BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

X-9648

ADDRESS OFFICIAL CORRESPONDENCE TO THE BOARD

July 13, 1936

SUBJECT: Guarantor, Lessor, or Majority Stockholder as "Obligor or Maker" within Section 5136 of Revised Statutes.

Dear Sir:

There are inclosed herewith for your information copies of the following:

1. Letter dated May 6, 1936, and inclosures, from the Assistant Federal Reserve Agent at Cleveland to the Board.

2. Letter dated May 29, 1936, from the Deputy Comptroller of the Currency to the Board.

3. Letter dated July 13, 1936, from the Board to the Assistant Federal Reserve Agent at Cleveland.

These letters relate to the question whether, under the provision of section 5136 of the Revised Statutes which states that the total amount of the investment securities of any one obligor or maker, held by a bank for its own account, shall not exceed at any time 10 per cent of the bank's capital and surplus, the words "obligor or maker" include, in addition to a corporation primarily liable on an obligation, another corporation which has guaranteed such obligation, a parent corporation, or a lessor corporation.

Very truly yours,

Chester Morrill

Chester Morrill,
Secretary.

Inclosures.

TO ALL FEDERAL RESERVE AGENTS

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FEDERAL RESERVE BANK OF CLEVELAND X-9648-a

May 6, 1936.

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

Gentlemen:

Enclosed with this letter you will find copies of correspondence between this office and that of our counsel relating to the question whether bonds of affiliated or subsidiary companies, in some instances guaranteed both as to principal and interest, should be included with obligations of the parent company or the guarantor in determining the maximum amount of securities of one obligor or maker which member banks may lawfully purchase under section 5136 of the Revised Statutes, as amended by the Banking Act of 1935.

It is noted in this connection that section 5200 provides that the ten per cent limitation prescribed therein shall include, in the case of a corporation, all obligations of all subsidiaries thereof in which such corporation owns or controls a majority interest. Section 5136 contains no such provision.

The question was raised with counsel because of what appears to be a difference in practice between the examiners of this office and examiners representing the Comptroller of the Currency. It has not been our custom to include with bonds on which an obligor is primarily liable, bonds of subsidiary or affiliated companies, or bonds of other corporations guaranteed as to principal or interest by the corporation whose line was being considered. In a recent report of examination of a national bank in this district, whose authority to purchase the bonds of one obligor or maker is limited to $18,000, the examiner classes as unlawfully acquired $10,000 of Pennsylvania Company 4% bonds of 1963, because the bank already held $10,000 Pennsylvania RR 4's of 1960. The Pennsylvania Company is a wholly owned subsidiary of the Pennsylvania RR Company.

In view of the fact that the terms of section 5136 are applicable uniformly to national and State banks, the question is referred to the Board of Governors of the Federal Reserve System for whatever consideration it may deem appropriate.

Very truly yours,

/s/ Howard Evans,
Assistant Federal Reserve Agent

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SQUIRE, SANDERS & DEMPSEY

Counsellors at Law

X-9648-a

Cleveland, Ohio. May 4, 1936

Mr. J. B. Anderson,
Assistant Federal Reserve Agent,
Federal Reserve Bank of Cleveland,
Cleveland, Ohio.

Dear Mr. Anderson:

We have given consideration to the questions raised in your letter of April 10th and beg to advise as follows:

Your first inquiry raises the question as to whether the term "obligor" in section 5136 of the Revised Statutes would extend to corporations other than the issuer in cases where affiliate or subsidiary relations are maintained, and also whether issues which are guaranteed by a company other than the issuer would be included in determining the percentage of securities issued by the guarantor which might be held by national banking associations.

The statute uses the term "investment securities of any one obligor or maker". We believe the answer to your question is determined by the meaning to be ascribed to the term "obligor". The dictionary definition of this term is:

> "One who binds himself, or gives his bond to another; one who places himself under a legal obligation." (Webster's New International Dictionary).

In 46 Corpus Juris 851, the term "obligor" is defined as follows:

> "In its more technical sense (obligor means) the maker of a bond or writing obligatory; in its more general sense it designates persons obligated, in whatever manner it may be, to the doing or forbearing of an act".

As Congress was dealing with securities, it seems reasonable to assume that the term "obligor" was used in its technical, rather than its general sense, and that consequently it was not intended to comprehend such relationships to the security as guarantors. The obligation or debt evidenced by a corporation bond is that of the maker and not of the guarantor, if there be one. A maker's promise is to meet or pay his own obligation when due, while the guarantor's promise

is always to pay the debt of another. In other words, the guarantor is the insurer of the solvency of the maker or debtor, and is secondarily liable. See Daniels Negotiable Instruments, 6th Edition, Section 1753. Consequently, the maker and not the guarantor is the obligor on a promissory note or bond of indebtedness. It follows, therefore, that a guarantor is not an obligor within the meaning of section 5136 and that the investment securities of a guaranteeing corporation are not included in determining whether a bank's holdings of investment securities of the maker corporation are in excess of the 10% limitation prescribed in this section, or vice versa, that the investment securities of the guarantor held by the bank include those of the maker whose securities it has guaranteed. In other words, we believe that it was the intention of this provision to cover only investment securities upon which a corporation was obligated as a "maker" as distinguished from the case of a corporation which might be conditionally obligated as a guarantor.

Having reached this conclusion with respect to guaranteed obligations, it necessarily follows that the obligations of an affiliate or subsidiary would not be included as investment securities of the parent, or vice versa, that obligations of the parent would not be included as investment securities of the subsidiary in determining the application of this section. The latter conclusion is further warranted because the parent and its subsidiary or affiliate companies are separate and distinct corporate entities, neither one of which is obligated upon the securities of the other in the absence of a contract to that effect.

The second question raised in your letter relates to investment holdings of State member banks. You list five different issues which have been guaranteed either as to interest or as to both principal and interest by a corporation other than the issuer.

Unless the obligation has been assumed by the so-called "guarantor" so as to make it primarily liable, it is our opinion that the investment security represented by the obligation of the maker would not be included in computing the investment securities of the guarantor held by the member bank.

As the first question raised by you relates primarily to investment securities which may be held by national banking associations, and as a uniform application of section 5136 should be made with respect to both national banking associations and State member banks, we would suggest the advisability of referring this matter to the Board with the view of possibly securing an interpretation by the Comptroller of the Currency.

Very truly yours,

(signed) SQUIRE, SANDERS & DEMPSEY

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FEDERAL RESERVE BANK OF CLEVELAND X-9648-a

April 10, 1936

Squire, Sanders & Dempsey,
Union Trust Building,
Cleveland, Ohio.

ATTENTION: Mr. Paul Holden

Dear Mr. Holden:

Section 5136 of the Revised Statutes, as amended by the Banking Act of 1935, provides in part as follows:

> "In no event shall the total amount of the investment securities of any one obligor or maker, held by the association for its own account, exceed at any time 10 per centum of its capital stock actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund, * * * * ."

There has been presented to us for determination the question whether the term "obligor" would extend to corporations other than the issuer in cases where affiliate or subsidiary relationships are maintained and more particularly in cases where issues are guaranteed by companies other than the issuer.

With respect to investment holdings of State member banks, should the following described securities be considered as part of the "investment securities of any one obligor or maker" in the situations cited below:

(1) Central Pacific Ry. Co. 1st Ref 4's 1949
This issue is guaranteed as to principal and interest by the Southern Pacific Company.

(2) El Paso & Southwestern RR Co. 1st Ref 5's 1965
This issue is not guaranteed, but the road is operated under lease by the Southern Pacific Company.

(3) St. Louis Southwestern Ry. Co. 1st 4's 1989
This obligation is not guaranteed either as to principal or interest by the Southern Pacific Company, although it has a controlling interest in the road.

(4) Chicago, Indiana & Southern RR 1st 4's 1956
This issue is guaranteed as to principal and interest by the Lake Shore & Michigan Southern Ry., which guarantee has been assumed by the New York Central RR., parent company.

(5) Peoria & Eastern RR 1st Cons. 4's 1940
This obligation is guaranteed as to interest by the Cleveland, Cincinnati, Chicago & St. Louis Ry., of which control is held by the New York Central RR.

It seems to me that obligations cited in cases (2), (3), and (5) may scarcely be considered as obligations of the Southern Pacific Company and the New York Central RR Company, respectively. Case (1), in which the Southern Pacific Company appears to be legally bound to pay both principal and interest in the event of default by the issuer, and case (4), in which the New York Central RR Company has assumed the guarantee of a subsidiary company, would appear to present legitimate questions as to whether such issues should be included with the direct issues of the Southern Pacific Company and the New York Central RR Company in determining the maximum amount of investment securities of those two companies which may lawfully be acquired by a State member bank.

Very truly yours,

(signed) J. B. ANDERSON

Assistant Federal Reserve Agent

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TREASURY DEPARTMENT X-9648-b

COMPTROLLER OF THE CURRENCY
WASHINGTON, D. C.

May 29, 1936

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

Dear Sirs :

This acknowledges yours of May 25, enclosing copy of a letter dated May 6, 1936, received by you from the Assistant Federal Reserve Agent at the Federal Reserve Bank of Cleveland with copies of enclosures to that letter, all relating to interpretation of Section 5136 of the Revised Statutes of the United States.

The particular provision of the statute with respect to which an expression of our views is requested reads as follows:

> "In no event shall the total amount of the investment securities of any one obligor or maker, held by the association for its own account, exceed at any time 10 per centum of its capital stock actually paid in and unimpaired and ten per centum of its unimpaired surplus fund."

In connection with this provision of the statute there should also be taken into consideration the statutory definition of investment securities, reading as follows:

> "As used in this section the term 'investment securities' shall mean marketable obligations evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes, and/or debentures, commonly known as investment securities, under such further definition of the term 'investment securities' as may by regulation be prescribed by the Comptroller of the Currency."

Five illustrative examples are submitted for opinion as to whether or not a bank which holds its limit of the securities issued by one particular obligor is prohibited from investing in securities of another issuer or obligor by reason of certain relationships between the two issuers. The examples submitted are

as follows:

(1) Central Pacific Ry. Co. 1st Ref 4's 1949, guaranteed as to principal and interest by the Southern Pacific Company.

It is our opinion that where the bank holds its limit in securities of the Central Pacific Ry. Co., it may not purchase securities of the Southern Pacific Company, and vice versa.

(2) El Paso & Southwestern R.R.Co. 1st Ref 5's 1965. This issue is not guaranteed, but the road is operated under lease by the Southern Pacific Company.

In our opinion the relationship indicated does not operate to prohibit the bank from investing up to its limit in the securities of each Company.

(3) St. Louis Southwestern Ry. Co. 1st 4's 1989. This obligation is not guaranteed either as to principal or interest by the Southern Pacific Company, although it has a controlling interest in the road.

In our opinion the relationship indicated does not operate to prohibit the bank from investing up to its limit in the securities of each Company.

(4) Chicago, Indiana & Southern RR 1st 4's 1956. This issue is guaranteed as to principal and interest by the Lake Shore & Michigan Southern Ry. which guarantee has been assumed by the New York Central R.R., parent company.

In our opinion where the bank holds its ten per cent limit in Chicago, Indiana & Southern RR 1st 4's, it is prohibited from purchasing securities issued by either the Lake Shore & Michigan Southern Ry. or by the New York Central RR.

(5) Peoria & Eastern RR 1st Cons. 4's 1940. This obligation is guaranteed as to interest by the Cleveland, Cincinnati, Chicago & St. Louis Ry. of which control is held by the New York Central RR.

In our opinion where the bank holds its limit in Peoria & Eastern RR 1st Cons. 4's, it may not purchase obligations of the Cleveland, Cincinnati, Chicago & St. Louis Ry., but is not prevented from purchasing obligations of the New York Central RR.

We have adopted this position as reflecting the spirit of the provisions of Section 5136, which are evidently aimed at requiring certain diversification of investment and limitation of risk on the part of the banks. We believe it is clear that where one corporation has assumed and agreed to pay the obligations of another, such obligation when held by the bank in fact represents the obligation of both corporations. It may be conceded that the situation is not so clear where one corporation has merely guaranteed the obligations of the other corporation and that there may be some question as to whether or not one who holds the obligations of a corporation which are guaranteed by a second corporation is, strictly speaking, holding obligations of both corporations. However, such guarantees are customarily given because deemed essential to the ready marketability of the obligations in question, and such obligations are frequently purchased with considerable reliance on the responsibility of the guarantor. Where a bank invests up to its ten per cent limit in such guaranteed obligations and makes a ten per cent additional investment in other obligations of the guarantor, then when, as may very well happen, with the maturity of the guaranteed obligations, the bank must look to the guarantor for payment, the bank at that time will be in the position of holding securities for which a single obligor must then respond by way of payment, the total of which securities will at that time be twice the amount of obligations of a single obligor permitted to be held under the statute.

We do not believe, however, that the foregoing reasoning should be extended or that the language of the statute permits its extension to the length of requiring application of this rule to issues of corporations which merely have interlocking relationships or affiliations.

Very truly yours,

(signed) GIBBS LYONS

Gibbs Lyons,
Deputy Comptroller

X-9648-c

July 13, 1936.

Mr. Howard Evans,
Assistant Federal Reserve Agent,
Federal Reserve Bank of Cleveland,
Cleveland, Ohio.

Dear Mr. Evans:

This refers to your letter of May 6, 1936, and inclosures, presenting the question whether, under the provision of section 5136 of the Revised Statutes which states that the total amount of the investment securities of any one obligor or maker, held by a bank for its own account, shall not exceed at any time 10 per cent of the bank's capital and surplus, the words "obligor or maker" include, in addition to a corporation primarily liable on an obligation, another corporation which has guaranteed such obligation, a parent corporation, or a lessor corporation.

Copies of your letter and its inclosures were submitted to the Comptroller of the Currency for an expression of his views thereon, and a copy of his reply is inclosed herewith.

Very truly yours,

(Signed) Chester Morrill

Chester Morrill,
Secretary.

Inclosure