X-4560

March 12, 1926.

SUBJECT: Additional Topic for Governors' Conference.

Dear Sir:

The Board has voted to place upon the program of the forthcoming Conference of Governors for their consideration certain questions which have arisen with regard to the Board's recent ruling upon the eligibility for rediscount of notes of a corporation representing borrowings of funds to be advanced to subsidiaries, which was contained in the Board's letter of December 30 (X-4484). These questions are discussed in a letter from Governor Fancher and in a memorandum from Counsel to the Board, both of which are enclosed herewith for your information in this matter.

Yours very truly,

Walter L. Eddy,
Secretary.

(Enclosures)

TO GOVERNORS OF ALL F. R. BANKS.

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March 10, 1926.

To The Federal Reserve Board.

From Mr. Wyatt - General Counsel.

SUBJECT: Eligibility for rediscount of notes of corporation representing borrowings of funds to be advanced to subsidiaries.

The attached letter from Governor Fancher raises a further question with reference to the above subject which was ruled on in the Board's circular letter of December 30, 1925, (X-4484).

In a letter dated November 28, 1925, Mr. Thomas P. Beal, President of the Second National Bank of Boston, called the Board's attention to the fact that, because of a recent change in the method of financing the business of the M. A. Hanna Company and its subsidiaries, the paper of the Hanna Company has recently been declared ineligible for rediscount by the Federal Reserve Banks of Cleveland and Boston. It appeared that the former practice of the Hanna Company had been to make loans to its subsidiaries taking the notes of the subsidiaries which were then endorsed by the Hanna Company and discounted at various banks. Such notes were considered eligible for rediscount when the proceeds were used by the subsidiaries in the first instance for agricultural, industrial or commercial purposes. Believing it to be a better form of financing, however, the Hanna Company had recently inaugurated a new system whereby it borrows on its own notes backed by the consolidated financial statement of the Hanna Company and all of its subsidiaries, and from the funds thus obtained the Hanna Company makes advances to its subsidiaries. These notes of the Hanna Company had been held to be ineligible because Section II(a) and (b) of Regulation A provides that, in order for notes, drafts and bills of exchange to be eligible for rediscount the proceeds must be used "in the first instance" for an eligible purpose and must not be "advanced or loaned to some other borrower". This provision of Regulation A is based upon long established and well recognized rulings of the Board which have always been deemed of fundamental importance.

Mr. Beal's letter was discussed at an informal meeting of the Board held in Governor Crissinger's office on December 1st, 1925, at which Governors Harding, Strong and Fancher were present. The business of the Hanna Company was discussed at some length and it was the understanding of all those present that the Hanna Company made no advances except to its own subsidiaries and that the subsidiaries borrowed no money except from the Hanna Company. On the basis of the assumed facts, it was agreed that the Hanna Company and its subsidiaries could be considered together as a single borrower and that the above quoted provisions of the Board's Regulation A pertaining to "finance paper" could be interpreted as not applying to a case of this kind. With this understanding,

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I left the meeting and immediately prepared a ruling on the subject and submitted it to the Board on the same day. This ruling, which was approved at the Board meeting on December 14, was to the effect that where a parent corporation owns at least 75 per cent of the stock of each of a number of subsidiary corporations the notes of such parent corporation the proceeds of which have been advanced or loaned to its subsidiary corporations will not be considered finance paper within the meaning of the Board's regulations: provided that (1) the parent corporation makes no advances except to its own subsidiaries, (2) the subsidiaries borrow no money except from the parent corporation, and (3) the proceeds of such advances have been or are to be used by the subsidiary corporation for an industrial, commercial or agricultural purpose, within the meaning of the Federal Reserve Act and the Board's regulations. It is understood, of course, that in order to be eligible for rediscount such paper must also comply in all other respects with the requirements of the law and the Board's regulations.

The ruling was later incorporated in a circular letter (X-4484) approved at Board meeting on December 29th and sent to all Federal reserve banks under date of December 30th which stated the fundamental basis for the ruling as follows:

> "The Board has heretofore published several rulings to the effect that paper representing borrowings by one person, firm or corporation of funds to be advanced to an independent person, firm, or corporation, is 'finance paper' and is therefore ineligible for rediscount; and this ruling is not intended as a reversal or qualification of those rulings. There is a clear distinction, however, between cases such as those covered in the rulings above mentioned and the case here presented; because, where the borrower is a parent corporation and makes advances only to subsidiary corporations owned by it, the parent corporation and the subsidiaries are in practical effect one single organization and may with propriety be viewed as a single borrower."

It now develops, however, that the M. A. Hanna Company does not confine its advances to its own subsidiaries in which it owns 75% of the stock, but makes advances to some corporations in which it owns only a minority of the stock and to some other corporations in which it owns no stock but for which it merely acts as a factor or commission merchant. This being the fact, it is clear that the Board's ruling (X-4484) is not applicable to such paper of the Hanna Company, nor do I believe that the Board could amend the ruling in such a way as to make it applicable to such paper without practically abrogating in toto the ruling against finance paper.

Governor Fancher suggests that the first condition mentioned in the Board's ruling - i..e., that the parent corporation shall make no advances except to its own subsidiaries, be eliminated from the ruling; but if this were done the fun-

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damental principle upon which that ruling was based would be eliminated and there would be no basis for the distinction between the circumstances covered by that ruling and circumstances of numerous other cases where the Board has held certain paper to be "finance paper" and, therefore, ineligible.

I am unable to recommend, therefore, that the Board attempt to amend the above mentioned ruling in such a way as to apply to the paper of the Hanna Company in the light of the facts which have developed since that ruling was made; and I can see no way in which the Board can go any further in declaring such paper to be eligible, unless it desires to abrogate entirely the ruling regarding finance paper.

I believe that the rulings heretofore made by the Board regarding finance paper are sound and reasonable constructions of the Federal Reserve Act and are calculated fairly to carry out the purpose and intent of those portions of Section 13 which define the classes of paper eligible for rediscount at Federal reserve banks.

The requirement that the proceeds of paper offered for rediscount must have been used in the first instance for an agricultural, industrial or commercial purpose, however, is not absolutely required by a strict technical construction of the language of the act; and it is conceivable that the Board might abolish that requirement if it so desires. That requirement, however, has always been considered one of fundamental importance and has long been in effect; and I believe it would be unwise to go any further in the direction of letting down the bars with respect to finance paper without first having a thorough study made of the practical effects of such a ruling and having the matter thoroughly discussed by the Governors of all Federal reserve banks at a Governors' Conference.

If, therefore, the Board is inclined to further liberalize its rulings with respect to finance paper in order to be of further assistance to the Hanna Company and other corporations similarly situated, I respectfully recommend that the Board place this subject on the program for discussion at the next Governors' Conference and send out to the Governors of all Federal reserve banks complete copies of the attached file at the earliest possible date, in order that each Governor may study the subject and come to the Conference prepared to discuss the matter and make a well considered recommendation to the Board.

Respectfully,

Walter Wyatt
General Counsel.

WW.OMC
File attached.

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FEDERAL RESERVE BANK
OF CLEVELAND

176

February 10, 1926.

Mr. D. R. Crissinger, Governor,
Federal Reserve Board,
Washington, D. C.

Dear Mr. Crissinger:

The M. A. Hanna Company of Cleveland, which company carries accounts with and borrows from some of our local member banks as well as some member banks in other districts, has taken up with us the question of the eligibility for rediscount of their paper.

It happens that this is the company in connection with which the recent ruling of the Federal Reserve Board (letter X-4484 dated December 30, 1925. Subject: Eligibility for Rediscount of Notes of Corporation Representing Borrowings of Funds to be Advanced to Subsidiaries) was made. This ruling set up the following conditions:

> Where the parent company owns at least seventy-five percent of the stock of each of a number of subsidiary corporations, the notes of such parent corporation, the proceeds of which have been advanced or loaned to its subsidiary corporations, will not be considered finance paper within the meaning of the Board's ruling; Provided, that -
>
> 1. The parent corporation makes no advances except those to its own subsidiaries;
>
> 2. The subsidiaries borrow no money except from the parent corporation;
>
> 3. The proceeds of such advances have been or are to be used by the subsidiary corporation for an industrial, commercial, or agricultural purpose within the meaning of the Federal Reserve Act and the Board's regulations.

These conditions can be met by the company in question, with the exception of No. 1, which (for reasons outlined later in this letter) cannot be met and which appear to the company to warrant further consideration by the Federal Reserve Board.

The company owns one hundred percent of the stock of nine different companies operating as miners and shippers of coal and ore and operators of docks and ships. They also own seventy-nine percent of the stock of a furnace company; seventy-nine percent of the stock of a coke company; eighty percent of the stock of a coal and dock company;

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and in addition to this, from forty-three to sixty-seven percent of the stock of seven different companies. These seven companies are coal and ore mining companies, manufacturers of by-products, iron companies and transportation companies.

Along with these operations, the M. A. Hanna Company acts as selling agent for ore mining companies and furnace operators, and it is in this capacity that the company at certain seasons finds it necessary to make advances for the stripping and mining of ore to be sold by the company when the shipping season is opened and for the production and carrying of pig iron during slack seasons or pending orderly marketing.

Their banks prefer that the obligations for borrowed money be represented by notes of the M. A. Hanna Company and that that company only should do the borrowing for the various operations of this company and its affiliated companies.

The consolidated statement of the company, as of December 31, 1925, would show current assets of approximately $15,000,000 of which approximately $2,150,000 is advances made to companies other than those in which they own seventy-five percent or more of the stock. Their current liabilities are approximately $4,600,000. It appears that it is not possible for this company to segregate their borrowings or earmark them to any particular one of their various operations but that their borrowings are necessarily a part of their general operations as outlined above.

As we understand it, these advances are not in the nature of loans to another party evidenced by notes or other paper but are in fact advances carried in separate accounts and are eventually settled through delivery of goods or commodities to this company or to customers to whom this company sells.

If another company without subsidiaries or affiliated companies were engaged in the same kind of operations, showing a similar condition of liquidity and strength, the paper of such company would hardly be considered ineligible merely because the company showed in their statement advances made to others, but provision No. 1 of the Federal Reserve Board's ruling in letter X-4484 at least appears to preclude the eligibility of the paper of the M. A. Hanna Company.

Under the circumstances, would the fact that the company is making advances other than those outlined in No. 1 of the Board's ruling preclude the eligibility of their paper under Regulation A, Section rr, which in effect states that the proceeds must have been used or borrowed to be used in the first instance in producing, purchasing, carrying, etc., and (b) that it must not be a note, draft, or bill of exchange, the proceeds of which have been or are to be advanced or loaned to some other borrower, etc.?

Very truly yours,
(signed) E. R. Fancher,
Governor.

P.S. The company in question has submitted to us tentatively separate statements of their own company and all of its subsidiary or affiliated companies.

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