclusively to producers of agricultural products in their raw state, but such an interpretation would exclude the paper of all factors who make advances to any one else. It is believed that this is not what was intended, and the provision has been construed in the regulation to apply to the paper of all factors issued as such for the purpose of making advances exclusively to producers of agricultural products in their raw state. This is believed to be a fair interpretation of the law and one which carries out in good faith the real intent of Congress.

Section X. Eligibility. The first paragraph of this section has been changed by striking out the words "of not more than three months, exclusive of days of grace", and inserting in lieu thereof the words "not greater than that prescribed by Section XI (a)." The purpose of this is to make it possible to cover in a different section the amendment to the law making six months' acceptances eligible for rediscount

when drawn for an agricultural purpose and secured at the time of acceptance by warehouse receipts or other such documents conveying or securing title covering readily marketable staples.

Section (i) has been amended by adding at the end the words "or between dependencies or insular possessions and foreign countries." This amendment covers a class of acceptances which has always been eligible under the law, but which was overlooked in writing the old regulation. The remainder of this section is identically the same as the corresponding part of the old regulation.

Section XI. Maturities. Subdivision (a) is entirely new and was inserted for the purpose of covering acceptances drawn for an agricultural purpose and secured at the time of acceptance by a warehouse receipt or other such document conveying or securing title covering readily marketable staples, which acceptances were made eligible for rediscount with maturities up to six months by an amendment contained in the Agricultural Credits Act.

Subdivision (b) is identically the same as Section IX of the old regulation, except that the words "of not more than three months, exclusive of days of grace" have been stricken out and the words "not greater than that prescribed under (a)" have been inserted in lieu thereof.

The remainder of Regulation A is identically the same as the old regulation, except that wherever the word "rediscount" occurs in the old regulation it has been changed to "discount", in order to meet a suggestion as to phraseology made by the Governors of several of the Federal Reserve Banks.

REGULATION B. Open Market Purchases.

There has been no substantial change in this regulation except that the omission therefrom of subdivision (c) of Section II, which was inserted by an amendment adopted by the Board under date of December 19, 1922, making a certain restricted class of acceptances of cooperative marketing associations eligible for purchase in the open market with maturities upto six months. This provision has been completely superseded by the amendment contained in the Agricultural Credits Act which makes a much broader class of acceptances drawn for agricultural purposes eligible for rediscount with maturities up to six months. Inasmuch as the first paragraph of Section II of Regulation B in general terms makes eligible for purchase on the open market all bankers' acceptances which are eligible for rediscount under Regulation A if secured in the manner required by the Agricultural Credits Act, subdivision (c) of the old regulation is now entirely unnecessary and would only cause confusion if retained in the new regulation.

The first paragraph of Section II has been rewritten and clarified; but the substance of it has not been changed.

REGULATION C. Acceptances of member banks.

This regulation is identically the same as the old Regulation C, except for slight changes in phraseology which were made in order to describe accurately the statutory provision referred to in the first section thereof; and wherever the expression "per centum" occurred in the old regulation it has been changed to "per cent", in order to make the "style" uniform.

REGULATION D. Time Deposits and Savings Accounts.

This regulation has not been changed in substance, but section numbers have been inserted and certain inaccuracies in the quotation from Section 19 of the Federal Reserve Act have been corrected.

REGULATION E. Purchase of Warrants.

This regulation has been rearranged and the appendices heretofore published separately have been incorporated in the body of the regulation. No material change has been made in the substance of the regulation, however, except the elimination of the 10 per cent limitation on the amount of warrants of any municipality which might be purchased by a Federal Reserve Bank with the endorsement of a member bank. This limitation did not apply to the purchase of warrants with the endorsement of nonmember banks, and it was contended that it operated as a discrimination against member banks and in favor of nonmember banks. This matter was called to the attention of the Board by Governor Young and was discussed at the last Governors' Conference.

REGULATION F. Trust Powers.

No change has been made in this regulation.

REGULATION G. Loans on Farm Land and Other Real Estate.

This regulation has been changed in only one respect. Paragraph (g) thereof has been changed so as not to require notes representing real estate loans to be cancelled at maturity and new notes taken in their places. It now permits an expiring note to be renewed or extended for an additional period. The important safeguard that the bank must not obligate itself in advance to make such a renewal is retained, and the only thing changed is the manner of making a renewal.



REGULATION H. Membership of State Banks.

This regulation has been changed materially so as to conform to the amendments to Section 9 of the Federal Reserve Act contained in the Agricultural Credits Act of 1923, which make a State bank with a capital equal to not less than 60 per cent of the amount required for the organization of a national bank eligible for admission to membership under certain terms and conditions. Section 9 thus amended, provides that the Federal Reserve Board shall prescribe rules and regulations fixing the time within which and the methods by which the unimpaired capital of such banks shall be increased out of net income to the amount required to entitle it to become a national banking association in the place where it is situated under the National Bank Act, "Provided, That every such rule or regulation shall require the applying bank to set aside annually not less than 20 per centum of its net income of the preceding year as a fund exclusively applicable to such capital increase." Such rules and regulations have been incorporated in subdivision 2, of Section I of the new regulation.

There is one point to which the Committee desires to call the Board's especial attention: The time within which such banks shall increase their capital. In the regulation as now drafted 10 years is named, but this is such a vital point that the Committee hesitates to name this time except tentatively. The time originally suggested was five years; but it was feared that it would be absolutely impossible for many of the smaller banks to increase their capital in the required amount (66-2/3 per cent) "out of net income" as required by the Act within five years. It probably would be equally impossible, however,

for many of the smaller banks to increase their capital such an amount out of net income in fifty years. The Committee has suggested ten years as a reasonable time limit and one which does not postpone the date of such increase so far in the future as to practically nullify the requirement that the capital must be increased.

There has also been inserted in Section IV of the regulation a new paragraph (numbered 4) specifically providing that all banks admitted to membership shall comply at all times with any and all conditions of membership prescribed by the Federal Reserve Board at the time of the admission of such member bank to the Federal Reserve System. This has been inserted because there is a technical difference between the Board's power to prescribe "conditions" of membership and its power to prescribe "regulations" governing state member banks, and Section 9 authorizes the Board to expel state banks from the System for failure to comply with the Board's regulations but does not authorize it to expel them for failure to comply with conditions of membership.

There is another matter in this regulation which the Committee desires to call to the Board's attention. The latter half of the second paragraph of Section V expressly authorizes the examiners of the Federal Reserve Banks to cooperate with the State examiners in examining State member banks. This is inconsistent with the rulings recently made on the subject and probably is not in accordance with the law, since Section 9 apparently contemplates that the examinations of a State member bank shall be either State examinations or Federal examinations. It provides that the expenses of Federal examinations shall be assessed against the bank examined but that the expenses of a State examination

shall not be assessed by the Federal Reserve Bank against the bank examined. The express mention of State examinations and Federal examinations impliedly exclude joint examinations, which are not mentioned in the Act at all, and the General Counsel is of the opinion that joint examinations are not authorized. For this reason he recommends that all but the first three lines of this paragraph be stricken from the regulation. This provision has been in the regulation for many years, however, and the Committee hesitated to strike it out without first submitting the matter to the Board.

REGULATION I. Increase or Decrease of Capital Stock.

Section I (a) has been amended so as to conform to the practice agreed upon between the Board and the Comptroller's Office in the fall of 1921 with reference to applications by newly organized national banks for membership in the Federal Reserve System.

Section II (b) and II (c) have also been amended so as to require the receivers of insolvent member banks and the liquidating agents of member banks in voluntary liquidation to apply for the surrender and cancellation of the Federal Reserve Bank stock held by such banks within six months after their appointment.

REGULATION J. Check Clearing and Collection.

This regulation has been rewritten and brought up to date. It has not only been amended by the addition of the two new paragraphs recently adopted by the Board, but it has also been entirely rearranged and reworded so as to conform to present practices and to the uniform check collection circular recently adopted by all the Federal Reserve Banks.

Each section of the new regulation will be discussed briefly in order.

Sections I and II are identically the same as the first three paragraphs of the old regulation.

Section III. Subdivision (a) is identically the same as condition (1) of the old regulation, except that the words "in acceptable funds" have been inserted.

Subdivision (b) is the same as condition (2) of the old regulation except that the words "in other Federal Reserve Districts authorized to route direct", have been substituted for the words "regardless of their location" and the words "which agree to remit at par in acceptable funds" have been substituted for the words "whose checks are collected at par by the Federal Reserve Bank."

Subdivisions (c) and (d) are the two new provisions recently adopted by the Board.

Section IV. The first sentence is substantially the same as the last paragraph of condition (7) of the old regulation. The remainder of the section correctly describes the present practice of the Federal Reserve Banks and supersedes condition (3) of the old regulation, which is obsolete.

Section V. correctly describes the present practice of Federal Reserve Banks in collecting checks and contains the limitation of liability and other safeguards against liability on the part of the Federal Reserve Bank which are contained in the old regulation and in the uniform check collection circular recently adopted by all the Federal Reserve Banks. It takes the place of condition (4) and the first four lines of condition (8) of the old regulation. It also permits Federal Reserve Banks to guarantee prior endorsements, a suggestion submitted

by the Collection Committee, made a topic of discussion at the last Governors' Conference and referred to the Federal Reserve Board for action. This matter was referred to the Board's General Counsel who has suggested that it be covered by this amendment to Regulation J. As a practical matter, it is necessary for Federal Reserve Banks to guarantee prior endorsements if they are to handle checks for collection and most of them have been doing it, though it probably constituted a technical violation of the old Regulation J.

Section VI. Subsections (a) and (b) are substantially the same as the first two paragraphs of condition (6) of the old regulations. Subsections (c) and (d) take the place of the third paragraph of condition (6) of the old regulation, but differ from it sufficiently to fit the present practice of the Federal Reserve Banks.

Section VII. Is identically the same as the last five lines of the old regulation.

REGULATION K. Edge Corporations.

There is no change in this regulation.

REGULATION L. Clayton Act.

This regulation is the same as the old regulation with the following exceptions:

1. The definition of the term "national bank" has been broadened so as to include all banking institutions organized or operating under the laws of the United States, and corresponding changes have been made elsewhere.

2. The words "such State bank has" have been stricken out of

subdivisions 7 and 8 of Section III and the words "either or both of such banks have" have been inserted in their place.

3. There has been inserted in Section IV under the sub-head "Substantial Competition" the statement of general principles adopted by the Board for its guidance in determining whether two or more banks are in substantial competition.

The Law Committee

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C. S. Hamlin

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Edmund Platt

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Walter Wyatt, Secretary