COPY

(PROPOSED LETTER TO COUNSEL FOR ALL FEDERAL RESERVE BANKS PREPARED BY MR. WYATT BUT NOT SENT OUT.)

July 29, 1929.

SUBJECT: Proposed Amendments to Regulation J.

Dear Sir:

Consideration of the proposed amendments to Regulation J recommended by the conference of Counsel held in Washington on April 1st and 2nd has been delayed owing to the fact that it was necessary to communicate with the Governors of all Federal reserve banks in order to ascertain whether there are any local arrangements in their respective districts which might be affected by such proposed amendments.

Replies have now been received from all of the Governors, and all of them except those at New York and Philadelphia state that they know of no local arrangements which would be affected by the proposed amendments to Regulation J.

The Federal Reserve Bank of New York has no local arrangements which would be affected by the proposed amendment except the agreement under which they handle checks drawn on practically all member banks located in the Boroughs of Manhattan, Bronx and Brooklyn which are not members of the New York Clearing House. The agreements with these member banks provide that each morning each member bank shall send a representative to the Federal Reserve Bank to receive checks drawn on the member bank and the Federal Reserve Bank may charge to the member bank's reserve account the amount of checks delivered to such representative, subject to the right of the member bank to return any checks before 3 o'clock the same day and

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receive credit therefor. With respect to certain large member banks, the reserve account would not be sufficient to cover such checks without credit for immediate credit items deposited by such member banks but which will not actually be collected until later in the day. The credit risk in such case is probably insignificant; but, because of the large amounts sometimes involved, the Reserve Bank considers it a serious question whether it should not take collateral to protect itself against possible loss from handling checks in this manner or to insure payment of such checks. The Federal Reserve Bank of New York has never taken such collateral but is considering the advisability of doing so. It would not consider the taking of such collateral a contravention of the general policy approved by the majority of counsel.

The Federal Reserve Bank of Philadelphia uses two forms of collateral agreement to protect it in collecting checks: (1) A form of agreement intended to protect it against loss incurred by it in leaving collection items at nonmember city banks for examination and payment or return at a later hour during the day; and (2) a form of agreement intended to make possible the collection of items upon certain nonmember country banks where existing circumstances would make it unwise to collect such items without the protection afforded the reserve bank by the deposit of collateral.

The pledge of collateral with the Federal reserve bank to protect it against liability under the circumstances described by the Federal reserve banks of New York and Philadelphia might be considered inconsistent with the uniform policy recommended by the conference of Counsel and approved by the Governors' Conference; but in my opinion it would not be a violation

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of the new language proposed to be added to the last paragraph of Section V of Regulation J.

The Federal Reserve Bank of Richmond calls attention to a local clearing house arrangement by which collateral is deposited by Richmond clearing house banks <u>with a trust company</u> to secure any member of the clearing house against loss as a result of checks being delivered through the clearing house for payment or return. The Federal Reserve Bank of Richmond does not consider this arrangement inconsistent with the proposed amendment and I concur in this view, since the securities are deposited with a trust company and not with the Federal reserve bank and are for the protection of all members of the clearing house and not for protection of the Federal reserve bank alone.

The Federal Reserve Bank of Boston suggests that the new regulations be not drawn in such a way as to deny to any Federal reserve bank, either specifically or by implication, the right <u>to protect itself</u> against liability by making special arrangements to secure the payment of checks in particular cases. I do not believe that the proposed amendments to the regulation could be construed as having this effect.

In a letter, a copy of which is enclosed herewith, Judge Ueland calls attention to two local arrangements in the Minneapolis District which he thinks might be affected by the proposed amendment to Regulation J. If the agreements referred to are construed as Judge Ueland apparently construes them, they would in my opinion be inconsistent with the uniform policy recommended by the conference of Counsel and approved by the Governors' conference and one of them would be inconsistent with the proposed amendment to Regulation J; but I do not agree with Judge Ueland's construction of

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these agreements. As I construe them, neither of these arrangements would be inconsistent with the proposed amendment to Regulation J.

The first arrangement referred to is the collateral agreement used by the Federal Reserve Bank of Minneapolis. It refers solely to indebtedness to the Federal reserve bank itself and I do not think it can properly be construed to apply to indebtedness owed to other banks for which the Federal reserve bank is handling checks only as agent. I realize that my view may be considered inconsistent with the decision of the Supreme Court of Minnesota, in the Midland National Bank case; but I think that decision is wrong and I believe it is distinguishable from the case of a Federal reserve bank handling checks pursuant to the express provisions of Regulation J.

The other arrangement referred to by Judge Ueland is one by which the Federal Reserve Bank of Minneapolis acts as a clearing house for the Twin City banks. Judge Ueland refers to the fourth paragraph of the rules and regulations governing the clearing house and states that it apparently constitutes the reserve account of a bank which is a member of the clearing house as a security fund for the payment of debit balances in the daily clearings, at the option of the Federal reserve bank. While I believe that this provision is objectionable, since it contains general authority to charge the reserve accounts of member banks, I do not see how it can be construed to have the effect of making the reserve balance literally a security fund for the payment of checks drawn on such banks. In view of the fact that such charges are to be made at the option of the Federal reserve bank, I do not believe that the owners of checks drawn on members of the clearing house would have any lien upon the reserve balance

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in the hands of the Federal reserve bank or any right to compel the Federal reserve bank to charge such checks to the reserve account. It might, however, have the effect of making the Federal reserve bank liable for the amount of any uncollected checks, on the ground that it is negligent if it fails to exercise its right to charge them to the reserve account. It is my personal opinion that all such blanket authorizations to charge the reserve account should be discontinued for this reason.

I assume that all questions of policy considered by the Conference of Counsel were definitely and finally settled when the Governors' Conference formally adopted the uniform policy recommended by the Conference of Counsel and that, therefore, the only question to be considered by the Federal Reserve Board is the question of adopting the proposed amendments to Regulation J recommended by the Conference of Counsel subject to my approval and possibly the question whether any further amendments to Regulation J should be adopted at the same time.

Some further differences of opinion have developed in regard to the proposed amendments recommended by the Conference of Counsel. Messrs. Logan and Leedy have suggested modifications of the language of the proposed amendment to paragraph 4 of section V of Regulation J; Mr. Agnew has suggested the addition of an entirely new provision to paragraph 6; and Mr. Logan has expressed the opinion that no amendment to paragraph 6 is necessary. I enclose for your information copies of letters from Messrs. Logan and Agnew on this subject. Mr. Leedy's suggestion was verbal.

I personally feel that it would be unwise to adopt the amendment to paragraph 4 recommended by the Conference of Counsel unless paragraph 3 is broadened so as to authorize every form of remittance proposed to be

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authorized in the amendment to paragraph 3; that the language of the proposed amendment to paragraph 4 is too broad and indefinite; that other amendments to the regulation may be necessary; and that the proposed amendment to paragraph 6 is not necessary if all Federal reserve banks comply strictly with the mandatory requirements of the present regulation and adhere strictly to the uniform policy recently adopted.

I am inclined to feel also that Section V of Regulation J either should not be amended at all or should be revised completely so as to conform more closely to the uniform policy recommended by the Conference of Counsel and so as to cover every contingency which may be foreseen in the light of such experience as we have had subsequent to the revision of Regulation J in 1924.

In view of the fact that Regulation J has been upheld by the courts and has been construed satisfactorily by them, I am somewhat reluctant to recommend that any amendments be made thereto, unless they are deemed to be absolutely necessary. The court decisions construing and upholding the regulation would lose some of their force and value if the regulation is amended, since lawyers attacking the amended regulation would claim that those cases are distinguishable. For this reason, piecemeal amendments to the regulation would seem undesirable.

On the other hand, the Conference of Counsel has recommended two amendments to Regulation J and this is very weighty evidence that such amendments are necessary. If these amendments are adopted, it would seem better to revise the regulation completely so that further piecemeal amendments would not be necessary.

With this in mind, I have prepared a tentative draft of a complete

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revision
/of Section V of Regulation J, which I am enclosing herewith for your consideration and comment.

The purpose of most of the proposed changes are self evident, but a brief discussion of them will do no harm.

No changes are suggested in the introductory paragraph of Section V, nor in the paragraphs numbered 1 and 2.

The proposed changes in paragraph 3 grew out of the proposed changes in paragraph 4 recommended by the Conference of Counsel. Immediately following that Conference, I discussed this subject informally with Messrs. Leedy and Agnew, and possibly one or two other Counsel, and we all agreed that it was unwise and possibly dangerous to authorize in paragraph 4 the acceptance of forms of payment or remittance for checks on member banks and nonmember clearing banks the acceptance of which is not authorized by the terms of paragraph 3 for checks on all banks, especially in view of the fact that paragraph 3 contains other provisions for the protection of Federal reserve banks when they accept something other than cash in payment or remittance for checks handled by them.

It would seem best, therefore, to broaden paragraph 3 so as to cover all forms of remittance customarily accepted by the Federal reserve banks, and this is the principal purpose of the revision of this paragraph. I believe the language is broad enough to cover payments or remittances by a correspondent bank for the account of the drawee bank, such as are referred to in Mr. Logan's letter. Not being as intimately acquainted with the details of the practice of the Federal reserve banks as you are, however, I may have failed to include some form of remittance which is customarily used. If so, I shall appreciate it if you will kindly call the matter to my

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attention and suggest how such forms of remittance could be described specifically in the regulation.

It is hoped that the foot-note to paragraph 3 will make it absolutely clear that Federal reserve banks are no longer permitted to receive blanket authority to charge any and all checks to the account of the drawee bank and that the foot-note will thus eliminate the basis for the decision of the Circuit Court of Appeals in the Early case and make it easier to distinguish other cases arising in the future. Incidentally, this foot-note will explain what is meant by an authorization to charge the reserve account or clearing account.

This foot-note would prohibit the present general agreement of the Federal Reserve Bank of New York for an immediate charge to the reserve account of local member banks which are not members of the clearing house; but the Federal Reserve Bank of New York could continue substantially the same practice without violating the proposed new regulation if it would require the messenger to whom checks are delivered to sign a receipt for such checks containing a specific authorization to charge the specific amount thereof to the reserve account or clearing account of the bank on which such checks are drawn, subject to the right of the member bank to return any checks before 3 o'clock the same day and receive credit therefor. It might be somewhat unusual for a messenger to sign such a document, but there would seem to be no practical reason why the messenger should not be authorized to do so, especially in view of the fact that informal authorizations to charge the reserve account for checks sent through the mails are at present frequently given by merely stamping a form of authorization enclosed in the cash letter.

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Paragraph 4 is entirely new, but its purpose is believed to be self-evident. It contains a provision similar to that suggested by Mr. Agnew, and also incorporates in another form a suggestion made by Messrs. Logan and Leedy.

Paragraph 5 is intended to take the place of old paragraph 4 and is much simplified in view of the fact that the different forms of payment or remittance are covered by paragraph 3. Attention is called to the fact that, under the terms of paragraph 3, the acceptance of anything other than cash in payment or remittance is in the discretion of the Federal reserve bank and at its option; that, under the terms of the footnote to paragraph 3, an authorization to charge the reserve account can be given only by previous arrangement with the Federal reserve bank; and that, under the terms of paragraph 4, such an authorization is expressly made subject to acceptance by the Federal reserve bank in its discretion.

Paragraph 6 is exactly the same as paragraph 5 of the old regulation.

Paragraph 7 is entirely new and is intended to extend to the Federal reserve banks the same protection in collecting remittance drafts as they have in collecting the checks for which such remittance drafts are given. The possible failure of the regulation to afford such protection in the past has given rise to much concern and has been the subject of numerous discussions between this office and Counsel to the various Federal reserve banks at various times during the past three or four years.

Paragraph 8 takes the place of old paragraph 6 and is substantially the same as the amended form recommended by the conference of Counsel, but I have endeavored to clarify the new language recommended by the conference

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of Counsel. As recommended by the conference of Counsel, this new language applies only to the "owner or holder" of any such check so charged back, and thus might be held not to apply to the bank which sent the check to the Federal reserve bank for collection and which, under the terms of paragraph 1, is the only party having any privity of contract with the Federal reserve bank. I have, therefore, changed the first part of the sentence to read, "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", etc. I have also inserted the words "of the drawee bank" immediately after the word "property", in order to make it clear that we are not attempting to protect the property of the Federal reserve bank from levy or execution where the Federal reserve bank is held liable for negligence.

In my opinion, the new provision of paragraph 6 recommended by the Conference of Counsel is not absolutely necessary in view of the mandatory requirement of the old paragraph, but I think it would do no harm. In my opinion it does not prevent any Federal reserve bank from taking collateral to protect itself but it would prevent the owners or holders of checks charged back from having any claim on such collateral.

You will understand, of course, that this proposed revision of Section V has not yet been submitted to the Federal Reserve Board and represents only my own tentative views. It is being sent out as something concrete for you and Counsel of all the other Federal reserve banks "to shoot at", and I hope that you will not hesitate to criticize it freely. On the other hand, I think it would be undesirable and unprofitable to attempt to reconsider at this time any of the principles or questions of policy covered by the resolution adopted by the Conference of Counsel and

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approved by the Governors' Conference.

As indicated above, I have not yet reached any conclusion in my own mind on the question whether the Federal Reserve Board should at this time:

(1) Leave the regulation in its present form without any further amendments whatsoever, or

(2) Undertake a complete revision of Section V along the lines of the tentative draft enclosed herewith, or

(3) Adopt only those amendments recommended by the Conference of Counsel.

I shall appreciate it very much, therefore, if you will kindly give me the benefit of your views as to which of these courses I should recommend to the Federal Reserve Board. In this connection I may say that a petition for writ of certiorari has been filed in the Supreme Court of the United States in the case of Early, Receiver, v. Federal Reserve Bank of Richmond and probably will be granted or denied by the Supreme Court early this fall.

Regardless of whether you think a complete revision of the regulation at this time is desirable, I shall appreciate it if you will also give me the benefit of your suggestions and criticisms with regard to the tentative draft enclosed herewith, in order that I may have the benefit of the views of all Counsel with reference to this draft if I finally decide to submit a draft of a complete revision to the Federal Reserve Board for its consideration either at this time or at some future date.

An early reply to this letter will be greatly appreciated.

With kindest personal regards, I am,

Very truly yours,

Walter Wyatt
General Counsel.

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