BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

June 12, 1968

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Holland

Enclosed is a copy of a memorandum from the General Counsel dated today entitled "Federal Reserve participation in Treasury refunding operations." This memorandum is being distributed in connection with item 6 on the agenda for the Committee meeting on June 18.

Robert C. Holland, Secretary,
Federal Open Market Committee.

Enclosure

CONFIDENTIAL (F.R.)

June 12, 1968.

To: Federal Open Market Committee

From: Mr. Hackley

Subject: Legal considerations regarding Federal Reserve participation in Treasury refunding operations.

In his memorandum of June 6, 1968, Mr. Holmes, Manager of the System Open Market Account, describes the refunding operations utilized by the Treasury in February and May 1968 and proposes certain changes in procedure "that would give the Federal Reserve greater flexibility in subscribing to new Treasury issues."

It is understood that essentially Mr. Holmes' memorandum contains two recommendations, one (p. 8) relating to a "straight cash refunding" or a simultaneous combined exchange and cash operation, and the other (pp. 11, 12) relating to an exchange offering followed in a few days by a cash offering. The memorandum states (p. 12) that these proposals "will of course require legal review by Counsel for the Committee."

Cash or Simultaneous Exchange-Cash Refunding

The first proposal, as I understand it, is that, in the case of a straight cash refunding or the cash portion of a simultaneous combined exchange-cash refunding, the Treasury would offer to the public a specified amount of each of the new issues and at the same time would announce that additional amounts of either issue would be fully allotted to the Federal Reserve, to the extent that it held maturing issues, and to Government Trust Accounts.

This procedure would differ in two respects from the procedures followed in February and May of this year. In the first place, in both of those instances the alternatives were an exchange of maturing issues for a new 7-year note or a cash subscription to a 15-month note; and the Federal Reserve, because of the statutory restriction on direct purchases from the Treasury, was limited to the exchange offering of the longer-term issues. Under Mr. Holmes' proposal, the Federal Reserve would have the option of exchanging the maturing securities held by it for the new short-term securities offered for "cash". In the second place, the proposal would provide for full allotment to the Federal Reserve and Government Trust Accounts but not necessarily to other "bedfellows" as in the past, i.e., to State and local governments, foreign governments and central banks, international financial institutions of which the United States is a member, and publicly administered pension funds. However, Mr. Holmes recognizes that the Treasury might decide, as a matter of policy, to extend the full allotment privilege to these bedfellows.

The single underlying legal question raised by this proposal appears to be whether the new securities acquired by the Federal Reserve would fall within the purview of section 14(b) of the Federal Reserve Act. That section provides that, until July 1, 1970, direct obligations of the United States and obligations fully guaranteed by the United States "may be bought and sold . . . either in the open market or directly from or to the United States", and that the aggregate amount of such obligations "acquired directly from the United States" that are held at any one time by the Reserve Banks shall not exceed $5 billion.

It might be argued that securities are "bought" directly from the Treasury even though paid for with maturing securities instead of with cash. It might further be argued that securities acquired in exchange for maturing securities are "acquired directly" from the Treasury within the literal language of section 14(b). In addition, as a matter of policy, it might be urged that securities allotted to the Federal Reserve in exchange for maturing securities do not fully meet the "test of the market".

For more than 30 years, however, Counsel for the Federal Open Market Committee have consistently held that U. S. obligations acquired from the Treasury in exchange for maturing securities acquired by the Federal Reserve in the open market are not covered by the provisions of section 14(b).

Between 1935 and 1942, the Reserve Banks were permitted to purchase U. S. obligations only in the open market. However, in 1937, Mr. Dreibelbis, then Assistant General Counsel of the Committee, held that exchanges of maturing securities could be made by the Reserve Banks, directly with the Treasury, for newly issued securities.

After the Reserve Banks were permitted by law in 1942 to purchase securities directly from the Treasury for a limited period and up to a specified amount, Mr. Wyatt, then General Counsel of the Committee, concluded that obligations acquired through exchange for maturing obligations need not be counted in computing the amount subject to the limitation on direct purchases. A similar opinion was subsequently rendered by Mr. Dreibelbis in 1942. In 1947, Mr. Vest, then General Counsel, concurred in this opinion. Among other things, he pointed out that, since the power to exchange maturing securities directly with the Treasury for new securities existed prior to 1942, when the Reserve Banks were permitted to deal in Government securities only in the open market, it seemed clear that this power continued to exist after the liberalizing 1942 amendment which permitted direct purchases up to a certain amount. In a memorandum dated October 16, 1958, Mr. Frederic Solomon and I acquiesced in the view held by earlier General Counsels that exchanges of securities directly with the Treasury were not covered by section 14(b).

Briefly, the rationale of this position is that the power to make such an exchange is incidental to the basic authority of the Reserve Banks to purchase Government obligations; that the purpose of the prohibition against direct purchases from the Treasury was to prevent the Treasury from acquiring unlimited new funds by borrowing them from the Reserve Banks without going to the public; and that the acquisition of new issues, as part of a refunding open to the general public, in exchange for maturing securities acquired by the Reserve Banks in the open market would not violate the primary purpose of the law.

It may be noted that in 1937, when the law required all Federal Reserve purchases of Government securities to be made in the open market, the Federal Open Market Committee itself went on record as not only accepting the legality of exchanges of maturing certificates directly with the Treasury for new issues of securities but as positively endorsing such exchanges in order to facilitate administration of the System Open Market Account.*

Whether sound or not, the position that the limitations of section 14(b) do not apply to securities acquired by the Federal Reserve directly from the Treasury in exchange for maturing securities purchased in the open market appears to be supported by at least reasonable arguments and by long administrative practice.

Although Mr. Holmes' proposal relates to "straight cash refundings" or to the "cash portion" of a combined exchange-cash refunding, it is assumed that Federal Reserve subscriptions to the new "cash" offerings would be effected by exchanges of maturing securities. Accordingly, it is my opinion that new securities acquired in this manner would not be subject to the direct purchase limitations of section 14(b) of the Federal Reserve Act.

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* See Board's Annual Report for 1937, p. 211. In explanation of the reasons for this policy action, the Annual Report stated:

> "The Committee was of the opinion that the provision contained in section 14(b) of the Federal Reserve Act that bonds, notes and other direct obligations of the United States may be bought or sold without regard to maturities but only in the open market does not prohibit the exchange of maturing Government securities for an equal amount of new securities carrying the conversion privilege, and that, inasmuch as such exchanges would result in saving a substantial amount previously paid as commissions in connection with the purchase and sale of securities which otherwise might be exchanged without such expense and it would be possible thereby to eliminate the accounting problem of the treatment to be given to profits on securities sold and premiums paid on securities purchased in the market, such direct exchanges should be made."

The "Bedfellow" Question

A subsidiary question arises in connection with Mr. Holmes' suggestion that full allotments might be made only to the Federal Reserve and to Government Trust Accounts.

In a memorandum dated October 16, 1958, previously mentioned, Mr. Frederic Solomon and I expressed the view that the limitations of section 14(b) would not apply to an operation under which new securities would be offered to the public either for cash or maturing securities, with no allotment privilege to holders of maturing securities, but under which the new securities would be allotted in full to Federal Reserve holdings of the maturing securities. It was pointed out that any differences in treatment of the general public and the Federal Reserve would be in favor of, rather than adverse to, the Reserve Banks.

In a memorandum dated April 15, 1960, regarding a proposal to offer new securities for either cash or maturing securities, with full allotment extended to holdings of maturing issues by the Federal Reserve, Government Investment Accounts, and all subscriptions up to a specified amount, I expressed the opinion that that proposal could not be distinguished in principle from that advanced in 1958.

It is always possible, of course, that a procedure under which full allotment of new issues is made only to the Federal Reserve and Government Investment Accounts might be criticized as not representing "arms-length" dealings between the Federal Reserve and the Treasury, despite the fact, as pointed out by Mr. Holmes, that such a procedure would not place the System in a position subservient to the Treasury and would actually increase the System's flexibility. However, as a legal matter and apart from any policy considerations, it is my opinion that, if one accepts the position that securities acquired in exchange for maturing securities do not fall within the purview of section 14(b), the fact that full allotment of the new securities is made only to the Federal Reserve and Government Trust Accounts, or even only to the Federal Reserve, is not legally relevant.

Exchange Offering Followed by Cash Offering

Mr. Holmes' second recommendation relates to the situation in which an exchange offering is followed a short time later by a cash offering, the situation that existed in the case of the February refunding. In such a situation, the question arises as to the disposition by the Federal Reserve of securities maturing at the time of the exchange offering which the Federal Reserve might wish to exchange for the shorter-term securities involved in the subsequent cash offering.

If the maturing securities held by the Federal Reserve should be redeemed or "paid off" in cash at their maturity, subscription by the Federal Reserve for a like amount of the new securities involved in the cash offering and payment for those securities at a later date would be difficult to regard as anything but a "cash" purchase by the Federal Reserve directly from the Treasury within the purview of section 14(b).

Mr. Holmes suggests four possible approaches that might be followed in dealing with situations of this kind.

First, the Federal Reserve might continue to hold the maturing certificates after maturity and surrender them at the later date when payment is made for the new securities. I concur in Mr. Holmes' view that, since this would be tantamount to a holding by the Federal Reserve of Government securities for several days without interest, it would create a dangerous precedent and be subject to valid criticism as not constituting an arms-length relationship between the Federal Reserve and the Treasury.

A second possible approach would be for the Federal Reserve to exchange the maturing securities for a special certificate issued by the Treasury and in turn exchange that certificate for the new short-term issues on the subsequent payment date. It might be argued that such an exchange of maturing securities for a special certificate would fall within the principle that "exchanges" do not involve direct purchases from the Treasury under section 14(b), particularly since the Treasury would not be acquiring "new" money. However, it is seriously questionable whether this principle should apply in such a case, since the special certificate would be issued only to the Federal Reserve and bear a favorable interest rate and would therefore not have the appearance of an "arms-length" transaction. Moreover, the Committee's Continuing Authority Directive specifically refers to the "purchase" of special certificates "directly" from the Treasury and provides that the rate shall be one-quarter of one per cent below the Federal Reserve discount rate. Consequently, it is my opinion that the exchange of maturing securities for such a special certificate issued by the Treasury to the Federal Reserve would fall within the limitations of section 14(b). That being so, new issues of securities for which the special certificate would be exchanged would likewise be subject to such limitations. In other words, the direct purchase by the Treasury of the certificate would not be "extinguished" by exchange of the certificate for the new issues.

With respect to the third approach mentioned by Mr. Holmes - payment by the Treasury of interest to the Federal Reserve on the maturing certificates until exchanged for the new issues - I agree with him that new legislation would apparently be required in order to authorize the payment of interest in this manner on Government obligations for any period after their maturity.

Finally, Mr. Holmes suggests that the new issues might be dated as of the maturity date of the maturing securities even though a later date would be fixed for payment for the new issues. Under this approach, the Federal Reserve would continue to hold the maturing certificates after maturity and exchange them for the new issues on the payment date, but the Federal Reserve would receive interest on the new issues from the maturity date of the maturing securities. Since this would not involve any loss of interest to the Federal Reserve, I can perceive no objection from a legal point of view to the approach here suggested.

If the procedures recommended by Mr. Holmes should be approved by the FOMC and adopted by the Treasury, no change would be required in the outstanding Continuing Authority Directive. The Directive specifically authorizes the New York Federal Reserve Bank "to exchange maturing U. S. Government securities with the Treasury".