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

August 14, 1973

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: A. L. Broida

Enclosed is a copy of a memorandum from the Secretariat, dated today and entitled "Proposed actions with respect to bankers' acceptances."

It is contemplated that this memorandum will be discussed at the August 21 meeting of the Committee, under agenda item 7.

Arthur L. Broida
Secretary
Federal Open Market Committee

Enclosure

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

August 14, 1973

CONFIDENTIAL (FR)

To: Federal Open Market Committee
From: The Secretariat

Subject: Proposed actions with respect to bankers' acceptances

On July 3, 1973, the Board of Governors considered a memorandum from its Legal Division dated June 28, 1973 (copy attached), in which it was recommended that the Board revoke its Regulation B[1/]--which relates to open market purchases of bills of exchange and bankers' acceptances--and that, on the same effective date, the Federal Open Market Committee amend Section 270.4(c)(2) of its Regulation to delete the reference therein to the Board's Regulation B.

The Board was favorably inclined toward the Legal Division's recommendations, but decided to defer action with respect to its own Regulations until the Open Market Committee had had an opportunity to consider the recommendation for an amendment in the FOMC Regulation. The latter recommendation, specifically, is to delete from Section 270.4(c)(2) the words stricken by dashes in the following:

Section 270.4 Conduct of Open Market Operations.

* * * * * *

(c) In accordance with such limitations, terms and conditions as are prescribed by law and in

1/ The concurrent recommendation that the Board revoke Regulation C, "Acceptance by member banks of drafts or bills of exchange", is not relevant for present purposes.

authorizations and directives issued by the Committee, the Reserve Bank selected by the Committee is authorized and directed--

* * * * * *

(2) To buy and sell bankers' acceptances ~~of the kinds made eligible for purchase under Part 202 of this Chapter--[Regulation B]~~ in the open market for its own account.

If the FOMC Regulation is amended in the manner proposed, paragraph 1(b) of the Committee's Authorization for Domestic Open Market Operations would also be in need of amendment. This is because that paragraph authorizes the New York Bank "To buy and sell prime bankers' acceptances of the kinds designated in the Regulation of the Federal Open Market Committee...." and the revised Regulation would no longer designate any particular kinds of acceptances. To meet this problem, a description of the kinds of bankers' acceptances in which the Committee wishes transactions to be undertaken could be incorporated in the authorization itself, or in separate guidelines analogous to those now in effect for operations in agency issues.

The Committee may wish to take advantage of the occasion on which these technical changes are made to introduce substantive changes appropriately liberalizing and modernizing its rules governing the kinds of acceptances in which the Desk is authorized to operate. The present rules are set forth in the Board's Regulation B--which, as noted in the Legal Division's memorandum, has not been amended since 1923--and in the opinion of Board members and staff they are badly in

need of liberalization and modernization. Various proposals for this purpose have been debated within the System in recent years.

The Secretariat recommends:

1. That the Committee agree in principle at this time that it will amend Section 270.4 of its Regulation, in the manner described above, at such time as it is prepared to approve the necessary amendment to paragraph 1(b) of its Authorization, possibly involving modified rules regarding the kinds of bankers' acceptances in which the Desk is authorized to operate.

2. That a staff committee be appointed to develop recommendations regarding the content of these rules and the manner in which they might be incorporated in the authorization and/or separate guidelines.

Messrs. Holmes, O'Connell, and Partee concur in these recommendations.

ATTACHMENT

June 28, 1973

To: Board of Governors

Subject: Revocation of Regulations B and C regarding bank acceptances.

From: Legal Division
(J. Ferrell)

ACTION REQUESTED: Revocation of Board Regulations B and C, and an amendment by the FOMC of the FOMC Regulation Relating to Open Market Operations of Federal Reserve Banks.

Regulation B

Regulation B--which relates to open market purchases of bills of exchange and acceptances--has not been amended since 1923, thus antedating, in unamended form, the Federal Open Market Committee by ten years. When section 12A of the Federal Reserve Act was added in 1933 to establish a Federal Open Market Committee, it provided that "no Federal reserve bank shall engage in open-market operations under section 14 of this Act except in accordance with regulations adopted by the Federal Reserve Board." In 1935, this provision was amended to read:

> No Federal Reserve bank shall engage or decline to engage in open-market operations under section 14 of this Act except in accordance with the direction of and regulations adopted by the Committee [i.e., the FOMC].

Thus, only the FOMC has the authority to adopt regulations governing open-market operations. Therefore, the Board's Regulation B is invalid, and has been invalid since 1935.

The FOMC Regulation presently authorizes the Reserve Bank selected by the Committee "to buy and sell bankers' acceptances of the kinds

made eligible for purchase under Part 202 of this Chapter [Regulation B] in the open market for its own account" (§ 270.4(c)(2)). Thus, it could be argued that, although Regulation B itself is invalid, portions of it are incorporated by reference into the FOMC Regulation, which is a valid regulation.

In 1923, the Board ruled that "bankers' acceptances may . . . be eligible for purchase in the open market by Federal Reserve banks, even though not of the kinds and maturities made eligible for rediscount"; in this connection, it was noted that the "language of section 14 of the Federal reserve act is broader than that of section 13." 1923 F. R. Bulletin 317, 317. In effect, any bankers' acceptance is legally eligible for purchase in the open market (if authorized for purchase by the FOMC), although only certain types of such acceptances are eligible for discount by a Federal Reserve Bank.

The thrust of the recent revisions in the FOMC Regulation was "to incorporate in the Regulation general authorizations for transactions of the kinds subject to the regulatory jurisdiction of the FOMC and at the same time to make it clear that such general authorizations may be limited and restricted by specific authorizations and directives of the Committee." Final Report dated January 4, 1973 of the Ad Hoc Staff Committee on FOMC Rules and Regulations, page 25. Consistent with this effort, the Legal Division recommends (1) that § 270.4(c)(2) of the FOMC Regulation be amended to authorize the selected Reserve Bank "to buy and sell bankers' acceptances in the open market for its own account," subject to such authorizations and directives

as may be issued by the Committee from time to time,* and (2) that the Board revoke its Regulation B. The proposed changes would be technical and need not entail any change in the actual conduct of open market operations. Attached are drafts of Federal Register notices designed to implement such changes (Attachment A and B).

Regulation C

The Board's Regulation C ("Acceptance by Member Banks of Drafts or Bills of Exchange") is premised on the assumption that a member bank may make acceptances only of the type described in section 13 of the Federal Reserve Act. However, in 1923 the Board ruled that "the acceptance power of State member banks is not necessarily confined to the provisions of section 13, inasmuch as the laws of many States confer broader acceptance powers upon their State banks. . . ." 1923 F. R. Bulletin 316, 317. (Under F.R. Act § 19, ¶13, "any bank becoming a member of the Federal Reserve System shall retain its full charter and statutory rights as a State bank or trust company, and may continue to exercise all corporate powers granted it by the State in which it was created.") Therefore, under the 1923 ruling, a State member bank may make acceptances that are not of the type described in § 13 if they are so authorized under State law. In 1963, the Comptroller ruled that "[n]ational banks are not limited in the character of acceptances which they may make in financing credit transactions, and bankers' acceptances may be used for such purpose, since the making of

* This would require action on the part of the FOMC, not on the part of the Board itself.

acceptances is an essential part of banking authorized by 12 U.S.C. 24." Comptroller's Manual 7.7420. Thus, national banks are authorized by the Comptroller to make acceptances that are not of the type described in § 13. (See Legal Division dated January 12, 1973, entitled "Working-capital acceptances".) Therefore, the premise for Regulation C is no longer valid.

From 1963--the date of the Comptroller's acceptance ruling--until April 18, 1973, the only real significance of Regulation C was in determining the eligibility of bankers' acceptances for discount. The old Regulation A contained a cross-reference to Regulation C (12 CFR 203), viz., by referring to "such transactions. . .more fully described in § 203.1(a)(1), (2), and (3), respectively, of this subchapter" and referring to dollar exchange acceptances "as provided in § 203.2 of this subchapter." Effective April 19, 1973, this reference to Regulation C was deleted. In the bankers' acceptance provisions in the new Regulation A, the sole reference is to "applicable requirements of section 13 of the Federal Reserve Act."

Most of Regulation C merely repeats the statutory provisions of section 13. It adds very little of a substantive nature to the statutory provisions, and the few substantive provisions that are contained in the Regulation are of questionable legality. Attachment C is a paragraph-by-paragraph analysis of Regulation C. If Regulation C were revised so as to contain only those provisions that (1) do not merely restate the statute and (2) are clearly a permissible exercise of the Board's regulatory powers, there would be virtually nothing left to the regulation.

Accordingly, it is recommended that Regulation C be revoked; Attachment D is a draft of a Federal Register notice designed to accomplish this.

Attachments

Attachment A

TITLE 12--BANKS AND BANKING

CHAPTER II--FEDERAL RESERVE SYSTEM

SUBCHAPTER B--FEDERAL OPEN MARKET COMMITTEE

PART 270--REGULATION RELATING TO OPEN MARKET OPERATIONS OF FEDERAL RESERVE BANKS

Bank Acceptances

In 1923, the Board of Governors ruled that "bankers' acceptances may. . .be eligible for purchase in the open market by Federal Reserve banks, even though not of the kinds and maturities made eligible for rediscount"; in this connection, it was noted that the "language of section 14 of the Federal reserve act is broader than that of section 13." 1923 F.R. Bulletin 316, 317. In accordance with this interpretation of the statutory provisions, the Federal Open Market Committee has decided to amend its Regulation relating to open market operations to authorize the purchase and sale of bankers' acceptances, without regard to whether the acceptances are eligible for discount by a Federal Reserve Bank. The kind and amount of bankers' acceptances purchased and sold in the open market will be governed by authorizations and directives issued from time to time by the Federal Open Market Committee. For the present, no change in monetary policy is intended to result from this amendment.

It should be noted that the Board of Governors of the Federal Reserve System has, of this date, revoked its Regulation B (12 CFR Part 202). All provisions relating to open market operations in bankers' acceptances are now incorporated into the Regulation Relating to Open Market Operations of Federal Reserve Banks (12 CFR Part 270) of the Federal Open Market Committee.

The requirements of section 553, Title 5, United States Code, with respect to notice, public participation, and deferred effective date were not followed with respect to this matter because the changes "relieve a restriction" (see 5 U.S.C. § 553(d)(1)) and following such procedures would be unnecessary (see 5 U.S.C. § 553(b)).

Effective immediately, section 270.4(c)(2) of the Regulation Relating to Open Market Operations of Federal Reserve Banks is amended to read:

§ 270.4 Conduct of Open Market Operations.

* * *

(c) In accordance with such limitations, terms, and conditions as are prescribed by law and in authorizations and directives issued by the Committee, the Reserve Bank selected by the Committee is authorized and directed--

* * *

(2) To buy and sell bankers' acceptances in the open market for its own account;. . . .

* * * *

By order of the Federal Open Market Committee,

Arthur L. Broida
Deputy Secretary

Attachment B

TITLE 12--BANKS AND BANKING

CHAPTER II--FEDERAL RESERVE SYSTEM

SUBCHAPTER A--BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

[Reg. B]

PART 202--OPEN MARKET PURCHASES OF BILLS OF EXCHANGE, TRADE ACCEPTANCES, BANKERS ACCEPTANCES

The Board of Governors hereby revokes its Regulation B (12 CFR 202). Henceforth, all provisions relating to the open market purchase and sale of bankers' acceptances will be included in the Regulation Relating to Open Market Operations of Federal Reserve Banks (12 CFR Part 270) of the Federal Open Market Committee, in accordance with section 263, Title 12, United States Code.

The requirements of section 553, Title 5, United States Code, with respect to notice, public participation, and deferred effective date were not followed with respect to this matter because the revocation of this Regulation is a technical matter and would not, in itself, result in the material alteration of any substantive rule; under the circumstances, providing notice, public participation and deferred effective date would be unnecessary.

By order of the Board of Governors,

Chester B. Feldberg
Assistant Secretary of the Board

Attachment C

PARAGRAPH-BY-PARAGRAPH ANALYSIS OF REGULATION C

Section 203.1(a) restates the first sentence of the seventh paragraph of section 13 of the Federal Reserve Act (12 U.S.C. 372), relating to so-called "commercial" acceptances, that

> "Any member bank may accept drafts or bills of exchange drawn upon it having not more than six months sight to run, exclusive of days of grace, which grow out of transactions involving the importation or exportation of goods; or which grow out of transactions involving the domestic shipment of goods provided shipping documents conveying or securing title are attached at the time of acceptance; or which are secured at the time of acceptance by a warehouse receipt or other such document conveying or securing title covering readily marketable staples."

It also contains (in the text or by footnote) (1) indications as to the meaning of the phrases "importation or exportation of goods" and "readily marketable staples" and (2) rules with respect to (a) an evidentiary requirement in connection with acceptances involving importation or exportation of goods and (b) a permissible departure from the statutory requirement that shipping or title documents be attached to an acceptance involving the domestic shipment of goods at the time of acceptance.

Section 203.1(b) restates the provision of the seventh paragraph of section 13 with respect to maturity of "commercial" acceptances.

Section 203.1(c) restates the provision of the seventh paragraph of section 13 with respect to the limitation on the amount of "commercial" acceptances a bank may have made for one person at any time. It also contains a provision interpreting, in a negative manner, the meaning of "actual security" as used in the statute.

Section 203.1(d) and (e) restate the provisions of the seventh paragraph of section 13 with respect to the aggregate amount of "commercial" aceeptances a bank may have outstanding at any one time. Those paragraphs also establish a procedure for a member bank to follow in obtaining the Board's permission "to accept [commercial] bills to an amount not exceeding . . . one hundred per centum of its . . . capital stock and surplus." The Board is specifically authorized to establish such a procedure by general regulation.*

Paragraph (d) also contains a provision under which commercial acceptances made by one member bank at the request of another that agrees to put the former in funds to meet the acceptance at maturity must be considered as part of the acceptance liabilities of both banks. Essentially this is an interpretation of the meaning of "to accept" in the provision quoted above and might have been appropriately published as an interpretation rather than embodied in the regulation.

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* Because of the Board's 1923 ruling that State banks are not limited by the section 13 qualitative restrictions on acceptances, the quantitative limitations operate in a paradoxical manner. The more stringent the Board's rules with respect to the qualitative requirements, the greater "legal" freedom a State bank has in accepting "commercial" drafts, because only those that fall within the Board's qualitative requirements are subject to the quantitative limitations.

Section 203.2(a) restates most of the first sentence of the twelfth paragraph of section 13 of the Federal Reserve Act. In addition it engrafts upon the statutory authorization for member banks to accept dollar-exchange drafts a condition precedent that each bank individually obtain the Board's permission to exercise that authority.

The legality of such requirement is questionable, despite its presence in the regulation for decades. The statute gives the Board some regulatory power with respect to the qualitative requirements of dollar-exchange acceptances in that they must be "drawn under regulations to be prescribed by the Board" in order for a member bank to accept them. It does not, however, suggest that the Board has authority with respect to what banks may accept such drafts.

Even more fundamental, however, is a contention that the particular "usage of trade" that led to the enactment of the twelfth paragraph of section 13 no longer exists. As the statute does not grant a member bank permission to accept a dollar-exchange draft unless drawn to furnish such exchange "as required by the usages of trade", it has been suggested that all of section 203.2 is obsolete.

Section 203.2(b) restricts the acceptance of "dollar-exchange drafts" (as defined) by member banks to those originating in certain countries. This is based on the Board's consideration as to the requirements of the "usages of trade" in various countries.

Section 203.2(c) qualifies the types of "dollar exchange drafts" that may be accepted by member banks pursuant to the twelfth paragraph of

section 13 by imposing a "good faith" requirement. To qualify for bank acceptance within the terms of the regulation, the draft "must be drawn and accepted in good faith for the purpose of furnishing dollar exchange as required by the usages of trade in the country" in which drawn. The paragraph then specifies three types of drafts that do not fulfill the "good faith" requirement, one of which is "finance bills", which arguably includes all dollar-exchange bills.

Section 203.2(d) restates the statutory provision with respect to maturity.

Section 203.2(e) restates the statutory provision with respect to the limitation on amount of "dollar-exchange drafts" that a bank may accept for one drawer.

Section 203.2(f) restates the statutory provision with respect to the limitation on the aggregate amount of "dollar-exchange drafts" that a bank may have outstanding at any one time. It also contains a provision similar to that in section 203.1(e) with respect to acceptances made by one bank at the request of another.

Legal Division
Board of Governors of the
Federal Reserve System
June 26, 1973

Attachment D

TITLE 12--BANKS AND BANKING

CHAPTER II--FEDERAL RESERVE SYSTEM

SUBCHAPTER A--BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

[Reg. C]

PART 203--ACCEPTANCE BY MEMBER BANKS OF DRAFTS OR BILLS OF EXCHANGE

The Board of Governors hereby revokes its Regulation C (12 CFR 203). This Regulation has been premised on the assumption that a member bank may make acceptances only of the type described in paragraph 7 and 12 of the Federal Reserve Act. However, in 1923 the Board ruled that "the acceptance power of State member banks is not necessarily confined to the provisions of section 13, inasmuch as the laws of many States confer broader acceptance powers upon their State banks. . . ." 1923 F.R. Bulletin 316, 317. Therefore, under the 1923 ruling, a State member bank may make acceptances that are not of the type described in section 13 if they are so authorized under State law. In 1963, the Comptroller of the Currency ruled that national banks are authorized to make acceptances that are not of the type described in section 13. Comptroller's Manual ¶7.7420. Therefore, the premise for Regulation C is no longer valid.

Interpretations of the statutory provisions that have been issued by the Board from time to time remain, for the present, in full force and effect. The Board intends to undertake a general review of its outstanding statutory interpretations with a view to determining whether any modifications should be made in light of current business and banking practices.

By order of the Board of Governors,

Chester B. Feldberg
Assistant Secretary of the Board