BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

X-9124

February 13, 1935.

CONFIDENTIAL

SUBJECT: Reports of Apparent Violations of Section 22(g) of the Federal Reserve Act.

Dear Sir:

It has been observed that in numerous instances the reports which have been made with regard to apparent violations of section 22(g) involved comparatively small amounts and in many instances involved violations which apparently resulted from ignorance or misunderstanding of the law. It also appears that when violations of this section are called to the attention of the banks and executive officers involved the unlawful loans or extensions of credit usually are eliminated promptly. In view of these circumstances, the Board has decided that the procedure which has heretofore been followed with regard to reports of apparent violations of section 22(g) involving State member banks should be revised.

In the future, when an apparent violation of section 22(g) comes to your attention and it does not appear that it was committed knowingly or as a result of a willful disregard of the provisions of the law, you are requested to call the attention of the bank and the executive officer involved to the applicable provisions of the law

and the penalties for violations thereof and to suggest that immediate steps be taken to eliminate the unlawful loans or extensions of credit involved and to advise you of the action taken. If such correction is effected within a reasonable time, you need not report the matter to the local United States District Attorney. However, if the matter is not corrected within a reasonable time, you should report the facts to the local United States District Attorney and to the Board, in accordance with the usual procedure. In any case where a correction is effected, please advise the Board for its information and records of the circumstances involved in the case and the correction obtained. If an apparent violation of section 22(g) involving a State member bank located in another district should come to your attention, you should call the matter to the attention of the Federal Reserve Agent in that district for attention in accordance with the procedure herein outlined.

The revised procedure described above is intended to be followed by Federal Reserve Agents where it appears that the violation resulted from inadvertence or from ignorance or misunderstanding of the law. If the Federal Reserve Agent feels that the violation was committed knowingly or as a result of a willful disregard of the provisions of the law, he should report the facts to the local United States District Attorney and to the Federal Reserve Board in the usual manner without waiting to take the matter up with the bank involved.

In order to avoid unnecessary correspondence with regard to apparent violations of the provisions of section 22(g) disclosed by reports of examinations and analyses of such reports forwarded to the Federal Reserve Board, it will be appreciated if you will indicate in connection with such reports and analyses, when you forward them to the Board, whether any apparent violations of section 22(g) which may appear therein have been corrected, and, if not, what steps are being taken to obtain corrections.

In order not to encourage any disregard of the provisions of section 22(g), this letter should be held in the strictest confidence.

In view of the difficulties which have arisen in administering this section of the law, the Federal Reserve Board has recommended that it be amended in several respects; and there are inclosed for your information a copy of a letter on this subject which the Board addressed to the Chairman of the Committee on Banking and Currency of the United States Senate under date of January 14, 1935, and a copy of a proposed bill incorporating the proposed amendments.

Very truly yours,

Chester Morrill

Chester Morrill,
Secretary.

Inclosures.

TO ALL FEDERAL RESERVE AGENTS.

COPY L-9124-a

January 14, 1935.

Honorable Duncan U. Fletcher, Chairman,
Banking and Currency Committee,
United States Senate,
Washington, D. C.

My dear Mr. Chairman:

This refers to the bill, S. 370, submitted on January 9, 1935, to the Federal Reserve Board for a report by Mr. Sparkman, Acting Clerk of your Committee. This bill would amend section 22(g) of the Federal Reserve Act so as to permit loans made by a member bank to its own executive officers prior to June 16, 1933, the date of the enactment of the Banking Act of 1933, to be renewed or extended for a period of four years from that date rather than for a period of two years from that date as now provided in the law.

The Federal Reserve Board is of the opinion that section 22(g) should be amended and is in general agreement with the purpose which it is contemplated would be accomplished by the proposed amendment contained in the bill, S. 370. However, in view of a number of administrative difficulties which have been encountered under the present provisions of section 22(g), the Board believes that it would be desirable to make a further revision of that section. Accordingly, there is inclosed a draft of a bill for that purpose which the Federal Reserve Board recommends be enacted into law.

The principal changes which would be made in the provisions of section 22(g) by the inclosed draft of a bill and the reasons therefor are as follows:

The inclosed draft of a bill would amend section 22(g) so as to permit loans made by a member bank to its executive officers prior to June 16, 1933, to be renewed or extended for periods expiring not more than five years from that date. The present provisions of the law permit such loans to be renewed or extended not more than two years from that date. At the time of the enactment of the Banking Act of 1933, it appeared that executive officers of member banks should reasonably be expected to eliminate their indebtedness to such banks within a period of two years. However, in view of the conditions which have existed in the meantime, it has not been possible in many instances for executive officers to arrange for the retirement of such indebtedness. In the circumstances, and in view of the effect which the enforcement of the present provisions of the law in this respect might have upon the member banks and executive officers involved, the Board believes that an extension for three years of the time in which the retirement by executive officers of such indebtedness may be accomplished is highly desirable. In this connection, you will observe from the inclosed bill that a provision has been added to the effect that in any such case the board of directors of the member bank

must have satisfied themselves that the extension is in the best interest of the bank and that the officer indebted has made reasonable effort to reduce his obligation.

Under the present provisions of section 22(g), an executive officer of a member bank who borrows from any bank other than the member bank of which he is an executive officer is required to make a written report to the chairman of the board of directors of the member bank of which he is an executive officer. In some instances, boards of directors of banks do not have chairmen designated as such and questions have arisen as to whom the report should be made in cases of this kind. In these circumstances, the Board believes that it would be desirable to require that the report of borrowings from other banks be made to the board of directors of the member bank of which the borrower is an executive officer, and a provision to this effect is included in the inclosed draft of a bill.

Under the present provisions of section 22(g) a loan by a member bank to a partnership in which an executive officer of the member bank is a partner may be considered a loan or extension of credit to such executive officer regardless of the extent of his interest in the partnership. In this connection, it is a hardship, in small communities with but one bank, to prohibit the bank from loaning to a local partnership consisting of a number

of members, one or more of whom may be executive officers of the bank. It would be desirable to permit member banks to make loans to partnerships in these circumstances where the transactions do not involve evasions of the provisions of section 22(g), and a provision is contained in the attached draft of a bill which would except from the provisions of section 22(g) loans to a partnership other than where executive officers of the member bank are partners having a majority interest in such partnership.

When notes and other assets acquired by member banks from persons other than executive officers are classified by the examiners as of doubtful value, the executive officers, who may also be directors of the banks, frequently endorse or guarantee such assets for the protection of the banks. Sometimes, in order to eliminate doubtful assets from the banks, executive officers purchase such assets, giving the banks their own promissory notes, which, in many instances, are well secured or are otherwise good and collectible. Such transactions are for the benefit of the banks rather than the executive officers and are not believed to be within the intent of the statute, although they are prohibited by the language of the statute. The inclosed bill, therefore, would exempt transactions of this character from the prohibitions of the statute.

It has been observed that in many instances the loans made in violation of section 22(g) are in small amounts, that

many of the violations have been made inadvertently through ignorance of the provisions of the law, or, in some cases, through misunderstandings as to the applicability of the terms of the law. In cases where criminal proceedings are instituted by the United States, even though the amount of the loans may have been small or the violations inadvertently made, such criminal proceedings may have a serious effect on the reputations and standing in the community of the bank officers involved.

Much confusion and difficulty has grown out of the uncertainty as to the meaning of the term "executive officer" and as to whether or not certain transactions are loans or extensions of credit within the meaning of this section. Many appeals have been made to the Federal Reserve Board by member banks for administrative rulings on questions of this kind; but the Board has felt that it could not safely issue such administrative rulings because of the fact that violations of this section constitute misdemeanors punishable by fine or imprisonment and the determination of whether or not criminal proceedings should be instituted in any given case is a matter within the jurisdiction of the Department of Justice and is usually left to the judgment of the local United States Attorney. Administrative interpretations of the law by the Federal Reserve Board would be of no protection to member banks or their officers, if the Department of Justice or the local United States Attorneys should construe the law

differently and prosecute the bank's officials for transactions which the Board believed to be entirely lawful. The Department of Justice, in accordance with its long established practice, has declined to express opinions on such questions and the banks have been without any means of obtaining authoritative rulings.

It is believed that these difficulties could be eliminated without impairing the effectiveness of this salutary provision of the law if the criminal penalty were repealed and there were substituted a provision making it clear that the Federal Reserve Board could remove offending officers from office under the provisions of section 30 of the Banking Act of 1933 for violations of the provisions of section 22(g) without waiting for repetitions of such offenses.

As you know, under the provisions of section 30 of the Banking Act of 1933, the Federal Reserve Board is authorized to remove officers or directors of member banks or trust companies who shall have continued to violate any law relating to such banks or trust companies or shall have continued unsafe or unsound practices in conducting the business of such institutions, and a provision is contained in the inclosed draft of a bill to amend section 22(g) which would also authorize the Board to remove executive officers of member banks who violate that section.

In view of the difficulties which have been experienced, as indicated above, with regard to who is an "executive officer",

and in order that the provisions of section 22(g) may be effectively enforced, the inclosed draft of a bill also contains a provision which would authorize the Board to define the term "executive officer" and other terms contained in the law and to prescribe such rules and regulations as are necessary to effectuate the provisions of section 22(g) in accordance with its purposes and to prevent evasions of such provisions. A provision of this kind would be of material assistance to the Board in enforcing the provisions of section 22(g).

Very truly yours,

(Signed) Chester Morrill

Chester Morrill,
Secretary.

Inclosures.

A BILL

To amend Section 22(g) of the Federal Reserve Act relating to loans to executive officers of member banks.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That subsection (g) of section 22 of the Federal Reserve Act, as amended, is amended to read as follows:

"(g) No executive officer of any member bank shall borrow from or otherwise become indebted to any member bank of which he is an executive officer, and no member bank shall make any loan or extend credit in any other manner to any of its own executive officers: Provided, That loans made to any such officer prior to June 16, 1933, may be renewed or extended for periods expiring not more than five years from such date where the board of directors of the member bank shall have satisfied themselves that such extension or renewal is in the best interest of the bank and that the officer indebted has made reasonable effort to reduce his obligation, these findings to be evidenced by resolution of the board of directors spread upon the minute book of the bank. If any executive officer of any member bank borrow from or if he be or become indebted to any bank other than a member bank of which he is an executive officer, he shall make a written report to the board of directors of the member bank of which he is an executive officer, stating the date and

amount of such loan or indebtedness, the security therefor, and the purpose for which the proceeds have been or are to be used. Borrowing by, or loaning to, a partnership in which one or more executive officers of a member bank are partners having either individually or together a majority interest in said partnership, shall be considered within the prohibitions of this subsection. Nothing contained in this subsection shall prohibit any executive officer of a member bank from endorsing or guaranteeing for the protection of such bank any loan or other asset which shall have been previously acquired by such bank in good faith or from incurring any indebtedness to such bank for the purpose of protecting such bank against loss or giving financial assistance to it. The Federal Reserve Board is authorized to define the term 'executive officer', to determine what shall be deemed to be a borrowing, indebtedness, loan or extension of credit, for the purposes of this subsection, and to prescribe such rules and regulations as it may deem necessary to effectuate the provisions of this subsection in accordance with its purposes and to prevent evasions of such provisions. Any executive officer of a member bank accepting a loan or extension of credit which is in violation of the provisions of this subsection shall be subject to removal from office in the manner prescribed in section 30 of the Banking Act of 1933, Provided, That, for each day that a loan or extension of credit made in violation of this subsection exists, it shall be deemed to be a continuation of such violation within the meaning of the said section 30."