

BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON

X-9539



ADDRESS OFFICIAL CORRESPONDENCE  
TO THE BOARD

April 4, 1936.

SUBJECT: Interpretation of Comptroller's  
Regulation re Investment Securities.

Dear Sir:

There are inclosed herewith a copy of a letter dated February 28, 1936, from the President of the Federal Reserve Bank of New York, a copy of a letter dated March 2, 1936, from the Assistant Federal Reserve Agent at Cleveland, and a copy of a telegram dated March 6, 1936, from the Assistant Federal Reserve Agent at San Francisco, each of which presents certain questions arising under the provisions of the regulation of the Comptroller of the Currency governing the purchase of investment securities.

Copies of these inquiries were referred to the Comptroller for a statement of his views concerning the questions presented therein. There are inclosed herewith copies of the Comptroller's replies and of the Board's letters to the President of the Federal Reserve Bank of New York, to the Federal Reserve Agent at Cleveland, and to the Assistant Federal Reserve Agent at San Francisco, inclosing copies of such replies.

Very truly yours,

*Chester Morrill*

Chester Morrill,  
Secretary.

Inclosures.

COPY

X-9539-a

FEDERAL RESERVE BANK  
OF NEW YORK

February 28, 1936.

Dear Governor Broderick:

Referring to my conversation over the telephone yesterday, there appears to be some confusion among member banks as to the interpretation and effect of the "Regulations Governing the Purchase of Investment Securities, and Further Defining the Term 'Investment Securities' as Used in Section 5136 of the Revised Statutes as Amended by the 'Banking Act of 1935'", promulgated by the Comptroller of the Currency on February 15, 1936. We received copies of these regulations from the Board on February 26, 1936, and in accordance with the Board's request on that day we mailed copies to all State member banks in this district, copies having previously been sent to all national banks by the Comptroller of the Currency.

Judging from the inquiries which we have received, the confusion in regard to these regulations relates principally to the following points:

1. Whether the regulations prohibit the purchase by member banks of certain municipal obligations which are not readily "marketable" as that term is defined in the regulations.
2. Whether member banks may continue to hold securities which were purchased prior to the issuance of the present regulations and which do not meet the test of "investment securities" as laid down in such regulations, but which the banks were permitted to acquire under the terms of the regulations in effect at the time of purchase.
3. Whether or not the ratings of securities by recognized rating manuals conclusively establish the status of securities as being, or not being, securities "in which the investment characteristics are distinctly or predominantly speculative" within the meaning of subdivision (3) of Section II of the regulations; and, if so, at what point in such scale of ratings are securities to be conclusively deemed to be "distinctly or predominantly speculative", or, in other words, how many of the highest grades of securities as so rated may be considered not to be "distinctly or predominantly speculative". The section in question, and the footnote thereto, read as follows:

"(3) The purchase of 'investment securities' in which the investment characteristics are distinctly or predominantly speculative, or 'investment securities' of a lower designated standard than those which are distinctly or predominantly speculative, is prohibited.\* The purchase of securities which are in default, either as to principal or interest, is also prohibited.

\* The terms employed herein may be found in recognized rating manuals, and where there is doubt as to the eligibility of a security for purchase, such eligibility must be supported by not less than two rating manuals."

4. Whether all so-called "convertible" bonds are ineligible for purchase by member banks by reason of subdivision (5) of Section II which reads: "Purchase of securities convertible into stock at the option of the issuer is prohibited."

It would be helpful if these points could be clarified and I am therefore calling the matter to your attention in the hope that it may be possible to discuss these questions with the Comptroller's office with a view to such clarification.

With respect to the first point, it is our understanding that as a matter of law neither Section 5136 of the Revised Statutes, nor any regulation of the Comptroller issued thereunder, can apply to "general obligations of any state or of any political subdivision thereof", which would include most municipal securities.

With respect to the second point, it is our understanding that while the present regulations are silent on the question, they do not in fact prohibit a member bank from holding securities which the bank purchased prior to the issuance of such regulations and which the bank was permitted to acquire under the terms of the regulations in effect at the time of purchase.

With respect to the third point, we question the advisability of making the manual ratings the conclusive test of whether or not securities are "distinctly or predominantly" speculative. This is particularly true in the case of new issues which have not yet received ratings and which are often offered to banks on the original issue at a few points below the retail price. Many of these new issues may be entirely sound, and we believe the bank officers should be permitted to exercise their discretion in the

purchase of them when they are honestly believed to be sound investments and otherwise comply with the legal requirements. If, however, it is the Comptroller's purpose to make manual ratings the conclusive test, it would seem to us that the regulations should be more definite as to which grades include, or may include, eligible securities and which are necessarily considered ineligible as speculative. We construe the regulations as now drawn as permitting the purchase of securities in any of the four highest grades, since the definitions in the manuals of the fourth highest grade, that is, the highest of the three grades in the B group, indicate that in general the securities included therein are in the investment class, although in some instances having speculative elements. It appears that there has been considerable confusion on this point, however, as we understand that conflicting views have been expressed as to whether the securities eligible for purchase under the terms of the regulations as now drawn are limited to the three or four highest grades.

With respect to the fourth point, subdivision (5) of Section II in terms prohibits the purchase only of securities convertible into stock "at the option of the issuer" and would not appear to apply to securities convertible only at the option of the holder. Most, if not all, of what are commonly referred to as "convertible" bonds, are convertible only at the option of the holder. These undoubtedly include some entirely sound issues which can be purchased on an investment yield basis without paying any substantial premium for the conversion privilege.

Very truly yours,

(Signed) George L. Harrison

George L. Harrison,  
Governor.

Hon. Joseph A. Broderick,  
Board of Governors of the  
Federal Reserve System,  
Washington, D. C.

## OF CLEVELAND

March 2, 1936.

Board of Governors of the  
Federal Reserve System,  
Washington, D. C.

Gentlemen:

In order that we may make prompt and accurate replies to inquiries concerning the interpretation of the Comptroller's regulation dated February 15, 1936, governing the purchase of investment securities and further defining the term "investment securities" as used in section 5136 of the Revised Statutes, as amended, we should appreciate it if our understanding of the following items is confirmed.

(1) That investment securities lawfully acquired prior to February 15, 1936, need not be disposed of if such obligations do not conform to terms of the regulation made effective as of that date.

(2) That under the Moody classification bonds rated Baa, defined as those "in which speculative elements begin distinctly to appear," may lawfully be purchased since they may scarcely be classed as investments whose characteristics are "distinctly or predominantly speculative".

(3) Under the Standard Statistics classification, bonds rated B, which are classed as "semi-speculative" are in the twilight zone, their eligibility for purchase being dependent upon the degree to which speculative elements appear.

(4) In Fitch's ratings it is our impression that bonds rated to and including BB may be regarded as proper investments under the terms of the regulation.

(5) Under the Poor classification it is our impression that all bonds rated to and including B\* meet the requirements of the regulation.

It is assumed in all cases that bonds are otherwise legally purchasable.

Very truly yours,

(Signed) J. B. Anderson

Assistant Federal Reserve Agent.

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## FEDERAL RESERVE SYSTEM

## TELEGRAM

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San Francisco Mar 6 338p

Board

Washn

Reference is made to the Comptrollers regulations Governing the purchase of investment securities referred to in the Board's telegram No. 2379. Some State bank members have informed us that prior to receiving the subject regulations they had invested in some instances in non excepted bonds in amounts permitted under State law but in excess of limit prescribed under Section 5136, and wish to be advised whether, in the circumstances, immediate reduction to conform to the provisions of said Section and regulations will be required. It would seem equitable that if reductions are to be required, an orderly liquidation to avoid loss to the bank should be permitted. The Board's advice as to requirements and policy to be followed in the circumstances will be appreciated

Sargent

649p

COPY

X-9539-d

## TREASURY DEPARTMENT

Comptroller of the Currency

Washington

March 18, 1936.

Board of Governors,  
Federal Reserve System,  
Washington, D. C.

Dear Sir:

Reference is had to yours of March 3, enclosing a copy of a letter received by you from the Governor of the Federal Reserve Bank of New York, dated February 28, 1936, presenting various questions rising under the regulations issued by this office February 15, 1936, governing the purchase of investment securities.

With respect to the questions raised, our position is as follows:

(1) The regulations do not prohibit the purchase by Member Banks of municipal obligations which are not readily "marketable" as defined by the regulations, if such municipal obligations are in fact "general obligations" as distinguished from limited or special obligations, and further provided that such obligations are in fact obligations of a "political subdivision" of the State. This question sometimes becomes important, as, for example, bond issues for the improvement of a municipal electric light plant, where the issue is not by its terms an obligation of the municipality but some unit, board or entity within the municipality.

It will be understood that even though a "municipal" obligation is not a "general obligation" and even though the entity issuing it is not a political subdivision of the State, such obligation may still be eligible for investment provided it meets with all the requirements of the regulations.

(2) The regulations do not require the banks to dispose of securities which are now ineligible under the present regulations but which were purchased prior to the issuance of the regulations, if they were otherwise lawfully acquired at the time of their purchase.

(3) On the question as to whether or not eligibility from a non-speculative standpoint under the regulations is to be conclusively determined by the ratings of rating manuals, we have dealt with this question at length in a separate communication of this date addressed to you, in reply to an inquiry submitted by the Assistant Federal Reserve Agent at Cleveland. Governor Harrison does raise one point not discussed in the above referred to separate communication, namely: the fact that new issues which have not yet received ratings are often offered to the banks, which issues are entirely sound; the query being whether or not absence of a rating in such cases would operate to prevent the acquisition of such securities.

The absence of a rating in no instance is conclusive and if any issue of securities otherwise meets the requirements of the regulations, and if its investment characteristics are not distinctly or predominately speculative, as judged by whatever means are available for determining such question, then the purchase of such a security would be permissible.

(4) With regard to the provision "Purchase of securities convertible into stock at the option of the issuer is prohibited", it was not intended that such provision should operate to prohibit the purchase of securities convertible only at the option of the holder.

Very truly yours,

(Signed) J. F. T. O'Connor

J. F. T. O'CONNOR,  
Comptroller.



COPY

X-9539-e

## TREASURY DEPARTMENT

Comptroller of the Currency

Washington

March 18, 1936.

Board of Governors,  
Federal Reserve System,  
Washington, D. C.

Dear Sirs:

This acknowledges yours of March 10, enclosing a copy of a letter dated March 2, 1936, received by you from the Assistant Federal Reserve Agent at Cleveland, and a copy of a telegram dated March 6, 1936, from the Assistant Federal Reserve Agent at San Francisco, both of which raise certain questions of interpretation under the regulations recently issued by this office relative to investment securities.

As respects the letter from the Assistant Federal Reserve Agent at Cleveland, the questions raised therein are as follows:

(1) Whether or not investment securities lawfully acquired prior to February 15, 1936, need to be disposed of if such obligations do not conform to the terms of the regulations.

If the investment securities were lawfully acquired prior to the issuance of the regulations, there is no obligation under the regulations to dispose of same.

Under questions (2), (3), (4) and (5) the inquiry is made as to whether bonds classified under certain rating symbols by the various rating services are to be considered as within the eligible classification defined in Section II (3) of the regulations.

This office has had numerous inquiries of a similar nature from banks and from the public, and we have consistently refrained from specifically advising whether or not a security under a specific rating classification of a specific rating service is eligible. This position has been taken for the reason that such information may operate to cause those responsible for the investments of the bank to assume that their responsibility has been borne when they determine that a particular security falls within a specific rating classification, with the result that the judgment of the rating service supplants

the responsibilities of those primarily charged with properly investing the bank funds. Furthermore, it is not possible to draw a definite line that would operate satisfactorily in the case of all rated securities. In individual cases a security of a rating one class below what would be generally considered satisfactory might for particular reasons still be eligible, and vice versa.

It was intended that reference to the rating manuals was not to be the exclusive guide on the question of eligibility but that the use of such manuals was to be permissible as an aid in determining eligibility, particularly in the case of banks which do not have the facilities for making an independent investigation of the history and prospects of an issuer.

You will appreciate from the foregoing considerations that we cannot state that a security having a specific rating is necessarily within the eligible class.

The question raised by telegram from your Assistant Federal Reserve Agent at San Francisco involves a situation where the State banks, prior to receiving the regulations, had invested in non-accepted bonds in amounts permitted under State law but in excess of the limit prescribed under Section 5136, and the question is raised as to whether in the circumstances immediate reduction to conform to the limitations will be required, it being suggested that if reductions are to be required, an orderly liquidation to avoid loss to the bank should be permitted.

Inasmuch as the limitations as to amount prescribed in Section 5136 of the Revised Statutes were made effective as to State Member Banks by the Banking Act of 1933, as of June 16, 1933, the limitations prescribed by Section 5136 as amended from time to time naturally operated from that date. Consequently, securities purchased in excess of the limitations subsequent to June 16, 1933, by the State Member Banks were held in violation of law independent of our regulations, and it would seem to follow that such holdings should be reduced in conformity to the limitations. As to whether or not such reduction must be immediate or gradual in order to avoid loss, that is a matter of policy, and as respects National Banks which may have excess holdings of securities, a gradual liquidation in most cases would be permissible if immediate liquidation would involve loss to the bank.

Very truly yours,

(Signed) J. F. T. O'Connor

J. F. T. O'CONNOR,  
Comptroller.

COPY

X-9539-f

April 4, 1936.

Mr. George L. Harrison, President,  
Federal Reserve Bank of New York,  
New York, New York.

Dear Mr. Harrison:

This refers to your letter to Mr. Broderick dated February 28, 1936, regarding the interpretation of the regulation issued under the provisions of section 5136 of the Revised Statutes by the Comptroller of the Currency, governing the purchase of investment securities.

Your letter was referred to the Comptroller for an expression of his views upon the questions presented therein. There is inclosed herewith a copy of a reply from the Comptroller, which was received by the Board on March 25, 1936, setting forth his views concerning the questions presented in your letter.

A copy of the letter referred to in paragraph numbered (3) of the Comptroller's letter is also inclosed herewith.

Very truly yours,

(Signed) Chester Morrill

Chester Morrill,  
Secretary.

Inclosures

X-9539-g

April 4, 1936

Mr. E. S. Burke, Jr.,  
Federal Reserve Agent,  
Federal Reserve Bank of Cleveland,  
Cleveland, Ohio.

Dear Mr. Burke:

This refers to Mr. Anderson's letter of March 2, 1936, presenting certain questions concerning the interpretation of the Comptroller's regulation governing the purchase of investment securities which was promulgated under the authority of section 5136 of the Revised Statutes.

A copy of Mr. Anderson's letter together with a copy of a telegram from the Assistant Federal Reserve Agent at San Francisco was submitted to the Comptroller of the Currency with a request for an expression of his views thereon.

A copy of the Comptroller's reply, which was received by the Board on March 25, 1936, is inclosed herewith.

Very truly yours,

(Signed) Chester Morrill

Chester Morrill,  
Secretary.

Inclosure.

April 4, 1936.

Mr. S. G. Sargent,  
Assistant Federal Reserve Agent,  
Federal Reserve Bank of San Francisco,  
San Francisco, California.

Dear Mr. Sargent:

This refers to your telegram dated March 6, 1936, presenting a question regarding the interpretation of the Comptroller's regulation governing the purchase of investment securities which was promulgated under the authority of section 5136 of the Revised Statutes.

A copy of your telegram, together with a copy of a letter from the Assistant Federal Reserve Agent at Cleveland, was submitted to the Comptroller of the Currency with a request for an expression of his views thereon. There is inclosed herewith a copy of the Comptroller's reply, which was received by the Board on March 25, 1936.

It will be observed that the Comptroller has stated that, in the case of national banks which hold securities in excess of the limitations prescribed by section 5136, a gradual liquidation in most cases would be permissible if immediate liquidation would involve loss to the bank.

Likewise, it is the view of the Board that, in cases of the kind described in your telegram where a State member bank holds investment securities in excess of the limitations prescribed by section 5136, a gradual liquidation is permissible if immediate liquidation would involve loss to the bank.

Very truly yours,  
(Signed) Chester Morrill  
Chester Morrill,  
Secretary.

Inclosure.