

FEDERAL RESERVE BOARD

WASHINGTON

ADDRESS OFFICIAL CORRESPONDENCE TO
THE FEDERAL RESERVE BOARD

February 27, 1926.

SUBJECT: Designation on applications for rediscount of person from whom member banks acquired paper offered for rediscount.

Dear Sir:

There are enclosed for your information copies of certain correspondence between the Federal Reserve Board and the Governor of the Federal Reserve Bank of San Francisco, and a copy of a memorandum by the Board's General Counsel on the above subject.

You will note that, for the present, and until further notice, the Board will waive compliance with that provision of Section IV(b) of Regulation A which provides that in applying for the rediscount of promissory notes, "The member bank shall certify in its application whether the note offered for discount has been discounted for a depositor other than a bank or for a nondepositor and, if discounted for a bank, whether for a member or nonmember bank"; provided, that the application for rediscount shall require member banks to designate which paper offered for rediscount, if any, was acquired from nonmember banks and shall contain a certificate that none of the paper offered for rediscount except that so designated was acquired from a nonmember bank.

The Board is considering the advisability of amending the above provision of its Regulation A in accordance with the suggestion contained in the memorandum of the Board's General Counsel; but, before taking any definite action on the subject, it desires to have the matter discussed at the next Governors' Conference with a view of determining whether there is any practical reason why member banks should be required to specify on applications for rediscount the persons from whom they acquired the paper offered for rediscount, except in the case of paper acquired from nonmember banks. This subject, therefore, will be made a topic for discussion at the next Governors' Conference.

Very truly yours,

Walter L. Eddy,
Secretary.

TO ALL GOVERNORS.

Enclosure:

(C O P Y)

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X-4544-a

February 24, 1926.

Mr. J. U. Calkins, Governor,
Federal Reserve Bank of San Francisco,
San Francisco, California.

Dear Governor Calkins:

The Board has carefully considered your letter of December 22nd and the enclosed memorandum by Deputy Governor Clerk, and has voted that, for the present and until further notice, it will waive compliance with that provision of Section IV(b) of Regulation A which provides that in applying for the rediscount of promissory notes, "The member bank shall certify in its application whether the note offered for discount has been discounted for a depositor other than a bank or for a nondepositor and, if discounted for a bank, whether for a member or a nonmember bank"; provided, that the application for rediscount shall require member banks to designate which paper offered for rediscount, if any, was acquired from nonmember banks and shall contain a certificate that none of the paper offered for rediscount except that so designated was acquired from a nonmember bank.

The Board is considering the advisability of amending this portion of its regulations; but in view of the fact that the practical situation in other Federal reserve districts may be different from that in your district as described by Mr. Clerk's memorandum, the Board will defer any action on a definite amendment to its regulations until after the matter has been discussed at the Governors' Conference.

Very truly yours,

Edmund Platt
Vice Governor.

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OFFICE CORRESPONDENCE

Federal Reserve
BoardDate February 16, 1926To The Federal Reserve Board
From Mr. Wyatt - General CounselSubject: Designation on applications for
rediscount of the party from whom the
member bank acquired the paper offered
for rediscount.

The attached letter from Governor Calkins requests the Board's permission to discontinue the practice of requiring member banks to designate on their applications for rediscount the parties from whom such member banks acquired the paper offered for rediscount, except in cases where the paper was acquired from nonmember banks.

Section IV(b) of Regulation A, which pertains to the rediscount by member banks of promissory notes, provides that, "The member banks shall certify on its application (for rediscount) whether the note offered for discount has been discounted for a depositor other than a member bank or for a non-depositor and, if discounted for a bank, whether for a member or a non-member bank". Governor Calkins' request, therefore, is in effect that the Board waive this requirement of its Regulation A except that part of it which requires member banks to designate which paper was acquired from nonmember banks.

RECOMMENDATION.

I respectfully recommend that:

- (1) Until further notice, the Board waive this requirement of its Regulation; provided that the application for rediscount requires member banks to designate which paper offered for rediscount, if any, was acquired from nonmember banks and contains a certificate that none of the paper offered for rediscount except that so designated was acquired from a nonmember bank.
- (2) That the Board make this subject a topic for discussion at the next Governors' Conference with a view of considering the desirability of an amendment to this portion of its Regulation; and
- (3) That a copy of this correspondence be sent to all Federal reserve banks for their information.

DISCUSSION.

This suggestion of Governor Calkins arose out of the decision of the Circuit Court of Appeals in the case of Idaho-Grimm Alfalfa Seed Growers Association v. Federal Reserve Bank of San Francisco, wherein the Court held in effect that if a member bank which is known by its officers to be insolvent receives commercial paper on deposit such action constitutes a fraud on the depositor and the bank acquires no title to such

paper; and if the member bank rediscounts such paper with a Federal reserve bank and the Federal reserve bank has knowledge of the insolvency of the member bank and also of the fact that the paper offered for rediscount was received on deposit by the member bank, the Federal reserve bank is charged with notice of the fraud and acquires no title to the paper and is, therefore, accountable to the depositor for the proceeds of the paper upon the insolvency of the member bank.

In that case the only evidence of the fact that the paper was received on deposit was that such paper was designated by the letter "D" on the application for rediscount, which required member banks to designate "Depositor's Paper" by the letter "D". The court evidently construed this designation to mean that the paper was the property of the depositor or was received on deposit, whereas the designation was really intended to mean that the paper was acquired from a depositor as distinguished from paper acquired from non-depositors. Governor Calkins fears that this designation on the application for rediscount may be embarrassing in the future and may in other cases enable depositors to defeat the title of the Federal reserve bank to paper acquired under such circumstances. Hence his recommendation.

Governor Calkins encloses a memorandum on this subject from Deputy Governor Clerk which contains the following statement:

"In our revised form of application for discount, we have used the following terms to designate the source from which paper is received:

Write "D" for paper title to which has been acquired from a depositor.

Write "P" for paper purchased without endorsement or guaranty of seller.

Write "R" for paper title to which has been acquired from another member bank.

Write "N" for paper title to which has been acquired from a nonmember bank.

Although we feel that these designations fully clear the title to a bill accepted under discount, item "D" is susceptible to the interpretation that a deposit is created by the discount of the bill by the offering bank, and subjects us to the claim that we thereby were placed on notice that the bank discounting the paper with the Federal Reserve Bank was receiving deposits at a time when its condition was such as to constitute the receipt of deposits a fraud on the depositor."

I think the revised form is a great improvement over the one formerly used by the San Francisco Bank, since it is much clearer and eliminates the use of the possessive expression "Depositors' Paper". In view of the fact that paper discounted for a depositor is usually credited to his account as a deposit, and is, in effect, received on deposit, however, I fear that even the designation contained in the new form might be held by the courts to justify a jury in finding that the Federal reserve bank had knowledge of the fact that such paper was received on deposit. I believe, therefore, it would be desirable to eliminate all of these designations except the designation of paper acquired from nonmember banks, unless there is some important practical reason why this should not be done.

I do not know of any practical reason why member banks should be required by the Board's regulations to specify on applications for rediscount the person from whom they acquired the paper offered for rediscount, except in the case of paper acquired from nonmember banks; and I am unable to find in the files of the Board anything which will throw any light on the reason for the above quoted requirement, which has been in the Board's regulations since 1915.

On this point Mr. Clerk says:

"The primary purpose of designating the source from which paper is acquired is to inform the Federal Reserve Bank whether the member bank is using the facilities of the Federal Reserve Bank to accommodate nondepositors or nonmember banks, etc. In the early stages of the organization of the Federal Reserve Bank, this form of designation may have been very essential but today we are so intimately in touch with the affairs of our member banks that if a bank is borrowing to any considerable extent it is not difficult for us to detect whether it is using its credit to grant accommodations to nondepositors even though it uses only depositor's paper for discount purposes. Moreover, every bill offered for discount is supported by a financial statement of the borrower and such supplemental information which clearly would show whether or not the borrower was a regular customer of the bank."

If Mr. Clerk is correct as to the original reason for this requirement and the lack of practical necessity for it now, I see no reason why this requirement of the Board's regulations should not be eliminated altogether and a requirement substituted that member banks shall designate which paper offered for rediscount has been acquired from nonmember banks and shall certify that none of the paper offered for rediscount except that so designated

was acquired from nonmember banks. I hesitate to recommend that the regulations be amended in this respect, however, until the subject has been considered more thoroughly and the Board has been thoroughly convinced that there is no practical value in the existing requirement of its regulation on this subject. While Mr. Clerk may be entirely right as to the practical situation in his District, the situation in other Districts may be materially different. Hence my recommendation that the matter be discussed at the next Governors' Conference.

In this connection I desire to suggest that the substance of the Board's ruling in the Federal Reserve Bulletin with reference to the rediscount of paper acquired from nonmember banks should be incorporated in Regulation A. If the McFadden Bill becomes a law, however, it will be necessary for the Board to get out a complete new edition of its regulations, and I do not believe the Board should at this time attempt to make any piece-meal amendments to its regulations.

The above mentioned requirement of the Board's regulations is not contained in the law, but is merely a matter of regulation which the Board can waive if it so desires. I believe, therefore, that the situation discussed by Governor Calkins will be sufficiently met for the present if the Board adopts the recommendations which I have made above.

I respectfully submit herewith a proposed draft of a letter to Governor Calkins.

Respectfully,

(Signed) Walter Wyatt,

Walter Wyatt,
General Counsel.

Letter attached

(COPY)

X-4544-c

FEDERAL RESERVE BANK
OF SAN FRANCISCO.

December 22, 1925.

Federal Reserve Board,
Washington, D.C.

Dear Sirs:

We recently sent to the Board's Counsel, Mr. Wyatt, copy of briefs, petitions for rehearing and all pleadings in the action of Idaho Grimm Alfalfa Seed Growers' Association vs. Federal Reserve Bank of San Francisco.

You will recall that one of the points at issue was that the Federal Reserve Bank was on notice that the bill submitted for discount was not the property of the discounting member bank, because the application specifically stated that it was depositor's paper, the use of the possessive implying that the paper belonged to the depositor and not to the bank.

There is attached a memorandum prepared by Deputy Governor Clerk, and it would be appreciated if the Board would inform us whether or not we may follow the suggestion contained therein and require the member banks to use in their applications for discount merely the designation

"N" indicating that the title to the paper had been acquired from a non-member bank.

As we desire to recall the outstanding stock of applications for discount now held by discounting member banks and distribute a revised form, it will be appreciated if the Board will telegraph us whether or not we may make the change recommended.

Yours very truly,

(Signed) Jno.U.Calkins

Governor.

December 22, 1925.

MEMORANDUM TO MR. CALKINS

FROM MR. CLERK.

Federal Reserve Board Regulation A, Series of 1924, Section IV, B, provides as follows:

"The member bank shall certify in its application whether the note offered for discount has been discounted for
a depositor other than a bank,
or for a non-depositor, and
if discounted for a bank, whether for a member or non-member bank."

As a consequence of the following paragraph of Regulation B, Series of 1915,

"Member banks shall certify in their letters of application for rediscount whether the paper offered for rediscount is depositor's or purchased paper, or paper rediscounted for other member banks," etc.,

which in effect is practically the same as the 1924 Regulation, the Federal Reserve Banks quite generally designate, in their applications for discount, paper acquired from a customer as "depositor's paper." Your attention is drawn to the use of the possessive.

In the case of Idaho Grimm Alfalfa Seed Growers' Association vs. Federal Reserve Bank of San Francisco, plaintiff claimed that the Federal Reserve Bank of San Francisco had no title to a certain negotiable draft secured by bill-of-lading because the member bank offering the bill for discount to the Federal Reserve Bank designated in its application that the bill was depositor's paper. Although our Counsel attempted to show that the designation was intended to mean the source from which title to the paper was acquired, the Court was persistent in its ruling that the use of the possessive settled the question that the bill-of-lading draft belonged to a depositor of the bank and that the Federal Reserve Bank took it with knowledge thereof.

In our revised form of application for discount, we have used the following terms to designate the source from which paper is received:

- Write "D" for paper title to which has been acquired from a depositor
- Write "P" for paper purchased without endorsement or guaranty of seller
- Write "R" for paper title to which has been acquired from another memberbank
- Write "N" for paper title to which has been acquired from a non-member bank.

Although we feel that these designations fully clear the title to a bill accepted under discount, item "D" is susceptible to the interpretation that

a deposit is created by the discount of the bill by the offering bank, and subjects us to the claim that we thereby were placed on notice that the bank discounting the paper with the Federal Reserve Bank was receiving deposits at a time when its condition was such as to constitute the receipt of deposits a fraud on the depositor.

The primary purpose of designating the source from which paper is acquired is to inform the Federal Reserve Bank whether the member bank is using the facilities of the Federal Reserve Bank to accommodate non-depositors or non-member banks, etc. In the early stages of the organization of the Federal Reserve Bank, this form of designation may have been very essential but today we are so intimately in touch with the affairs of our member banks that if a bank is borrowing to any considerable extent it is not difficult for us to detect whether it is using its credit to grant accommodations to non-depositors even though it uses only depositor's paper for discount purposes. Moreover, every bill offered for discount is supported by a financial statement of the borrower and such supplemental information which clearly would show whether or not the borrower was a regular customer of the bank.

Would it not be desirable to suggest to the Board that we be permitted to discontinue these designations except

"N" for paper title to which has been acquired from a non-member bank?

The only reason this one designation is suggested is so that a Federal Reserve Bank would not discount paper actually acquired from a non-member bank without its knowledge.

Respectfully submitted,

(Signed) Ira Clerk

Deputy Governor.