FEDERAL RESERVE BANK

COPY

OF NEW YORK

X-6445

OFFICE CORRESPONDENCE

DATE December 3, 1929.

To Governor Harrison

SUBJECT: GOVERNORS CONFERENCE - December 11, 1929.

From Walter S. Logan

Uniform Policy re Check Collections.- Should Federal Reserve Banks take collateral from remitting banks in special cases? (F.R.Board letter X-6409, Nov. 7, 1929.)

Governor Harding's letter of October 19, 1929 to the Federal Reserve Board (X-6409-b) raises the question whether a Federal Reserve Bank in taking collateral to insure the payment of checks in special cases will be acting in contravention of the uniform policy recommended by a majority of the counsel of Federal Reserve Banks and approved by the last Conference of Governors and by the Federal Reserve Board.

At the Conference of Counsel in April 1929 eight of the counsel of Federal Reserve Banks voted in favor of the majority policy, i. e., that reserve balances of member banks and collateral held to secure indebtedness of member banks to Federal Reserve Banks should not in the event of the member banks' insolvency be applied in payment of checks drawn on the member banks and in process of collection through Federal Reserve Banks. The report of the majority of counsel recommended two specific amendments to Regulation J. Three of these eight counsel (Mr. Weed of Boston, Mr. Stroud of Dallas, and myself) asked to be recorded as voting for the majority report with the understanding that the report was not intended to carry with it any implication that a Federal Reserve Bank may not make special arrangements to insure the payment of checks in special cases.

The Conference of Governors on April 3, 1929 adopted the following resolution:

"RESOLVED, That we approve in substance the majority report of the Conference of Counsel with the understanding that to assist the General Counsel of the Federal Reserve Board in framing the exact language of any amendment that may be found necessary to make the substance of the report effective, each Federal Reserve Bank shall be at liberty to call his attention to any local arrangement that might be affected by his amendment."
(Governors McDougal, Geery, and Seay voted in the negative on the above resolution.)

With certain changes in phraseology recommended by Mr. Wyatt, the Federal Reserve Board adopted, effective January 1, 1930, the amendments to Regulation J recommended by the Conference of Counsel. One of these was to make paragraph 6 of Section V of Regulation J read as follows:

(New matter underlined)

"(6) The amount of any check for which payment in actually and finally collected funds is not received shall be charged back to the forwarding bank, regardless of whether or not the check itself can be returned. In such event, neither the owner or holder of any such check, nor the bank which sent such check to the Federal reserve bank for collection, shall have any right of recourse upon, interest in, or right of payment from, any fund, reserve, collateral, or other property of the drawee bank in the possession of the Federal reserve bank."

I think it is fair to say that the basic reason for the so-called majority policy is the belief that there may be a conflict of interest between a Federal Reserve Bank in its individual capacity on the one hand and the principals for whom the Federal Reserve Bank acts in the collection of checks on the other hand, if the same property is available for the payment both of obligations due to the Federal Reserve Bank individually and

of obligations owned by such principals. I am confident that it was the intention of most of the counsel that the approval of the majority policy should not preclude Federal Reserve Banks from taking collateral to insure the payment of checks in special cases under agreements which would not make the collateral available for the payment of obligations due to the Federal Reserve Bank in its individual capacity. This intention is not, however, indicated in the specific language of amended paragraph 6; and I believe that a fair interpretation of that paragraph prohibits a Federal Reserve Bank from taking collateral to insure payment of checks under any circumstances. It may be argued that collateral is not technically "in the possession of the Federal Reserve Bank" if held by the bank in its capacity as agent and as security for the payment only of obligations owned by its principal. In my opinion, however, a court would hold that the broad language of the paragraph indicates an intent to include in "collateral, or other property of the drawee bank in the possession of the Federal Reserve Bank" collateral held by the Federal Reserve Bank as collecting agent as well as collateral held by it to secure its own obligations. In this connection I may say that in a suit by or against the receiver of an insolvent drawee bank I do not think a court would permit the record of the proceedings of the Conference of Counsel to be introduced as evidence of the intended scope of this paragraph of the regulation.

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In my judgment Federal Reserve Banks should be permitted to take collateral to insure payment of checks in special cases where this seems to them necessary in order to protect themselves against possible liability as collecting agents, and I therefore believe that either (1) the language of paragraph 6 of Section V of Regulation J as amended to become effective January 1, 1930, should be further revised so as specifically to provide for this, or (2) this paragraph of Regulation J as now effective should be left unchanged. As you know, I personally favor the latter alternative, as I believe that no amendment to this paragraph of the regulation is necessary or advisable to make effective the policy adopted by the majority of counsel and approved by the Conference of Governors. Paragraph 6 of Section V of Regulation J as now effective reads as follows:

> "(6) The amount of any check for which payment is actually and finally collected funds is not received shall be charged back to the forwarding bank, regardless of whether or not the check itself can be returned."

I attach for your convenience an extract from my letter of May 6, 1929 to Mr. Wyatt explaining my reasons for believing it unnecessary and inadvisable to amend this paragraph of Regulation J.

WSL:GSR
Encl.

C O P Y X-6445-a

EXTRACT FROM LETTER DATED MAY 6, 1929,
FROM WALTER S. LOGAN, GENERAL COUNSEL, FEDERAL RESERVE BANK OF NEW YORK,
TO WALTER WYATT, GENERAL COUNSEL, FEDERAL RESERVE BOARD.

"I think that paragraph (6) of Section V of the existing regulation should be left unchanged because no amendment is necessary in order to carry out the general policy approved by the majority committee.

My understanding of the argument for an amendment is that as the regulation now stands, when a member bank fails without having remitted for cash letters it is unsafe for the Federal Reserve Bank to do what it should do in order to carry out the general policy recommended by the majority committee (i.e., turn over to the Receiver of the failed member bank, in so far as not needed to pay indebtedness due to the Federal Reserve Bank in its own right, any balance in the member bank's reserve account and any collateral security which has been pledged by the member bank to the Federal Reserve Bank); and that this is due to the uncertainty as a matter of law whether such reserve balance and such collateral security should be turned over to the Receiver or should be applied in payment of unremitted-for items drawn on the failed bank, this uncertainty being due mainly to the recent decisions in the cases of Midland National Bank & Trust Company v. The First State Bank of Sioux Falls 222 N.W. 274 (Supreme Court of Minnesota), and Early v. Federal Reserve Bank of Richmond 30 Fed. (2nd) 198 (Circuit Court of Appeals, Fourth Circuit). It seems to me, however, that this attributes to these two decisions a broader scope and effect than they really have.

The Midland Bank case involved the interpretation of a specific contract under which securities were pledged as collateral, and the Federal Reserve Banks can avoid its effect by using a different form of contract of pledge containing express language showing an intent to exclude from the liabilities secured thereby any liabilities upon checks received by the Federal Reserve Banks as collecting agents or upon instruments given in payment of such checks.

An analysis of the opinion of the Circuit Court of Appeals in the Early case shows clearly, I think, that the court based its decision upon the fact that the failed member bank had, by agreeing to the terms of the Federal Reserve Bank of Richmond's then effective check collection circular, authorized the Reserve Bank to charge cash letters against the member bank's reserve account at the expiration of the designated transit time or at any other time the Reserve Bank deemed it necessary to do so. In other words, the decision is based on the fact that the Federal Reserve Bank of Richmond was using the so-called "charge" system in collecting the checks involved. Since the time of the events involved in the Early case the Federal Reserve Bank of Richmond has adopted the "remittance" system and all Federal Reserve Banks are now collecting checks on that system. It seems to me that as to any cases likely to arise in the future the decision in the Early case will not only not be considered a precedent for the application of reserve balances to the payment of unremitted-for items, but will be a strong authority against such application.

I am aware that the following cases might be used to support an argument that a Federal Reserve Bank has the right, if it so desires, to apply the reserve balance of a failed member bank in payment of unremitted-for items drawn on such member bank: Storing v. First National Bank of Minneapolis 28 Fed. (2d) 587 (C.C.A., 8th Circuit); Keyes, Receiver, v. Federal Reserve Bank of Minneapolis (unreported decision U. S. D. C., for the District of Minnesota, 1927); Federal Reserve Bank of Minneapolis v. First National Bank of Eureka, S. D., 277 Fed. 300 (U.S.D.C., for the District of South Dakota, Northern District, 1921). For various reasons, however, I do not believe that these cases would be entitled to much weight in an attempt to establish that Federal Reserve Banks must apply failed member banks' reserve balances in payment of unremitted-for items; and consequently I believe that these decisions need cause no real embarrassment to Federal Reserve Banks in carrying out the general policy recommended by the majority committee of counsel. For example, one of the reasons I have in mind is that the three cases just mentioned involved for the most part checks drawn on other banks, which checks had been sent to and collected by the failed banks thereby increasing the failed banks' assets; whereas the unremitted-for checks involved in our problem are those drawn on the failed bank itself, so that the collection thereof would be accomplished merely by a transfer of the failed bank's liability from its depositors to the check owners without any increase in the bank's assets.

As I have already indicated, I am satisfied that no amendment to paragraph (6) of Section V of Regulation J is necessary to enable the Federal Reserve Banks effectively and safely to carry out the general policy approved by the majority committee of counsel. Moreover, I think there is great advantage to all concerned in trying to work out the solution of this intricate problem as far as possible by the application of accepted principles of law rather than by resorting to regulations that may be considered arbitrary, particularly as the purpose of this particular provision of the regulations would be to determine rights as between third parties as well as to protect the Federal Reserve Banks. In fact to the outsider the protection afforded Federal Reserve Banks would appear to be incidental. It is possible, of course, that further study and future developments may indicate that an amendment is advisable, but in determining just what form such amendment should take we will then have the benefit of additional knowledge and information, including, I hope, a decision by the United States Supreme Court in the Early case.

If any Federal Reserve Bank really feels it now needs additional protection in carrying out the general policy approved by the majority committee, I think that rather than have the Federal Reserve Board amend Regulation J it would be better for the particular Federal Reserve Bank to incorporate such protective provision as it deems necessary in its check collection circular.

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Federal Reserve Bank of New York 3 Walter Wyatt, Esq. May 6, 1929.

The specific amendment to paragraph (6) of Section V of Regulation J as proposed by the majority committee of counsel is open to the objection that it goes beyond the scope of the general policy approved by the committee and might affect, even as between third parties, rights and property not intended to be affected and having no relation to the general policy. The object of the proposed amendment is, as I understand it, to make clear that the owners of unremitted-for items have no right to receive or require payment of such items out of (a) reserve and clearing balances, (b) Federal Reserve Bank capital stock refunds, and (c) collateral pledged to secure indebtedness to the Federal Reserve Bank. It is not intended, of course, to affect such rights as the owners of the checks might have by agreement with other parties with respect to other property, such for example as securities held by Federal Reserve Banks in safekeeping for member banks. I assume it would be possible to redraft the amendment to this paragraph so as to limit its effect to the precise purposes intended, but the result would be a long and cumbersome paragraph; and as I have previously indicated I think it unnecessary and inadvisable to make any amendment."