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X-6596

489

FEDERAL RESERVE BANK OF SAN FRANCISCO

April 18, 1929.

Walter Wyatt, Esq.,
General Counsel,
Federal Reserve Board,
Washington, D. C.

Dear Mr. Wyatt:

As you know, I had to go to Pocatello on my way back to San Francisco to argue a case before the Supreme Court there. My return here was thus delayed until the 15th instant.

Since my return, I have discussed with the officers of this bank, particularly with Mr. Clerk, the suggested amendment to paragraph 6, Section V of Regulation J, adopted at the recent Conference of Counsel.

Mr. Clerk and I both feel (and in this conclusion Governor Calkins concurs) that it would be well to add to this paragraph a provision definitely stating that drafts, or other forms of payment from reserve balances of remitting banks, will not be functioned after receipt by the Federal Reserve Bank of notice of suspension of the remitting bank. The addition of such a provision would remove from the paragraph in question all doubt as to whether or not such charges against reserve balances are optional with the Federal Reserve Bank after notice of suspension.

A situation might very easily arise where the remitting bank would forward to the Federal Reserve Bank an authorization to charge or a draft upon its reserve balance which would be received simultaneously with or after notice of suspension of the remitting bank. As the Regulation with the amendment auggested by the Conference of Counsel reads, there would still be room for argument as to whether or not the Federal Reserve Bank should have charged the items back. While it is true that the Regulation with the suggested amendment states that the owner or holder of a cash item shall have no proprietary right in funds of the remitting bank held by the Reserve Bank after the item is charged back, the question still arises as to whether or not the act of charging back was proper where the Reserve Bank had possession of a draft against sufficient collected funds issued before but received after notice of suspension.

In the case of Reserve Banks which have in the past adopted an equivocal attitude in the treatment of reserve balances, the

Regulation with the amendment suggested by Counsel still leaves open the question of whether or not in a given case cash items should be charged back, and, if not charged back, the provisions of the Regulation would not apply. The amendment suggested by Mr. Clerk and myself would remove all option in such a case. We have accordingly wired you today as per enclosed copy.

We believe that paragraph 6 of Section V, Regulation J, would be materially strengthened by adding at the end thereof the following sentence:

> "No draft, authorization to charge or other order upon funds of a remitting bank in the possession of a Federal Reserve Bank, issued for the purpose of settling items handled under the terms of this Regulation, will be paid after receipt by such Federal Reserve Bank of notice of suspension of such remitting bank."

This section, with the suggested addition, would then read as follows:

> "(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. The owner or holder of any such check so charged back shall, in such event, have no right of recourse upon, interest in or right of payment from any fund, reserve, collateral or other property in the possession of the Federal Reserve Bank. No draft, authorization to charge or other order upon funds of a remitting bank in the possession of a Federal Reserve Bank, issued for the purpose of settling items handled under the terms of this Regulation, will be paid after receipt by such Federal Reserve Bank of notice of suspension of such remitting bank."

You will notice that in the suggested addition we have used the phrase "issued for the purpose of settling items handled under the terms of this Regulation." This phrase was used in order to remove all doubt as to the right to offset existing on the part of the Federal Reserve Bank for cash items in which the Federal Reserve Bank itself had a proprietary interest. In view of the fact that the entire Regulation and the paragraph entitled "Terms of Collection," refer only to items handled as agent, this phrase may be considered an excess of caution. We believe, however, that its use is justifiable.

Mr. Clerk desires to call to your attention the fact that, while the Federal Reserve Board has not issued any regulation governing non-cash

collections, the circulars of all Federal Reserve Banks relating to such matters must be uniform in certain terms which are approved by the Federal Reserve Board. It will, of course, be necessary, for the same reasons hereinabove stated, to include in the non-cash collection circulars issued by the several Federal Reserve Banks the statement relating to the dishonor of settlement drafts received after suspension of the drawer. This is a matter with which you are not directly concerned, but which you will probably desire to call to the attention of the Standing Committee on Collections.

WYATT

RESERVE BOARD

WASHINGTON

April 18, 1929

After careful consideration suggested amendment paragraph 6 section V Regulation J adopted at recent Conference Counsel, officers this bank and I agree that right to charge against reserve balances in settlement cash item transactions after notice suspension of remitting bank should be made more definite. Therefore suggest that in redrafting this paragraph for consideration Board following provision be added to paragraph 6

> "No draft, authorization to charge or other order upon funds of a remitting bank in the possession of a Federal Reserve Bank issued for the purpose of settling items handled under the terms of this Regulation, will be paid after receipt by such Federal Reserve Bank of notice of suspension of such remitting bank."

AGNEW

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FEDERAL RESERVE BANK

OF NEW YORK

May 6, 1929.

Walter Wyatt, Esq., General Counsel,
Federal Reserve Board,
Washington, D.C.

Dear Mr. Wyatt:

Receipt is acknowledged of Mr. Vest's letter of April 15, enclosing two copies of the record of proceedings of the Conference of Counsel of all Federal Reserve Banks held on April 1 and 2.

Since the conference I have thought a great deal about the amendments to Regulation J recommended by the majority committee. As a result, I would like to suggest, first, that a slight change be made in the phraseology of the proposed amendment to paragraph (4) of Section V and, second, that no amendment to paragraph (6) of Section V be made but that this paragraph be left as it now is in the existing regulation.

The suggested change in phraseology of paragraph (4) of Section V is indicated below:

Small type indicates amendments to paragraph (4) of Section V of Regulation J as recommended by majority committee.
Proposed new matter is in CAPITALS.
Matter proposed to be stricken out is indicated by - - - .

(4) Checks received by a Federal Reserve Bank on its member or nonmember clearing banks will ordinarily be forwarded or presented direct to such banks and such banks will be required to remit or pay therefor at par. Such remittance or payment may be made in cash, OR by bank draft acceptable to the collecting Federal Reserve Bank, OR WITH THE CONSENT OF THE COLLECTING FEDERAL RESERVE BANK BY AUTHORIZED CHARGES AGAINST BALANCES WITH IT, OR by other funds or transfers acceptable to the collecting Federal Reserve Bank ~~or by authorizing the collecting Federal Reserve Bank to charge their reserve accounts or clearing accounts.~~

The principal purpose of this change is to make it clear that payment may not be made by authorizing the Federal Reserve Bank to charge unless this is satisfactory to the Reserve Bank. Mr. Leedy of Kansas City called my attention when we were in Washington to the need for some change

for this purpose. The proposed change will also have the effect of making the language broad enough to cover payment by means of authorizations to charge accounts other than those of the drawee banks. My impression is that it is the present practice of certain member banks in other districts to pay their cash letters by having their correspondent banks authorize the Federal Reserve Bank to charge the reserve accounts of such correspondents.

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

Federal Reserve Bank of New York 4 Walter Wyatt, Esq.

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.

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.

For your information I am enclosing a copy of Governor Harrison's letter of May 6, 1929 in reply to the Federal Reserve Board's letter of April 23, 1929, (X-6296), with reference to the action of the recent Governors' Conference regarding proposed amendments to Regulation J.

Very truly yours,

(S) Walter S. Logan,
General Counsel.

Encl.

COPY

X-6596-a

497

FEDERAL RESERVE BANK

OF NEW YORK

May 6, 1929.

Federal Reserve Board,

Washington, D. C.

S i r s:

Receipt is acknowledged of your letter of April 23, 1929, X-6296, referring to the action taken by the recent Conference of Governors upon the report of the Conference of Counsel with regard to the policy to be pursued by Federal Reserve Banks in asserting rights in behalf of depositors of unremitted-for cash letters against Receivers of insolvent member banks. The resolution adopted by the Conference of Governors recited that the Governors "approved in substance the majority report of the Conference of Counsel, with the understanding that, to assist the Counsel of the Federal Reserve Board in framing the exact language of any amendments 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 any such amendments." Your letter requests us to advise you whether or not there are any such local arrangements in this district.

We have no "local arrangement" such as is intended to be referred to in the resolution of the Conference of Governors, except the agreements pursuant to which we handle checks drawn on practically all the member banks located in the Boroughs of Manhattan, Bronx, and Brooklyn, New York City, that are not members of the New York Clearing House. The agreements we have with these member banks provide that each morning the member bank shall send a representative to the Federal Reserve Bank to receive the checks drawn upon the member bank, and that we may charge to the member bank's reserve account the amount of the checks delivered to such representative, subject to the right of the member bank to return any checks before 3 o'clock that day and receive credit therefor. With respect to certain large member banks the exchanges of which are handled in this manner it is frequently the case that at the time the checks are delivered to the member bank's representative the member bank's reserve account would not be sufficient to cover such checks without the credits for "immediate credit" items which have just been deposited by the member bank but which will not be actually collected until later in the day. As a practical matter the credit risk assumed by this bank is probably insignificant, but because of the very large amounts sometimes involved it is nevertheless a serious question whether it should not take collateral to protect itself against

possible loss from handling checks in this manner or to insure the payment of such checks. To do so would not, in our opinion, be in contravention of the general policy approved by the majority committee at the recent Conference of Counsel. The question of taking collateral from some of these member banks has been raised several times and is in fact now under consideration.

Checks drawn on New York Clearing House banks are, of course, presented through that clearing house, of which this bank is a member. And in certain other communities there are clearing houses with the members of which we have arrangements whereby their clearing house balances are settled by debits and credits to their reserve accounts with this bank. Also, a few of our member banks have requested us to handle the checks drawn on them on the "charge" system and we accordingly do so. We do not understand that the arrangements involved in the transactions referred to in this paragraph are the type of "local arrangement" contemplated by the resolution of the Conference of Governors, but I am mentioning them for the sake of completeness.

I enclose a copy of a letter dated May 6, 1929, which Mr. Logan, our general counsel, has written to Mr. Wyatt with reference to the amendments to Regulation J as suggested in the report of the majority committee of the recent Conference of Counsel. I agree with Mr. Logan that it is unnecessary and in all the circumstances probably inadvisable to amend paragraph (6) of Section V of Regulation J at this time.

Very truly yours,

George L. Harrison,
Governor.

Encl.
WSL-GSR
(EB)

COPY

X-6596-b

499

FEDERAL RESERVE BANK

OF NEW YORK

April 4, 1930.

Walter Wyatt, Esq., General Counsel,
Federal Reserve Board,
Washington, D. C.

Dear Mr. Wyatt:

In accordance with our recent telephone conversation I am sending you herewith a copy of the proposed amendment to paragraph (6) of Section V of Regulation J with the last sentence revised so as to refer only to reserve balances, i.e., eliminating the specific reference to collateral. As I told you on the telephone, Mr. Agnew and I spent some time discussing this question of the proposed amendments to Regulation J, and as a result I think we are both in favor of this amendment to paragraph (6) of Section V. I know that as far as I am concerned the consideration I have given the matter since I talked with Mr. Agnew has confirmed my belief that this is the best solution of the problem. This suggested amendment would offset the effect of the decision in the Early case, but it would not (as I think the amendment to this paragraph as drafted by the Conference of Counsel would) preclude a Federal Reserve Bank, while acting in good faith and with no intent to adopt a general policy inconsistent with the uniform policy that has been approved, from exercising its judgment and discretion as to the best way to protect itself in emergencies.

Mr. Agnew and I both assumed that the amendment to paragraph (4) of Section V of Regulation J as drafted at the Conference of Counsel would be adopted. This amendment merely clarifies this paragraph and does not change the effect of it.

I am sending a copy of this letter and draft of suggested amendment to paragraph (6) of Section V of Regulation J to Mr. Agnew.

Yours faithfully,

(S) Walter S. Logan,
General Counsel.

Encl.

Revised Suggested Amendment

To Paragraph (6), Section V of Regulation J.

(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 the reserve balance of the drawee bank with the Federal reserve bank.

(WSL:GSR)

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501

FEDERAL RESERVE BANK

OF NEW YORK

April 9, 1930.

Walter Wyatt, Esq., General Counsel,
Federal Reserve Board,
Washington, D. C.

Dear Mr. Wyatt:

You will recall that when I was in Washington some time ago I discussed with you the suggestion of an amendment to Regulation J to provide specifically that a Federal Reserve Bank has the right in its discretion to refuse to permit withdrawals against items which have been credited to member banks' reserve accounts but for which payment in actually and finally collected funds has not yet been received. Since that time I have been intending to write you to put the suggestion in more concrete form.

An amendment such as I have in mind would merely give definite sanction to the position taken by the Federal Reserve Bank of New York (and I presume by other Federal Reserve Banks) that credits for items entitled to immediate credit on day of receipt are not subject to withdrawal until the Federal Reserve Bank receives actual and irrevocable payment later in the day. No bank has ever objected to this, but we feel that our position would be stronger if the matter were specifically covered in Regulation J and our circular.

Section 19 of the Federal Reserve Act provides that

> "The required balance carried by a member bank with a Federal reserve bank may, <u>under the regulations</u> and subject to such penalties as may be prescribed by the Federal Reserve Board, be checked against and withdrawn by such member bank for the purpose of meeting existing liabilities;"

Subdivisions (2) and (3) of Section IV of Regulation J now provide as follows:

> "(2) For all such checks as are received for immediate credit in accordance with such time schedule, immediate credit, subject to final payment, will be given upon the books of the Federal reserve bank at full face value in the reserve account or clearing account upon day of receipt, and the proceeds will at once be counted as reserve and become available for withdrawal or other use by the sending bank.
>
> "(3) For all such checks as are received for deferred credit in accordance with such time schedule, deferred

> credit, subject to final payment, will be entered upon the books of the Federal reserve bank at full face value, but the proceeds will not be counted as reserve nor become available for withdrawal or other use by the sending bank until such time as may be specified in such time schedule, at which time credit will be transferred from the deferred account to the reserve account or clearing account subject to final payment and will then be counted as reserve and become available for withdrawal or other use by the sending bank."

The suggested amendment to Regulation J could be accomplished by adding a clause at the end of each of these subdivisions reading substantially as follows:

> "provided, however, that the Federal reserve bank may in its discretion refuse at any time to permit the withdrawal or other use of credit given for any item for which the Federal reserve bank has not yet received payment in actually and finally collected funds."

Under the terms of the time schedules, credit is often given in the reserve account both for immediate credit items and for deferred availability items before payment is actually received. From the standpoint of this bank, however, the suggested amendment would be of particular importance in connection with immediate credit items, because of the very large volume of the clearings of New York City banks.

For checks on New York City banks which we receive before 9 a.m. we give immediate credit on the day of receipt. Exchanges of clearing house checks are completed at 10 a.m. and the clearing house balances are settled on our books at 1 p.m., any bank having the right, however, up to 3 p.m. to return any check direct to the bank which received credit for it in the day's exchanges. If a clearing house check, deposited with us by a bank not a member of the clearing house, should be returned to us at, say, 2 p.m., we would of course immediately charge it to the depositing bank. If, however, the depositing bank has the technical right to check out its entire reserve balance during the day and should do so and then fail just before 2 p.m., there would of course be nothing against which we could charge the returned check. This example is one of many theoretically possible cases in which it might be important that we have the clear and definite right to refuse to permit withdrawals against uncollected immediate credit items. The number of such cases is larger than it otherwise would be because of the fact that the majority in number of the New York City banks are not members of the clearing house. We have agreements with most of these other banks under which we deliver their checks to them at 9 a.m. and simultaneously charge their accounts with the amount of such checks, they having the right, however, to return the checks up to 3 p.m.

The actual credit risk to the Federal Reserve Bank of New York in connection with the collection of these New York City bank checks is negligible, we believe, but in view of the very large amounts involved it is

important that we take every precaution against loss even though the possibility of such loss appears extremely remote. Our daily receipts usually aggregate $150,000,000 to $200,000,000 for New York clearing house checks, and $50,000,000 to $100,000,000 for other New York City checks.

Very truly yours,

(S) Walter S. Logan,
Deputy Governor and General Counsel.

COPY

X-6596-d

501

FEDERAL RESERVE BANK OF SAN FRANCISCO

April 25, 1930.

Walter Wyatt, Esq., General Counsel,
Federal Reserve Board,
Washington, D. C.

Dear Mr. Wyatt:-

On the occasion of my recent visit to Washington and New York, I took occasion to call upon Mr. Logan, counsel for the Federal Reserve Bank of New York and to discuss with him the dilemma into which we have fallen with relation to the proposed amendments to Regulation J.

Mr. Logan wrote you, I believe, in relation to the discussions which we had, on April 4.

My thought was to so amend paragraph 6 of Section V of the Regulation as to avoid the effect of the Early case and at the same time leave opportunity for a Federal reserve bank to exercise its judgment in taking special security to safeguard itself in particular instances. I therefore suggested to Mr. Logan that the amendment proposed to this section by the last conference of counsel be limited in its terms to reserve balances. I do not believe that the term "reserve balance" could by any stretch of the imagination be held to include special collateral taken for the specific purpose of safeguarding a Reserve bank in the collection of items drawn upon a particular member or non-member clearing bank.

I am very hopeful that the suggestion made may satisfy those Reserve banks who have protested against the adoption of the amendment to paragraph 6 proposed by counsel, and may at the same time leave those Federal reserve banks who do not consider it wise or expedient to enter into special arrangements free from the embarrassment arising through the decision in the Early case.

The addition to paragraph 6, Section V of Regulation J would, if our suggestion were adopted, read as follows:-

> "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 the reserve balance of the drawee bank with the Federal reserve bank."

Paragraph (4) of Section V of the Regulation should, however, be amended in the form proposed by conference of counsel. The suggested amendment to this paragraph merely serves to clarify it.

I would like very much to receive your opinion of the amendment proposed by Mr. Logan and myself, and the possibility of its being adopted and put into effect.

Yours very truly,

(S) Albert C. Agnew,
Counsel.