FEDERAL RESERVE BOARD

WASHINGTON

ADDRESS OFFICIAL CORRESPONDENCE TO
THE FEDERAL RESERVE BOARD

X-9362

November 13, 1935.

SUBJECT: Proposed Revision of Regulation F Relating to Exercise of Fiduciary Powers by National Banks.

Dear Sir:

There are inclosed herewith six copies of a tentative draft (L-349) of a revision of Regulation F relating to the exercise of fiduciary powers by national banks under the provisions of section 11(k) of the Federal Reserve Act, together with six copies each of applicable forms in connection with such regulation. It will be appreciated if you and the officers and counsel of your bank will study these inclosures and forward to the Board your comments and suggestions thereon at the earliest practicable date and not later than thirty days from the date of this letter. The tentative drafts of the regulation and forms have been prepared by the Board's staff but not considered by the Board, and, in order to expedite the matter and with the permission of the Board, are being sent to you at the same time that they are being submitted to members of the Board for consideration.

As you know, a conference of the trust examiners for the various Federal Reserve banks will be held in Washington on November 18th. It is suggested that any comments you may wish to forward to the Board be withheld until you have considered with the trust examiner

for your bank any suggestions which may have arisen out of a discussion of the revision of Regulation F by the trust examiners at the conference of November 18th.

Your especial attention is called (1) to the provisions contained in the first paragraph of subsection (b) of section 9 of the proposed revision of the regulation which eliminate the provisions of section VIII(b) of the Board's present Regulation F with specific reference to the deposit of trust funds awaiting investment or distribution in the commercial or savings department of a national bank acting as fiduciary and to the provisions contained in the last paragraph of such subsection (b) which are designed to prohibit the deposit of trust funds in the banking department of the national bank as an investment, (2) to the provisions in section 14 prohibiting the retention of trust fees by officers or employees of a national bank when acting as co-fiduciary with the national bank, and (3) to the provisions of section 15 relating to exemptions from liability by a national bank when acting as fiduciary. The provisions referred to are not necessarily recommended by the staff but have been incorporated in the revised draft of the regulation for purposes of discussion; and any suggestions regarding the desirability of such provisions or any modifications thereof will be particularly appreciated. There is inclosed a copy of a memorandum prepared in the Office of the Comptroller of the Currency furnishing the reasons for the elimination of the

provisions now contained in section VIII(b) of the Board's present Regulation F.

Very truly yours,

Chester Morrill

Chester Morrill,
Secretary.

Inclosures. (L-349)

TO ALL FEDERAL RESERVE AGENTS.

C O P Y X-9362-a

TREASURY DEPARTMENT

Comptroller of the Currency

Washington

November 8, 1935.

M E M O R A N D U M

Re: Section 9(c) of Tentative Draft of Regulation F Relating to Exercise of Trust Powers by National Banks.

In Section 9(c) provision is made for deposit of funds held in trust awaiting investment or distribution, in the commercial or savings departments of the trustee bank and the delivery of collateral security to protect such deposits.

I think it is extremely inadvisable and perhaps erroneous to take the position that banks are authorized to deposit trust funds awaiting investment in the savings department and pledge collateral to the trust department for the protection of such deposits. It is realized that similar permission is indicated in existing regulations of the Board on this matter, but this office has consistently refused to recognize the validity of such arrangement in connection with the liquidation of national banks having trust departments. The most common type of situation presented in this connection is where an individual deposits a sum of money in a trust department under an agreement directing that this money be deposited in the savings department at savings department rate of interest, the income therefrom to be paid to a designated party with a possible provision for principal to be paid out at a certain time for a certain purpose.

There are a number of objections to this type of arrangement. It is believed Section 11k of the Federal Reserve Act in permitting the bank to use trust funds awaiting investment in the conduct of its business contemplated a temporary arrangement whereby the bank would have the benefit of the use of the funds for such short periods of time as might elapse pending the investment of such funds in some form of security or otherwise. It is true that the Board by a regulation has extended the statute to include funds "awaiting distribution." Without passing upon the validity of this extension of the statute, it will be conceded that in such case there is contemplated merely a temporary short term deposit pending a more or less immediately contemplated distribution.

There can be no argument that a deposit of trust funds in a savings account is an investment thereof. Swan v. Children's Home Society, 67 Fed. (2d) 84. Consequently, when such fund is deposited

in the savings department, it is no longer a trust fund awaiting investment and since it is no longer a trust fund awaiting investment, then under Section 11k it is not entitled to the benefit of a pledge of collateral security to the trust department.

To permit a pledge of collateral to protect such savings deposit makes the bank a guarantor of the trust investments which it has in such accounts. If and when interest rates on savings deposits approach their former basis of three per cent, it is manifest that the average trust beneficiary or donor would rather have the trust funds carried in a savings account at three per cent fully protected by collateral security and insurance, than he would to have such funds invested even in Government bonds.

The Supreme Court of the United States has laid down the principle that national banks cannot pledge collateral for the protection of private deposits. We have come into frequent contact with arrangements whereby a deposit was made in the trust department under such conditions that the bank in fact had no true fiduciary duties as to such funds and the depositor was practically as free to obtain or use such deposit as though he had deposited direct in the savings department. We recently had a case where a church collected insurance as a result of a fire. One of the church officials was president of a national bank. They wanted to deposit this fund in the bank pending disbursement of it for construction of a new church. They desired to be protected by a pledge of collateral. The bank's attorney, who was also a church official, ascertained that the bank could not pledge collateral to protect a private deposit but accomplished the same result by depositing the fund with the trust department of the bank under an agreement which provided that the bank should deposit it in the savings department at interest and then should disburse the fund from time to time at the orders of the church trustees. The Federal courts held that this trust fund was entitled to the collateral protection given other funds in the trust department, thus clearly nullifying the principles that private deposits should not be protected by pledge of collateral. If such practices are to be permitted, there is nothing to prevent individuals who have funds in excess of the amount protected by insurance from making similar arrangements with trust departments of banks, and thereby obtaining in fact to the disadvantage of the other depositors of the bank full collateral coverage for their deposits.

Under existing regulations of the Federal Reserve Board it is not permissible for a national bank to accept in its savings department as a savings account funds which do not represent "thrift" accounts. The theory underlying such regulation even though it is not going to be incorporated in the new regulations in principle should operate to prevent the deposit of trust funds awaiting investment or distribution in the savings departments of banks, because rarely, if ever, can such fund come into the "thrift" account classification.

To permit such deposit of trust funds in principle seems to be a perversion of the intent of Congress in Section 11k and is

extremely questionable as an acceptable trust activity or as truly representing an element of fiduciary relationship.

A particularly significant statement was made in Carcaba v. McNair, 68 Fed. (2d) 795, certiorari denied, 292, U.S. 646. The court said, page 798, with respect to trust department transactions:

> "The deposits which are prohibited are not those made by the trust department in the exercise of its functions, but those made with the trust department by the bank's customers. The purpose is to prevent such customers in their ordinary commercial transactions from obtaining a preferential security from other commercial customers contrary to the general policy of the National Bank Act."

See also Santee Timber Corporation v. Elliott, 70 Fed. (2d) 179.

It is believed that permitting banks to deposit trust funds in the savings department and also secure them by pledge of collateral inevitably leads to the establishment of dubious relationships between the trust department and its customers which are not true trust transactions and in which the funds involved are not as against the other depositors of the bank, fairly entitled to the protection of collateral.

While the foregoing discussion deals specifically with the matter of depositing trust funds in the savings department the same objections in our opinion may be made to their deposit with the bank on any time and interest bearing basis such as by certificate of deposit or otherwise.

JOHN F. McGRATH,
Special Counsel.