

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

X-9611

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD


June 8, 1936.

SUBJECT: Exchange of Defaulted Bonds by Member
Bank under Comptroller's Regulations
Regarding Investment Securities.

Dear Sir:

There is inclosed herewith for your information a copy of a letter dated June 1, 1936, from the Comptroller of the Currency relating to the question whether member banks may exchange defaulted bonds for other defaulted bonds under the provisions of the regulations of the Comptroller of the Currency governing the purchase of investment securities.

Very truly yours,



L. P. Betnea,
Assistant Secretary.

Inclosure.

TO ALL FEDERAL RESERVE AGENTS.

COPY

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TREASURY DEPARTMENT
COMPTROLLER OF THE CURRENCY
Washington

June 1, 1936.

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

Dear Sirs:

This acknowledges your letter of May 6, submitting an inquiry you have received from a State member bank with respect to regulations issued by this office under date of February 15, 1936, governing the purchase of investment securities.

The inquiry in question is as follows:

"This bank is carrying in Non-Book Assets approximately \$100,000.00 of defaulted bonds, principally Real Estate issues. These have all been entirely charged off and do not appear in any way in our assets.

"During the past two years we have at times sold, or exchanged certain of our charged off bonds, for others which seemed to present better opportunities for recovery, and the results so far have been very satisfactory. In view of the recent requirements laid down by the Comptroller of the Currency, we are wondering if we will be permitted to continue this practice of exchanges. Of course, the bonds which we have heretofore obtained in this manner do not measure up to the Comptroller's requirements as to investment quality, but occasions frequently arise where defaulted Real Estate Subdivision issues which are in apparently hopeless condition can be switched into other issues which have better prospects of recovery. Of course, the bonds acquired in this manner are likewise carried in Non-Book Assets, and we have made, and will make no exchanges that will require the outlay of any additional cash."

The regulations prohibit the purchase of securities which are in default and also prohibit the purchase of securities in which the investment characteristics are distinctly or predominantly speculative. Consequently, the sale of a defaulted or sub-standard bond and purchase with the proceeds therefrom of another defaulted or sub-standard bond, even though such security in itself may be better than those sold, would, nevertheless, constitute a prohibited purchase of a sub-standard or defaulted security under the regulations.

We do, however, recognize an exception to the foregoing interpretation in that we will not consider it a prohibited purchase of a defaulted or sub-standard security where the security purchased is purchased exclusively with funds derived from the sale of a sub-standard or defaulted security and both the securities sold and the securities purchased are obligations of the same obligor, provided that as a result of the transaction the bank can satisfy the Examiner that through the exchange of securities it has definitely improved its position with respect to its holdings of obligations of the issuer in question. Such situation has come to our attention on several occasions with respect to certain railroad issues where two issues of a particular railroad are outstanding, both of sub-standard or defaulted classification but one having a definitely better underlying security than the other. A similar situation exists with respect to the so-called "Dawes" bonds and "Young" bonds of the German government.

We emphasize the point that this exception is recognized only where the securities sold and the securities purchased are obligations of the same obligor, and the sale and purchase are so closely connected in point of time that the transaction for practical purposes may be considered in effect an exchange of obligations for the purpose and with the result of improving the bank's position with relation to the particular obligor involved.

Very truly yours,

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

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