X-6260

COPY

March 7, 1929.

TO: The Federal Reserve Board

FROM: Mr. Wyatt, General Counsel.

SUBJECT: Power of Board to enforce principles regarding proper use of credit facilities of Federal Reserve System laid down in Board's letter of February 2, 1929.

C O N F I D E N T I A L

At the Board meeting on March 5th, I was requested "To report as to what powers the Board has under the Federal Reserve Act for the enforcement, should it become necessary, of the principles regarding the proper use of the credit facilities of the Federal Reserve System, laid down in the Board's letter of February 2nd to all Federal reserve banks."

The following paragraphs of the Board's letter contain the statement of principles referred to:

> "The Federal Reserve Act does not, in the opinion of the Federal Reserve Board, contemplate the use of the resources of the Federal reserve banks for the creation or extension of speculative credit. A member bank is not within its reasonable claims for rediscount facilities at its Federal reserve bank when it borrows either for the purpose of making speculative loans or for the purpose of maintaining speculative loans.
>
> "The Board has no disposition to assume authority to interfere with the loan practices of member banks so long as they do not involve the Federal reserve banks. It has, however, a grave responsibility whenever there is evidence that member banks are maintaining speculative security loans with the aid of Federal reserve credit. When such is the case the Federal reserve bank becomes either a contributing or a sustaining factor in the current volume of speculative security credit. This is not in harmony with the intent of the Federal Reserve Act nor is it conducive to the wholesome operation of the banking and credit system of the country."

It would appear, therefore, that the Board desires to be informed as to the powers which it has under the Federal Reserve Act which could

be used to prevent member banks from using Federal reserve credit for the purpose of making or maintaining speculative security loans.

In view of the further remarks contained in the press statement issued by the Board under date of February 5th (X-6233) and published on page 93 of the Federal Reserve Bulletin for February, 1929, to the effect that, "the great and growing volume of speculative credit has already produced some strain, which has reflected itself in advances of from 1 to 1½ per cent in the cost of credit for commercial use," I assume that the Board does not wish to know what powers it might exercise with a view of tightening the general credit situation, such as the power to increase the rediscount rates or further restrict the volume of open market investments of the Federal reserve banks.

With this understanding, I shall endeavor to point out certain powers which the Board possesses under the Federal Reserve Act and which might be exercised with a view of accomplishing the above purposes. In suggesting these powers, however, it is my intention merely to inform the Federal Reserve Board of its lawful rights; and the mention of these rights is not intended as a suggestion that they should be exercised. The question whether these rights ought to be exercised is a question of policy on which I intend to express no opinion.-

OPINION.

(1) Under Section 13 of the Federal Reserve Act, the Board has ample power to prescribe such restrictions, limitations and regu-

lations governing the rediscount of notes, drafts, bills of exchange and bankers' acceptances, the making of advances to member banks on their promissory notes, and the purchase of bills of exchange, bankers' acceptances and government, State, and municipal securities (including purchases under so-called repurchase agreements), as may be necessary to prevent member banks from using the credit resources of the Federal Reserve System for the purpose of making or maintaining speculative security loans.

(2) Thus, the Board could, if it deems it advisable, prescribe a regulation forbidding any Federal reserve bank to rediscount any paper for, make any loan or advance to, or purchase any bills of exchange, bankers' acceptances, or government, State, or municipal securities (under repurchase agreements or otherwise) from, any member bank which at the time: (1) Has loans outstanding to brokers or dealers in stocks, bonds or other investment securities; or (2) has unreasonably large amounts of speculative loans outstanding to customers secured by stocks, bonds, or other investment securities, or the proceeds of which have been or are to be used for the purpose of carrying or trading in stocks, bonds, or other investment securities.

(3) The Board has ample power to enforce such a regulation by suspending or removing from office the officers and directors of any Federal reserve bank which violates it.

(4) The Board has no independent power under Section 4 of the Federal Reserve Act to issue orders restricting or qualifying the right of member banks to demand of their Federal reserve banks "such discounts, advancements, and accommodations as may be safely and

reasonably made with due regard for the claims and demands of other member banks".

(5) This right of member banks, however, is expressly made subject to the exercise of such powers as the Federal Reserve Board has under other provisions of the Federal Reserve Act, including the power under Section 13 to prescribe restrictions, limitations and regulations governing the discount and rediscount and the purchase and sale by any Federal reserve bank of any bills receivable and of domestic and foreign bills of exchange and of acceptances; and the Board could order a Federal reserve bank to cease violations of any such restrictions, limitations or regulations which it may have prescribed.

(6) The Board could, if it so desires, prescribe a special rate (higher than the rediscount rate on industrial, commercial or agricultural paper) for advances to member banks on their promissory notes secured by bonds or notes of the Government of the United States.

DISCUSSION

I.

Section 13 of the Federal Reserve Act contains the following provision:

> "The discount and rediscount and the purchase and sale by any Federal reserve bank of any bills receivable and of domestic and foreign bills of exchange, and of acceptances authorized by this Act, shall be subject to such restrictions, limitations, and regulations as may be imposed by the Federal Reserve Board."

This, in my opinion, confers upon the Federal Reserve Board ample power to prescribe such restrictions, limitations and regulations governing the rediscount of notes, drafts and bills of exchange

by Federal reserve banks, the making of advancements by Federal reserve banks to member banks on the promissory notes of such member banks, and the purchase and sale of bankers' acceptances, bills of exchange, and Government, State and municipal securities under Section 14 (including the purchase of such bills, acceptances, and securities under repurchase agreements) as may be necessary to prevent member banks from using the credit resources of the Federal Reserve System for the purpose of making or maintaining speculative loans.

The above quoted provision of Section 13 has heretofore been considered by this office and it has been found that it applies not only to rediscounts under Section 13 but also to purchases and sales at home or abroad under Section 14. (See my opinion of October 20, 1927 (X-4980), pages 5 and 6, a copy of which is attached hereto.) It also applies to the making of advances to member banks on their promissory notes under the seventh paragraph of Section 13 (See opinion of Mr. Vest dated June 21, 1928, (X-6124-a), a copy of which is attached hereto.

The question might be raised whether this paragraph pertains to the rediscount of notes and "drafts" as well as bills of exchange and bankers' acceptances, but it is clear that notes and "drafts" are included in the term "bills receivable". That term has been held by the courts to include promissory notes, bills of exchange or other instruments for the payment of money. (See Words and Phrases, Bouvier's Law Dictionary, and authorities cited therein.)

The term "bills receivable" would seem to apply also to bonds and notes of the United States and bills, notes, revenue bonds and warrants issued by States, counties, districts, political subdivisions and municipalities; since all such obligations are "instruments for the

payment of money". Even if the above-quoted paragraph in Section 13 does not apply to these classes of securities, however, the Board has ample power under Section 14(b) to prescribe rules and regulations governing the purchase of such securities.

The Board has power, therefore, to prescribe rules and regulations governing practically every method by which a member bank obtains credit accommodations from a Federal reserve bank, including not only the rediscount of notes, drafts, bills of exchange and bankers' acceptances, but also borrowings by member banks from Federal reserve banks on the promissory notes of such member banks and sales of bills of exchange, bankers' acceptances and Government and municipal securities to Federal reserve banks under Section 14, including sales under so-called "repurchase agreements".

The exercise of all these powers is by the above quoted paragraph of Section 13 made subject to "such restrictions, limitations and regulations as may be imposed by the Federal Reserve Board." There is no limitation in the law on the character of restrictions, limitations and regulations which the Board may prescribe; and the matter is left to the discretion of the Federal Reserve Board, subject only to the usual qualification that the restrictions, limitations

and regulations prescribed by the Board must not be in conflict with other provisions of the Federal Reserve Act and must not be arbitrary, capricious or unreasonable. Any restriction, limitation, or regulation which is reasonably calculated to carry out the purposes of the Federal Reserve Act and the policies which Congress had in mind when it enacted the Federal Reserve Act would clearly be reasonable and within the Board's power.

Certain of these purposes and policies were summarized as follows on page 33 of the Board's Annual Report for the year 1923:

> "The Federal reserve act has laid down as the broad principle for the guidance of the Federal reserve banks and of the Federal Reserve Board in the discharge of their functions with respect to the administration of the credit facilities of the Federal reserve banks the principle of 'accommodating commerce and business.' (Sec. 14 of the Federal reserve act, par.(d).) The act goes further. It gives a further indication of the meaning of the broad principle of accommodating commerce and business. These further guides are to be found in section 13 of the Federal reserve act, where the purposes for which Federal reserve credit may be provided are described as 'agricultural, industrial, or commercial purposes'. It is clear that the accommodation of commerce and business contemplated as providing the proper occasion for the use of the credit facilities of the Federal reserve banks means the accommodation of agriculture, industry, and trade. The extension of credit for purposes 'covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States,' is not permitted by the Federal reserve act. The Federal reserve system is a system of productive credit. It is not a system of credit for either investment or speculative purposes. Credit in the service of agriculture, industry, and trade may be described comprehensively as credit for productive use. <u>The exclusion of the use of Federal reserve credit for speculative and investment purposes and its limitation to agricultural, industrial, or commercial purposes thus clearly indicates the nature of the tests which are appropriate as guides in the extension of Federal reserve credit</u>.

"They clearly describe the nature or character of the purposes for which such credit and currency may be extended. The qualitative tests appropriate in Federal reserve bank credit administration laid down by the act are, therefore, definite and ample."

That this is an accurate statement of certain of the purposes which Congress had in mind when it enacted the Federal Reserve Act can be conclusively demonstrated by a review of the legislative history of the Act.

After defining the character of paper which is eligible for rediscount at Federal reserve banks, Section 13 provides that:

"Such definition shall not include notes, drafts or bills covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds or other investment securities, except bonds and notes of the Government of the United States."

The policy of this provision is indicated by the following passages from the report of the Committee on Banking and Currency of the House of Representatives on the original Federal Reserve Act (H.R. Report No. 69, 63rd Congress, 1st Session, pages 11, 19, 20, 48, 59, 62 and 63):

ESSENTIAL FEATURES OF REFORM.

"The other plans before the committee or examined by it have likewise been found unsatisfactory-some for reasons analogous to those which made the Aldrich bill unacceptable, others because of defective detail, erroneous principle, or faulty construction. An effort was, however, made to ascertain the constituent elements of these measures and of the Aldrich bill, common to all, which should be recognized and provided for in any new plan because representing the fundamentals of legislation. It is believed that these are as follows:

"1. Establishment of a more nearly uniform rate of discount throughout the United States, and thereby the furnishing of a certain kind of preventive against over expansion of credit which should be similar in all parts of the country.

"2. General economy of reserves in order that such reserves might be held ready for use in protecting the banks of any section of the country and for enabling them to go on meeting their obligations instead of suspending payments, as so often in the past.

"3. Furnishing of an elastic currency by the abolition of the existing bond-secured note issue in whole or in part, and the substitution of a freely issued and adequately protected system of bank notes which should be available to all institutions which had the proper class of paper for presentation.

"4. Management and commercial use of the funds of the Government which are now isolated in the Treasury and subtreasuries in large amounts.

"5. General supervision of the banking business and furnishing of stringent and careful oversight.

"6. Creation of market for commercial paper.

"Other objects are sought, incidentally, in these plans, but they are not as basic as the chief purposes thus enumerated.

* * * *

"TRANSFER OF RESERVES.

"Reference has been briefly made to the fact that the committee's proposals provide for the transfer of bank reserves from existing banks which hold them for others to the proposed reserve banks. At present the national banking act recognizes three systems of reserves:

* * * *

"The original reason for creating this so-called 'pyramidal' system of reserves was that inasmuch as central banking institutions were absent, and inasmuch as banks outside of centers were obliged to keep exchange funds on deposit with other banks in such centers, it was fair to allow exchange balances with such centrally located banks to count as reserves inasmuch as they were presumably at all times available in cash. * * * * As matters have developed, it has been vicious in the extreme. Coupled with the inelasticity of the bank currency, the system has tended to create periodical stringencies and periodical plethoras of funds. Banks in the country districts unable to withdraw notes and contract credit when they have seen fit to do so, because of the rigidity of the bond-secured currency, have redeposited such funds with other banks in reserve and central reserve cities and have thus built up the balances which they were entitled to keep there as a part of their reserves. Moreover,

"the practice of thus redepositing funds having been once established, it has been carried to extreme lengths, and at times has been decidedly injurious in its influence. The payment of interest on deposits by banks in the centers has been used for the purpose of attracting to such banks funds which otherwise would have gone to other centers or to other banks in the same centers or which would have been retained at home. The funds thus redeposited, even when not attracted by any artificial means, have of course constituted a demand liability, and have been so regarded by the banks to which they were intrusted.

"In consequence, such banks have sought to find the most profitable means of employment for their resources and at the same time to have them in such condition as would permit their prompt realization when demanded by the depositing banks which put them there. The result has been an effort on the part of the national banks, particularly in central reserve cities, to dispose of a substantial portion of their funds in call loans protected by stock-exchange collateral as a rule. This was on the theory that, inasmuch as listed stock-exchange securities could be readily sold, call loans of this type were for practical purposes equivalent to cash in hand. The theory is of course close enough to the facts when an effort to realize is made by only one or few banks, but is entirely erroneous whenever the attempt to withdraw deposits is made by a number of banks simultaneously. At such times, the banks in central reserve and reserve cities are wholly unable to meet the demands that are brought to bear on them by country banks; and the latter, realizing the difficulties of the case, seek to protect themselves by an unnecessary accumulation of cash which they draw from their correspondents, thereby weakening the latter and frequently strengthening themselves to an undue degree. Under such circumstances the reserves of the country, which ought to constitute a readily available homogeneous fund, ready for use in any direction where sudden necessities may develop, are in fact scattered and entirely lose their efficiency and strength owing to their being diffused through a great number of institutions in relatively small amount and thereby rendered nearly unavailable. This evil has been met in times past by the suspension of specie payments by banks and by the substitution of unauthorized and extra-legal substitutes for currency in the form of cashiers' checks, clearing-house certificates and other methods of furnishing a medium of exchange. Needless to say such a method of meeting the evilisthe worst kind of makeshift and is only somewhat better than actual disaster.

"HOLDING OF FUNDS.

"The committee believes that the only way to correct this condition of affairs is to provide for the holding of reserves by duly qualified institutions which shall act primarily in the public interest and whose motives and conduct shall be so absolutely well known and above suspicion as to inspire unquestioning confidence on the part of the community. It believes

"that the reserve banks which it proposes to provide for will afford such a type of institutions and that they may be made the effective means for the holding of the liquid reserve funds of the country to the extent that the latter are not needed in the vaults of the banks themselves. * * *

* * * * *

"Section 20 (i.e., section 19 of the Federal Reserve Act) seeks to readjust the reserve requirements now provided by the national banking act in such a way as to make them conform to the dictates of scientific banking, and to adjust them to the provisions of the proposed bill. The following main objects have been had in mind:

"1. To abolish entirely the present system of redeposited or 'pyramided' reserves.

"2. To establish a moderate required reserve actually to be held in cash in the vaults of the banks.

"3. To prescribe a secondary reserve to take the form of a credit with the Federal reserve banks.

* * * * *

"In outlining the general philosophy of the proposed banking bill it was pointed out that the existing system of redeposited reserves gives rise to cheap money for stock-exchange speculation in the centers while it fails to provide in times of panic a reserve upon which the country can draw with assurance, because at such times stock-exchange securities can not be easily liquidated, so that call loans are unavailable as a resource, and the city banks in self-defense have deemed themselves warranted in suspending specie payments. It is contended, however, that these difficulties and irregularities of the existing system are mere blemishes upon the surface of an otherwise desirable state of affairs, and that there is good and sufficient economic reason for maintaining the present system of redeposited reserves at least in part. This claim may be reduced to a series of propositions as follows:

"1. The redeposited reserves are placed with the city banks not for stock speculation, but in large measure at least to supply exchange funds upon which the depositing banks may draw.

"2. The redeposited balances must be kept with the banks which now hold them, because the country banks look to these city banks for accommodation and the latter gauge the amount of accommodation to be granted them by the size of the balances.

"3. The country banks, and in general all banks making the redeposits get a rate of interest thereon. They are thus able to make use of a reserve which would otherwise be 'dead,' and which when held in cash or in the Federal reserve banks will yield them no revenue, the latter banks being forbidden by the terms of the bill to pay interest on deposits.

"These contentions are worthy of careful study, because they are widely urged.

* * * * *

"The second point already noted has even less force than the first. Not only does the proposed bill provide more extensive facilities for rediscount than have ever been known, but even if it didnot do so, and even if, as alleged, there are many kinds and classes of security not eligible for rediscount under the bill which country banks can use as a basis for accommodation only with city banks, it would still remain true that this does not afford any warrant for demanding the maintenance of the existing situation.* *

* * * * *

"* * In view of the great difficulty of defining 'commercial paper,' the actual definition of the same has been left to the Federal reserve board in order that it may adjust the definition to the practices prevailing in different parts of the country in regard to the transaction of business and the making of paper. For obvious reasons it is forbidden that any such paper shall be admitted to rediscount if made for the purpose of carrying stocks or bonds."

From this, it is perfectly clear that one of the fundamental purposes of the Federal Reserve Act was to prevent the bank reserves of the country from being tied up in speculative loans on stocks, bonds and other investment securities. It is obvious, therefore, that it would be entirely in accordance with the purposes of the Federal Reserve Act and the policy of Congress when it enacted the Federal Reserve Act if the Board should promulgate restrictions, limitations and regulations designed to prevent member banks of the Federal Reserve System from using the credit resources of the Federal Reserve System for the purpose of making

or maintaining loans, the proceeds of which are used for the purpose of carrying or trading in stocks, bonds or other investment securities.

It is true that the above-quoted provision of the Federal Reserve Act excluding loans of this character from the definition of eligible paper, does not itself prevent member banks from discounting eligible paper and using the proceeds to make loans on stocks, bonds and other investment securities; but it is equally clear that the broad powers of the Federal Reserve Board to prescribe restrictions, limitations and regulations governing the operations of Federal reserve banks were intended to enable the Board to meet just such contingencies and to prescribe such rules, regulations and restrictions as might be necessary to supplement the express provisions of the Act and more fully to carry out the broad purposes of the Act.

It has been argued that it is not inconsistent with the provisions of the FederalReserve Act for Federal reserve banks to make loans to, or to rediscount eligible paper for, member banks which at the time have surplus funds loaned to brokers or dealers in stocks, bonds and other investment securities; because it is impossible to trace the proceeds of any particular rediscount or advance to a member bank and show that the credit obtained from the Federal reserve bank is used for the purpose of making or obtaining such loans. While it may be true that this is not a technical violation of the Federal Reserve Act, it obviously is contrary to the policy of the Act, as indicated by the above quotations from the Committee report; and it clearly is within the Board's power to prescribe such rules, regulations and restrictions as may be nec-

essary to prevent any such evasion of the express provisions of the Act.

II.

One of the most direct, appropriate and effective powers which the Board could exercise for the enforcement of the principles laid down in its letter of February 2, 1929, therefore, would be to prescribe a regulation forbidding any Federal reserve bank to rediscount any paper for, or to make any loans or advances to, or to purchase any bills of exchange, bankers' acceptances or Government, State, or municipal securities (either outright or under repurchase agreements) from, any member bank which at the time: (1) Has loans outstanding to brokers or dealers in stocks, bonds or other investment securities; or (2) Has unreasonably large amounts of speculative loans outstanding to customers secured by stocks, bonds, or other investment securities, or the proceeds of which have been or are to be used for the purpose of carrying or trading in stocks, bonds, or other investment securities.

If the Board should decide to promulgate such a regulation, it probably would find it necessary, for practical reasons, to incorporate therein certain exceptions which would enable member banks embarrassed by sudden fluctuations in their reserves or their reserve requirements to obtain temporary accommodations at the Federal reserve bank until they could liquidate their investments in loans to brokers or dealers in stocks, bonds or other investment securities. However, exceptions to cover this practical difficulty can be devised; and, if the Board desires to promulgate such a regu-

lation, I believe that a thoroughly practical and workable regulation can be drawn.

III.

There can be no doubt that the Board has ample power to enforce such a regulation, or any other lawful regulation which it might prescribe; since Section 11 (f) of the Federal Reserve Act authorizes the Board,

> "To suspend or remove any officer or director of any Federal reserve bank, the cause of such removal to be forthwith communicated in writing by the Federal Reserve Board to the removed officer or director and to said bank".

This power to removal is subject only to the condition that the Board communicate the cuase of such removal in writing to the removed officer and to the Federal reserve bank. The cause of removal is not specified in the law but is left to the discretion of the Federal Reserve Board, the only limitation being that it must be reasonable and not capricious or arbitrary.

Clearly, the willful violation of a lawful regulation prescribed by the Federal Reserve Board would be a reasonable and valid cause for the removal of any officer or director of any Federal reserve bank.

The question has been raised whether, under the following provision of Section 4 of the Federal Reserve Act, the Federal Reserve Board has power to order a particular Federal reserve bank to cease or suspend the granting of any discounts, advancements or accommodations to a particular member bank.

> "Said board shall administer the affairs of said bank fairly and impartially and without discrimination in favor of or against any member bank or banks and shall, subject to the provisions of law and the orders of the Federal Reserve Board, extend to each member bank such discounts, advancements and accommodations as may be safely and reasonably made with due regard for the claims and demands of other member banks."

In view of the importance of this question, I have made a careful study of the legislative history of this paragraph of the Federal Reserve Act before undertaking to construe it. A complete statement of the legislative history of this paragraph, with lengthy quotations from the debates in Congress, has been prepared by this office and will be furnished to any member of the Board desiring to read it; but I believe that a brief statement of the situation and one or two quotations from the debates will be sufficient for the purposes of this opinion.

The above quoted paragraph was included in Section 4 of the Federal Reserve Act as originally enacted and has never been amended. It was not discussed in the reports on the original Federal Reserve Act either by the House Banking andCurrency Committee, by the Senate Committee, or by the conferees. This paragraph, however, was not contained in the

bill when it passed the House of Representatives, but was inserted in the bill by the Senate Committee on Banking & Currency as a compromise between various conflicting views.

It appears that certain Senators feared that the Federal reserve banks would come under the domination of the larger member banks and would discriminate against other member banks. It was feared that, through such discrimination, some member banks might be denied credit accommodations at the Federal reserve banks when it was badly needed in times of emergency; and, in order to prevent such discrimination, it was proposed to amend the bill so as to provide that, "Each member bank shall be entitled as a matter of right to the rediscount of eligible paper to the full amount of its capital stock upon the lowest current rate of discount." This was incorporated in an amendment proposed by Senator Hitchcock and was the subject of a bitter fight both in the committee and on the floor of the Senate.

It was felt, however, that such a provision would be absolutely contrary to accepted banking practices and would be extremely dangerous and unsound; and finally the above-quoted paragraph was inserted in the bill by the Senate Committee as a compromise. Senator Shafroth explained the matter as follows (Congressional Record for Dec. 13, 1913, Vol. 51, Part 1, page 859):

> Mr. SHAFROTH. "Mr. President, that clause was placed in that paragraph largely for the reason that the Hitchcock bill contained a provision for compulsory discounts, asserting that any member bank going with paper to a Federal reserve bank should be entitled, as

> a matter of right, which it could enforce perhaps by mandamus, to compel the Federal reserve bank to discount that paper. We thought that was too extreme a provision; it was thought wise that there might be conditions of the bank that would not justify the discounting of its paper. For that reason we put in a clause, which to a large extent is advisory to them, but which, nevertheless, indicates the policy that should be pursued by them in making these discounts where they fairly can."

It appears that this compromise was suggested by Senator Reed of Missouri during the meetings of the Senate Committee on Banking and Currency and that the above quoted paragraph was inserted in Section 4 of the Federal Reserve Act at his suggestion. Senator Reed's explanation of the purpose and effect of this paragraph, therefore, is entitled to great weight in construing it.

On pages 173 and 174 of the Congressional Record for December 4, 1913, (Vol. 51, Part 1) Senator Reed explained this paragraph as follows:

> "Mr. President, we did not stop at that point. I myself had the honor of offering an amendment prescribing or defining the duties of these directors. It is as follows:
>
> > "The board of directors shall perform the duties usually appertaining to the office of directors of banking associations and all such duties as are prescribed by law.
> >
> > "Said board shall administer the affairs of said bank fairly and impartially and without discrimination in favor of or against any member bank or banks, and shall, subject to the provisions of law and the orders of the Federal Reserve Board, extend to each member bank such discounts, advancements, and accommodations as may be safely and reasonably made with due regard for the claims and demands of other member banks.
>
> "Mr. President, the importance of that amendment lies in the fact that for the first time it wrote into the bill

language which commanded the directors of the regional banks to treat all member banks alike. It prohibits favoritism; it forbids discrimination; it gives to member banks the right to demand impartial treatment. The member bank is not left to solicit favors; it may insist upon rights.

"Mr. President, the provisions I have just discussed might be ineffectual if it were not for the fact that at the same time we enlarged the powers of the Federal reserve board so that it can compel regional banks to obey this mandate of the law. We conferred this power by providing in section 11, paragraph J, as follows: The Federal reserve board shall have power--

"To exercise general supervision over said Federal reserve banks.

"When, therefore, we imposed the duty upon the directors of the regional banks to treat all member banks fairly and impartially and without discrimination, and gave the Federal reserve board, which is appointed by the President of the United States, authority to exercise general supervision over the Federal reserve bank, we gave the Federal reserve board power and authority to compel the Federal reserve banks to be impartial in their dealings with member banks. The same authority empowers the Federal reserve board to protect the public against wrongs sought to be perpetrated by the reserve banks. The power conferred is sufficient to accomplish these ends, and if it be wisely exercised there is but slight danger of discrimination in favor of some bank and against others; or in favor of one section of the country and against another; or, I will add, the adoption of a policy by regional banks which will be oppressive to the public.

Powers of Reserve Board Increased.

"The Federal reserve board, appointed by the President, is, by the two amendments I have set out, given absolute command of the system. It can make the regional directors perform their full duty with fairness and impartiality to all.

"We followed these amendments with others of equal importance. We gave the reserve board the unrestricted right to remove any of the directors of a regional bank. Here is the language: 'The Federal Reserve Board shall have power to suspend or remove any officer or director of any Federal reserve bank, the cause of such removal to be forthwith communicated in writing by the Federal Reserve Board to the removed officer or director and to said bank.' The House bill only gave a restricted right of removal."

* * * * * *

"Putting together, then, these several provisions to which I have adverted, I believe we can say to the country with a clear conscience that while we have drawn these banks together into this great system, while we have given them a common stock ownership, while we have placed the control of the regional banks in the hands of the bankers, we have at the same time so safeguarded every avenue and so locked every door that the people may be content. In the last analysis the Federal reserve board, appointed by the President and representing the entire country, has

complete and absolute power, and will control the entire system and prevent discriminations, combinations, or other wrongs."

In view of this explanation, it is quite clear that this paragraph alone was not intended to confer additional power upon the Federal Reserve Board but was intended to prescribe a rule governing the administration of the affairs of the Federal reserve bank by the board of directors of the Federal reserve bank. This rule was intended to do two things: (1) To prevent discrimination either in favor of or against any member bank; and (2) To make it clear that member banks are entitled as a matter of right to "such discounts, advancements and accommodations as may be safely and reasonably made with due regard for the claims and demands of other member banks."

It was contemplated that, if any Federal reserve bank should discriminate against any member bank or should deny it such discounts, advancements and accommodations as might be safely and reasonably made with due regard to the claims and demands of other member banks, the bank so discriminated against could appeal to the Federal Reserve Board and the Board could order the Federal reserve bank to comply with the law and to cease such discrimination. It was pointed out, however, that such power was included in the Board's power under Section 11 (j) to exercise general supervision over the Federal reserve banks and could be enforced by the exercise of the Board's power under Section 11 (f) to suspend or remove any officer or director of any Federal reserve bank.

The power to exercise general supervision over the Federal reserve banks was inserted in Section 11 at the suggestion of Senator Reed, in order to enable the Board to enforce the above quoted paragraph

of Section 4; and this shows clearly that the provision of Section 4 was not intended to confer any independent power upon the Board.

Moreover, the fact that the whole purpose of this paragraph was to make it clear that member banks are entitled to reasonable credit accommodation from the Federal reserve banks without discrimination is clearly inconsistent with the thought that the same paragraph might possibly confer power upon the Federal Reserve Board to order a Federal reserve bank to deny credit accommodations to a particular member bank. Such an order by the Federal Reserve Board might amount to the very kind of discrimination against individual banks which this paragraph was intended to prevent.

The words "subject to the provisions of law and the orders of the Federal Reserve Board" obviously were inserted in this paragraph as a qualifying or saving clause similar to those found elsewhere in the Act and must have been intended to have substantially the following meaning: Subject to the provisions of law and to such orders, regulations, etc., as the Federal Reserve Board may lawfully promulgate pursuant to the power granted the Board under other provisions of the Federal Reserve Act.

I am of the opinion, therefore, that this language does not confer any additional power on the Federal Reserve Board and that any authority which the Board may have to issue orders qualifying the right of member banks to credit accommodations from the Federal reserve banks must be found elsewhere in the Act.

The clause "subject to the provisions of law and the orders of

the Federal Reserve Board", however, is important, since it makes the right of member banks to credit accommodations from the Federal reserve banks subject to such rules, regulations and restrictions as the Federal Reserve Board may lawfully prescribe under authority granted elsewhere in the Act. Thus, it makes this right of the member banks subject to such restrictions, limitations and regulations as may be imposed by the Federal Reserve Board under the paragraph of Section 13 discussed elsewhere in this opinion.

V.

Although the paragraph of Section 4 of the Federal Reserve Act discussed above does not itself confer any such power upon the Federal Reserve Board, it is perfectly obvious that, if the Federal Reserve Board should prescribe a regulation forbidding any Federal reserve bank to rediscount any paper for, grant any loan to, or purchase any bills of exchange, bankers' acceptances or Government, State, or municipal securities from, any member bank which at the time has loans outstanding to brokers or dealers in stocks, bonds or other investment securities, the Board would have power to issue such orders in specific cases as might be necessary to stop violations of this regulation.

Thus, if such a regulation were promulgated and the Board should find that a particular Federal reserve bank is rediscounting paper for, or making loans to, a particular member bank which has loans outstanding to brokers or dealers in stocks, bonds or other investment securities, the Board could order the Federal reserve bank to cease re-

discounting paper for, or making loans to, such member bank; and, if the Federal reserve bank should fail or refuse to comply with such an order, the Board could enforce its order by suspending or removing from office the offending officers and directors of the Federal reserve bank..

VI.

The question has been raised whether the Board could, if it so desires, prescribe a special rate (higher than the rediscount rate on industrial, commercial or agricultural paper) for advances to member banks on their promissory notes secured by bonds or notes of the Government of the United States.

While this does not have a direct bearing on the main question discussed in this opinion, it has been suggested that it might have a very practical and helpful effect on the main problem confronting the Board in this connection. Thus, it has been suggested by one member of the Board that, in practice, most of the credit accommodations obtained from the Federal reserve banks by reserve city member banks which are at the same time lending large sums to brokers and dealers in investment securities are obtained in the form of advances on the promissory notes of such member banks secured by bonds and notes of the Government of the United States; that this practice might be checked if a higher rate of interest should be prescribed for borrowings in this form; and that such a higher rate of interest of interest would not increase the cost of credit to commerce, industry and agriculture. One member of the Board, therefore, requested me to cover this point in this opinion.

The power to make advances to member banks on their promissory notes is conferred by the following paragraph of Section 13 of the Federal Reserve Act:

> "Any Federal reserve bank may make advances to its member banks on their promissory notes for a period not exceeding fifteen days at rates to be established by such Federal reserve banks, subject to the review and determination of the Federal Reserve Board, provided such promissory notes are secured by such notes, drafts, bills of exchange, or bankers' acceptances as are eligible for rediscount or for purchase by Federal reserve banks under the provisions of this Act, or by the deposit or pledge of bonds or notes of the United States."

It will be noted that this paragraph provides that such advances shall be made at rates to be established by such Federal reserve banks, subject to the review and determination of the Federal Reserve Board. It will be noted that the language here used is very similar to that used in Section 14(d) pertaining to other rates of discount to be charged by the Federal reserve banks and that the qualifying clause "subject to review and determination of the Federal Reserve Board" is precisely the same, word for word, in both sections.

The Attorney General of the United States has held that under Section 14(d) the Federal Reserve Board "has the right under the powers conferred by the Federal Reserve Act, to determine what rates of discount should be charged from time to time by the Federal reserve bank, and under their powers of review and supervision, to require such rates to be put into effect by such bank." (32 Op. Atty. Gen., p. 81.)

It is perfectly obvious that the Board has the same power with respect to the rates at which Federal reserve banks may make advances on the promissory notes of member banks under Section 13 as it has over the rates of discount to be established under Section 14(d).

It is well recognized that the Federal reserve banks may establish

and the Federal Reserve Board may approve, different rediscount rates for different classes of paper; and it would seem that the same power could be exercised in approving or fixing the rates at which advances will be made to member banks on their promissory notes under Section 13. While Section 13 does not contain the phrase "for each class of paper" found in Section 14(d), it is significant that Section 13 uses the plural "rates" and does not merely authorize the fixing of "a rate" at which Federal reserve banks may make advances to member banks.

The fact that the subject is treated separately clearly indicates that the promissory notes of member banks constitute a separate class of paper; and it would seem obvious that this class of paper may be further subdivided into other classes according to the maturity of the notes or the character of collateral security. It would seem perfectly obvious that member banks' promissory notes secured by Government bonds, which are not eligible for rediscount, are clearly in a different class from those secured by agricultural, industrial and commercial paper, which is eligible for rediscount.

I am of the opinion, therefore, that the Board could, if it so desires, prescribe a special rate (higher than the rate of discount on industrial, commercial or agricultural paper) for advances to member banks on their promissory notes secured by bonds or notes of the Government of the United States.

Respectfully,

Walter Wyatt
General Counsel.

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