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OFFICE CORRESPONDENCE

Date, August 18, 1923.

To Governor Crissinger

From Mr. Wyatt, General Counsel.

Subject: Purchase of Government Securities and Bankers' Acceptances by Federal Reserve Banks under so-called Repurchase Agreements.

Question has been raised as to the propriety of the practice engaged in by the Federal reserve banks of purchasing Government securities and bankers' acceptances from member and nonmember banks, and stock, bond and acceptance brokers, under agreements providing that the sellers of these securities or acceptances will repurchase the same from the Federal reserve banks within a specified period of time.

The details of such transactions vary, but it appears that in all cases United States Government securities or bankers' acceptances are transferred to the Federal reserve bank at a certain agreed price while at the same time an agreement is entered into obligating or permitting the seller of the securities or acceptances to repurchase the same within a certain period. It is sometimes provided that the Federal reserve banks shall have the right to require the seller to repurchase the securities or acceptances at any time within this period upon giving a certain number of days' written notice. The Federal reserve bank charges interest for the period during which it holds the securities or acceptances, and this interest is sometimes computed in advance and sometimes when the resale is effected. It is also provided in some of these agreements that the seller shall keep on deposit with the Federal reserve bank additional securities sufficient to maintain a margin of safety, based upon a ratio of $120 to each $100 of the difference between the par value of the securities purchased and the market value thereof.

The Comptroller's Office has ruled that national banks which have sold securities to Federal reserve banks under such agreements shall consider the transactions as borrowings of money and shall carry them on their books accordingly. On the contrary, the Federal Reserve Board has held in connection with the reports of member State banks and trust companies that such a transaction is not to be considered as a borrowing but should be included in a special item on the report as securities sold under repurchase agreements. You have requested the opinion of this office as to the true nature of such transactions, i.e., whether they constitute purchases on the open market by Federal Reserve banks as authorized by Section 14 of the Federal Reserve Act or merely loans secured by the deposit of securities or acceptances as collateral.

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In my opinion, a transaction whereby securities or acceptances are sold to a Federal Reserve bank under an agreement obligating the seller to repurchase the same on or before a certain date is in legal effect merely a loan secured by collateral, and not a sale; and Federal reserve banks have no legal authority to participate in such a transaction. Where the agreement merely permits, but does not obligate, the seller to repurchase the securities or acceptances, no universal rule can be laid down; but it is believed that even in these cases the transactions would generally be construed by a court as loans secured by collateral. The reasons upon which my opinion is based are stated below.

GENERAL PRINCIPLES

In construing an agreement such as that described above, a court would be guided by the intention of the parties as far as it can be ascertained from the agreement itself and the surrounding circumstances. For this purpose it is settled that parol evidence will be admitted to show the facts and circumstances attending the execution of the agreement. The court will look to the substance of the transaction and will not be controlled by the form which the agreement may happen to have. The actual intent of the parties will be the controlling factor. Where there is a contract of sale and a contemporaneous agreement to resell at a certain time the two agreements will be construed together in the endeavor to ascertain the true intention of the contracting parties. In 5 Ruling Case Law, p. 589, it is said:

> "Sometimes a bill of sale intended as a security for money lent is accompanied by the execution of a separate instrument of defeasance, by the terms of which, on the repayment of the loan at a certain time, the bill to be surrendered to the vendor. In such a case the two instruments must be construed together and constitute a mortgage."

In discussing the distinction between a conditional sale and a chattel mortgage 11 Corpus Juris at page 412, states as follows:

> "Intention of the parties. Whether a transaction constitutes a chattel mortgage or a conditional sale ultimately depends on the intention of the parties, which must be ascertained from their conduct and the attendant circumstances, as well as from the terms of the agreement. Further, the intention must be collected from the entire transaction and not from any particular feature of it, and from the actual agreement of the parties and not from their characterization of it, although the construction placed on the contract by the parties is properly considered. The form of the instrument is of little importance. A contract of conditional sale will not be regarded as a chattel mortgage merely because it is recorded as such."

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With regard to the specific provisions of the contract which indicate the intention of the parties as to the transaction, it is further stated in 11 Corpus Juris, at page 413, as follows:

> "Conditions Permitting Repurchase. A bill of sale with an agreement permitting repurchase may constitute either a chattel mortgage or a conditional sale, its character depending on the surrounding circumstances and the intention of the parties. The fact that a bill of sale contains an agreement to resell the property to the seller at a fixed price or confers on him an option to repurchase it does not, in itself, establish that the transaction is a mortgage, especially when there is no debt to be secured and no obligation to repay. But the transfer may be shown to be a mortgage by evidence that the vendor's obligation continued, that he bound himself to pay interest, that the bill of sale was given to secure a loan, or that the amount of consideration was inadequate as a purchase price."

From this statement of the law it is obvious that the specific provisions of a particular contract must be known in order to determine whether or not a conditional sale or a loan in the nature of a chattel mortgage is intended. This question turns upon the provisions of the particular contract and, therefore, an examination of each agreement entered into by the Federal reserve banks would be necessary for a definite opinion as to the effect of that particular agreement. There are, however, certain of these agreements which classify themselves very readily either as sales on condition or loans secured by chattel mortgage or pledges.

COMMON CHARACTERISTICS OF LOANS

There are several features found in many of the repurchase agreements of Federal Reserve banks which indicate that loans rather than conditional sales are intended. One of the most important of these is the stipulation that additional securities shall be deposited by the seller withthe Federal reserve bank to maintain a certain margin over and above the market value of the securities. If the parties intended a sale there would be no necessity for such a provision. This is a clause which is usually found in connection with chattel mortgages, pledges or other forms of loans secured by collateral; in such cases the provision is very desirable. The purpose of the provision is plainly to protect the Federal reserve bank from any possible loss by reason of fluctuation in the value of the securities or acceptances held by it as security for a loan.

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Another important characteristic of a loan is present when it is provided that the Federal reserve bank may sell at a public or private sale the securities or acceptances upon which it has advanced money, in case the so-called seller fails to comply with the agreement of repurchase and to buy back the securities or acceptances at the time specified. This also is a clause which is usually found in all forms of loan agreements but for which there can be no possible need in a contract of sale, even though such contract reserves to the seller the privilege of repurchasing within a certain time. If these securities or acceptances are really owned by the Federal reserve bank it would be entirely unnecessary to go through the form of a sale in order to transfer the title thereto to the Federal reserve bank, because it already has title; and if it is desired by the Federal reserve bank to have someone else purchase them, the Federal reserve bank, being the owner of the securities or acceptances, may make such sale in the ordinary manner and it would be entirely superfluous to provide for this kind of a sale in the agreement. But if the Federal reserve bank does not, as a matter of fact, take absolute title to the securities or acceptances, a provision for sale in case of default is necessary in order that the Federal reserve bank, or any other party purchasing at such sale, may acquire a clear title.

The fact that the Federal reserve banks charge interest on such transactions, and that this interest is computed in the same way as in the case of any ordinary loan is a very strong factor in evidencing the intention of the parties to this agreement in reality to negotiate a loan, although in form the transaction is an absolute sale with a right to repurchase reserved to the seller. In the case of an actual sale with right to repurchase there probably would be some form of fee or commission provided for to compensate the Federal reserve bank for its services, but it is unlikely that this fee or commission would take the form of interest and be computed in the same manner as interest, unless the parties were attempting to consummate a loan rather than a sale.

TWO CLASSES OF REPURCHASE AGREEMENTS.

Transactions of the kind under consideration may be divided into two general classes (1): Those in which the seller is obligated to repurchase the securities and acceptances on or before a certain specified date; and (2) those in which the seller is given the privilege of repurchasing if he so desires. In the first of these classes, the nature of the transactions seems entirely clear, but the proper construction of the second class of transactions depends largely on the terms of each particular agreement.

SELLER OBLIGATED TO REPURCHASE.

Where the so-called seller has not only a right or privilege to repurchase, but is absolutely required to repurchase by the terms of the agreement, this is conclusive of the intention of the parties to

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effect a loan secured by the deposit of securities or acceptances as collateral. Where the agreement entered into by the Federal reserve bank, therefore, contains a provision obligating the seller to repurchase the securities or acceptances within a certain specified period, or at the option of the Federal reserve bank upon a certain number of days written notice, there is no question but that the transaction is a loan, although in form a conditional sale. This position is sustained by the authorities.

In the case of Robinson v. Farrelly, 16 Ala., 472, the Court in discussing the nature of a transaction similar to that under consideration states as follows:

"The nature of a sale, with the right to repurchase for a given sum, and within a specified time, is a conveyance of the title to the purchaser; he is the owner of the property, but the vendor has the right to repurchase if he sees fit; no obligation rests on him to do so, it is a mere matter of volition, whether he will or not. If he declines to repurchase, he is not bound to refund the money, and the purchaser has no cause of action against him because he does not see fit to claim his privilege. If the purchaser retain the right to demand the money of the vendor, notwithstanding his purchase, a debt is then due from the vendor to him, and the existence of this debt within itself shows that the conveyance is a mere security for its payment."

In the case of Cake v. Shull, (N.J.) 16 Atl. 434, the court made the following statement:

"The right of a court of equity to declare a deed or bill of sale, which is absolute on its face, to be a mortgage, is clear, as is also the competency of parol evidence to prove the fact. The question turns upon the actual intention of the parties at the time of the transaction. Crane v. Decamp, 21 N.J. Eq. 414. If that intention was that the instrument should constitute security for the payment of money, or the performance or non-performance of any other act, then it is deemed a mortgage; but, if a real sale was intended, then it takes effect according to its terms, even though a contemporaneous right or privilege to purchase back the property sold was contracted for by the vendor. Gassert v. Bogk, (Mont.) 19 Pac. Rep. 281; Conway's Ex'r v. Alexander, 7 Cranch 218; notes to Thornbrough v. Baker, 2 Lead. Cas. Eq. 1030. An obligation to repurchase, or any other duty resting on the vendor by the performance of which the property was to revert to him, could ordinarily be conclusive evidence of a mortgage, while the absence of such obligation or duty, either expressed or implied, would be indicative of a sale.""

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SELLER WITH OPTION TO REPURCHASE.

Where the agreement provides that the seller shall have the right or privilege of repurchasing within a certain specified period, but there is no obligation upon him to do so, there may be some question as to the intention of the parties; it is sometimes uncertain whether such a transaction should properly be construed as a sale or a loan. In such cases the courts have, in endeavoring to ascertain the true intention of the parties, reached different conclusions, depending upon the purpose of the transaction, the result to be accomplished, and the other surrounding circumstances. As has been heretofore stated, each agreement must be construed according to its own particular terms and it is difficult to lay down any general rule which will be applicable to all cases. The fact that most of the repurchase agreements entered into by Federal reserve banks provide for the payment or deduction of interest is a strong indication of an intention to effect a loan rather than a sale. Further indication of such an intention is sometimes found in the payment of a price other than the market value for the securities or acceptances and in the provision for deposit of additional collateral. In view of these facts, I believe that it may be fairly said that most if not all sale agreements made by Federal reserve banks reserving to the seller the privilege of repurchasing are, properly construed, loans and not sales.

The cases hereafter cited show under what circumstances agreements reserving to the seller merely the privilege to repurchase are to be construed as loans secured by collateral although the transactions are in form conditional sales.

In the case of Dickinson v. Oliver, 89 N.Y. Supp., 52 (Affirmed in 88 N.E. 44), where a bill of sale was given for certain property together with an agreement permitting the seller to repurchase within a certain time, the transaction was held to constitute a loan in the nature of a chattel mortgage and not a sale with the right of repurchase. The court quotes with approval the following head note from the case of Susman v. Whyard, 149 N.Y. 127, 43 N.E. 413:

> "Where the provisions of an instrument which is in form an absolute bill of sale, taken in connection with the surrounding facts, indicate that the parties contemplated a loan of money and a sale of the property, upon the condition, however, that the property should be returned upon the payment of the money so loaned, the instrument is in effect a chattel mortgage, and the fact that it employs the term 'resale' will not change its meaning when no other sum than the amount of the loan is mentioned or contemplated as the price of such resale."

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In the case of O'Niell v. Walker, (La.) 12 South. 872, an agreement of sale permitted the seller to buy back timber purchased at any time within six months at cost plus eight per cent interest, the repurchaser to stand any loss incurred in the meantime. The court held that this agreement, in the light of all the surrounding circumstances, was in effect merely a transaction giving security for a loan and could not be construed as a sale.

In Sparks v. Robinson, (Ark) 515, S.W. 460, which was a case involving the usury laws, an absolute bill of sale, which purported to sell certain property at a price far less than the market value thereof, was construed as a cover for a loan. The court said that "The law shells the covering and extracts the kernel."

In the case of Mercantile Trust Company v. Kastor, (Ill.) 112 N.E. 988, the Trust Company, which had no power to make loans entered into a contract purporting to be a sale by a certain corporation of its accounts receivable to the Trust Company. The Trust Company was by the terms of this agreement to pay no more than 77% of the value of the said accounts. The corporation and the defendant guaranteed to pay these accounts if they were not paid at maturity. On a certain account which was unpaid the Trust Company brought suit against the defendant on this guaranty. It was held that the transaction constituted not a sale, but merely a loan with the accounts receivable assigned to the Trust Company as security, and the Trust Company was permitted to recover nothing because the contract was ultra vires and therefore void.

In the case of Home Bond Company v. McChesney, 239 U.S. 568, the Supreme Court of the United States approved the findings of a special master holding that a transaction very similar in its terms to that in the Kastor case, which is discussed above, was a mere loan with collateral security, and not a sale. The Supreme Court quotes with approval the language of the United States District Court as follows:

> "In so far as the contracts in question here used words fit for a contract of purchase, they are mere shams and devices to cover loans of money at usurious rates of interest."

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ORIGIN OF PRACTICE

That these transactions are in substance loans rather than bona fide purchases of securities on the open market is further confirmed by a consideration of the origin of the practice.

The practice of the Federal Reserve banks in purchasing Government securities and bankers' acceptances under re-sale agreements originated in November, 1917, when demands for accomodation upon the Federal reserve banks were very heavy and the Government was floating large issues of Liberty bonds. On December 1, 1917, the stamp tax on promissory notes was to become effective and this would have been a very heavy expense upon member banks in obtaining funds from Federal reserve banks upon their fifteen day collateral notes under Section 13 of the Act. The Federal Reserve Board, therefore, suggested that in order to avoid the payment of this stamp tax member banks might obtain short time advances from Federal reserve banks by rediscounting eligible commercial paper of longer maturities under re-purchase agreements. The Board pointed out that interest might be charged only for the period covered by the agreement, that is, from the date of discount to the date of repurchase, and that the interest might be adjusted in advance or at the time of the re-sale. The suggestion of the Board was adopted and the Federal reserve banks began purchasing paper from member banks under repurchase agreements as a substitute for the fifteen day collateral notes of member banks. Notes secured by Liberty Bonds or United States certificates of indebtedness were subsequently exempted from the stamp tax and thereupon at least one of the Federal reserve banks (Richmond) discontinued this practice. Other Federal reserve banks, (notably New York) have not discontinued it, however, but on the contrary have extended it by entering into transactions of this kind not only with their member banks but also with non-member banks and stock, bond, and acceptance brokers.

It is clear, therefore, that these transactions originated as loans (presumably under the authority to make direct loans to member banks) and the practice has simply grown and spread until it has gone far beyond the original purpose of the Board's ruling, and has been taken advantage of by the Federal reserve banks as a justification for making direct loans to non-member banks and to brokers - parties to whom the Federal Reserve Act never intended that Federal reserve banks should extend credit in any way without the intervention of a member bank.

CONCLUSIONS OF LAW.

When the transactions between the Federal reserve bank and the various member and non-member banks, and other corporations, therefore, are considered in the light of all the surrounding circumstances it seems clear that under the principles announced by the courts, most if not all

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of these transactions should be considered loans secured by the deposit of securities or acceptances as collateral, instead of sales with the right to repurchase reserved to the seller. The agreements, though in form sales, are in substance loans secured by the pledge of collateral.

The transaction described being a loan secured by collateral, instead of a sale which it purports to be, Federal reserve banks have no power to engage in such transactions and such agreements on the part of these banks are entirely ultra vires. Federal reserve banks have no power to make loans direct to the person or corporation primarily liable under any conditions, except that they make advances to their member banks upon promissory notes for a period not exceeding 15 days when properly secured in accordance with Section 13 of the Federal Reserve Act. Advances under repurchase agreements such as described above, however, can not be considered advances upon promissory notes, because the debt in such cases is not evidenced by notes of any kind. Federal reserve banks, therefore, can not in my opinion, make advances even to member banks under repurchase agreements.

POLICY

This subject has been discussed above largely as a question of general law, and I have not discussed the effect of its application to the Federal reserve banks. I think, however, it is perfectly manifest that the application of these conclusions of law to the operations of the Federal reserve banks will lead to a much closer adherence to the fundamental purposes and principles of the Federal Reserve Act than exists at the present time. The original Federal Reserve Act gave the Federal reserve banks no power to make direct loans even to their member banks.

The power to make direct loans to member banks on their fifteen day notes was granted on the recommendation of the Federal Reserve Board as a means of enabling Federal reserve banks to extend credit to their member banks for short periods of time on the security of paper eligible for rediscount. An amendment to the Act granting this power to Federal reserve banks was recommended by the Federal Reserve Board in 1916 when little use was being made of the rediscount facilities of the Federal reserve banks and it was hoped that this would induce the member banks to make more use of the system. The Board's proposed amendment, however, was not acted upon before it became evident that this country might be drawn into the world-war and in order that the banks of the country might be in position to facilitate Government financing in such an event, the Board made a further suggestion that the proposed fifteen-day collateral notes of member banks might be made eligible when secured by bonds and notes of the United States as well as when secured by paper eligible for rediscount.

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It was never contemplated by Congress that the Federal reserve banks should make direct loans to non-member banks nor to stock, bond and acceptance brokers or other individuals, partnerships or corporations which ordinarily would seek such accommodations from member banks. The practice which has grown up in the Federal reserve banks of buying bonds and bankers' acceptances under so-called "repurchase agreements" amounts to nothing more nor less than the making of direct loans on the security of such bonds or acceptances; and the making of such loans to parties other than member banks is manifestly inconsistent with the purposes of the Act in that it enables non-member banks and stock, bond and acceptance brokers to tap the resources of the Federal reserve banks directly and without the intervention of a member bank.

As stated above, I am of the opinion that these transactions are clearly ultra vires as to Federal reserve banks and it is respectfully recommended that the Board so rule.

Respectfully,

(Signed) Walter Wyatt,
General Counsel.

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