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July 10, 1968.

To: Federal Open Market Committee

From: Mr. Hackley, General Counsel

Subject: Legality of plan for lending of Government securities by Federal Reserve Banks.

BACKGROUND

A policy paper dated July 11, 1967 (Policy Issues #4), prepared in connection with the U. S. Government Securities Market Study, advanced a proposal for the lending of Government securities by the New York Reserve Bank to dealers in such securities. This paper was scheduled as an item for discussion at the September 12, 1967, meeting of the Federal Open Market Committee. At that meeting, however, Chairman Martin "suggested that that item be held over to provide more opportunity for Committee Counsel to study the matter."

Attached to the policy paper of July 11, 1967, was a memorandum describing the proposal, prepared in the Securities Department of the New York Reserve Bank, dated April 19, 1967. Also attached was a "draft" memorandum prepared in the New York Reserve Bank's Legal Department, dated September 29, 1966, in which it was concluded that, although the question is not free from doubt, the power to lend securities is within the "incidental" powers of the Federal Reserve Banks.

Drafts of memoranda prepared by Mr. Hexter, Assistant General Counsel to the FOMC, and by me, both concluding that the power of the Reserve Banks to lend securities is legally questionable, were transmitted for comment to Mr. Sloane, Assistant General Counsel at the New York Reserve Bank, on October 17, 1967. With a letter of May 20, 1968,

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Mr. Sloane transmitted to Mr. Hexter and me copies of a "draft" memorandum, dated May 6, 1968, concluding that Federal Reserve Banks "are authorized to lend securities in aid of open market operations." A copy of that memorandum is attached hereto.*

NATURE OF THE PROPOSAL

On the basis of the description contained in the New York Reserve Bank Securities Department memorandum of April 19, 1967, it is understood that in essence the proposal would contemplate (1) "overnight" loans of securities to participants in the present securities clearance arrangement operated by the New York Reserve Bank, or to dealers for whom such participants are acting, as a means of facilitating that arrangement, and (2) three-day loans to Government securities dealers to enable them to make deliveries where they have sold securities purchased from a customer who has failed to deliver the securities to the dealer. While loans of securities to dealers for a third purpose - to enable them to make short sales - has also been considered, it is understood that the proposal would not contemplate loans for this purpose at this time. Such loans of securities would be secured by other U. S. Government securities having a market value in excess of the securities loaned. The borrower would be charged a fee at the rate of 5/8 of one per cent per annum.

* Mr. Sloane has advised that this memorandum, although labeled a "draft", may be regarded as final for all practical purposes.

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According to the policy paper of July 11, 1967, the proposal is prompted principally by the fact that the willingness and ability of banks and insurance companies to lend Government securities to dealers have been reduced in recent years and that, consequently, trading activities of dealers have been "inhibited in many instances by lack of securities to be borrowed." The policy paper suggested that lending of securities by the Federal Reserve would give the dealer market more trading leeway and would be to the advantage of both the System and the Treasury.

The policy paper recognized that lending of securities by the System would "involve legal and operational complications". It contained the following statement:

> "Authority to lend depends on a showing that it would aid in carrying out System open market operations. Such a showing could be made on the general ground that it would give the market more flexibility and fluidity and hence would provide a better market for the execution of System transactions."

The April 19, 1967, memorandum described a possible alternative proposal for the sale of Government securities to dealers subject to a repurchase agreement coupled with a reverse repurchase agreement. However, the policy paper of July 11, 1967, stated that the lending of securities would be preferable to such an alternative. Accordingly, this memorandum does not consider the legality of that alternative proposal.

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OPINION

There is no provision of law expressly authorizing the Reserve Banks to lend Government securities. If the proposed practice of lending such securities should be adopted, it is unlikely that its legality would be questioned; and, in the event that it should be questioned in litigation, it is probable, though by no means certain, that a court would uphold the legality of the practice. However, for the reasons hereafter indicated, it is my opinion that it is doubtful whether the Reserve Banks have authority under the law to lend Government securities in the manner proposed.

DISCUSSION

Whether Embraced Within Authority to Make Advances on U. S. Government Obligations

Consideration has been given to the question whether the lending of U. S. Government securities to dealers is embraced within the authority conferred upon the Reserve Banks by the thirteenth paragraph of section 13 of the Federal Reserve Act (12 U.S.C. 347c), which reads as follows:

> "Subject to such limitations, restrictions and regulations as the Board of Governors of the Federal Reserve System may prescribe, any Federal reserve bank may make advances to any individual, partnership or corporation on the promissory notes of such individual, partnership or corporation secured by direct obligations of the United States. Such advances shall be made for periods not exceeding 90 days and shall bear interest at rates fixed from time to time by the Federal reserve bank, subject to the review and determination of the Board of Governors of the Federal Reserve System."

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This authority for advances by the Reserve Banks is not expressly limited to advances of money. A lending of U. S. Government securities may be regarded as an "advance" as much as a lending of money. As has been noted, loans of Government securities under the present proposal would be secured by U. S. Government obligations having a market value in excess of the securities loaned. Any dealer to whom such securities would be loaned clearly would fall within the phrase "individual, partnership or corporation". Consequently, it may be contended that the thirteenth paragraph of section 13 contains direct (as distinguished from "incidental") authority to make loans of Government securities to dealers secured by U. S. Government obligations.

As required by this paragraph, the Reserve Banks have established rates of interest for advances to others than member banks, subject to review and determination by the Board of Governors; and the rate now in effect for such advances under this paragraph at the Federal Reserve Bank of New York is 7 per cent per annum. Legally, this would not be an insuperable obstacle, since the Reserve Bank, with the approval of the Board of Governors, could establish the lower rate of 5/8 of one per cent per annum for advances of the kind here contemplated. Such action, however, could give rise to the erroneous impression that an extremely favorable rate was being given to a small and selected segment of the public.

In any event, there are obvious legal objections to the use of this paragraph of section 13 as authority for loans of Government

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securities. It seems reasonable to assume that the provisions of the Federal Reserve Act relating to discounts and advances by the Reserve Banks were intended to afford a means by which the Reserve Banks would be able to extend only money credit, i.e., financial assistance, to member banks and, on the security of U. S. obligations, to others than member banks. The present proposal clearly would not involve such extensions of credit.

The paragraph in question specifically provides that the advances there authorized shall be made on "the promissory notes of such individual, partnership or corporation". The words "promissory notes" may be liberally construed as including promises to pay in property as well as in money. However, the customary use of the words imports a promise to pay in money; and use of these words in this paragraph seems to support the assumption that the advances there authorized were intended as advances of money only.

Moreover, the thirteenth paragraph of section 13 was added to the law as a part of the Emergency Banking Act of March 9, 1933, with the apparent intent, though not expressly stated, of providing a source of emergency credit to individuals, partnerships, and corporations holding U. S. Government obligations. For many years, the Board's Regulation A has indicated in a footnote that advances under this paragraph will not be made to others than member banks except in "unusual or exigent circumstances". Clearly, loans of Government securities to dealers in the manner proposed could not be regarded as advances in unusual or exigent

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circumstances. While Regulation A could be amended, such action would be contrary to long administrative practice.

In the circumstances, it is my opinion that reliance upon the thirteenth paragraph of section 13 as authority for the lending of Government securities to dealers would involve an unreasonable departure from what appears to have been the Congressional intent in the enactment of that paragraph and that the legality of a practice of lending securities under this authority would be vulnerable to persuasive attack.

Judicial Construction of Incidental Powers of Reserve Banks

It remains to be considered whether the lending of securities as here proposed may be regarded as a power "incidental" to the authority of the Reserve Banks to buy and sell Government securities in the open market.

The fourth paragraph of section 4 of the Federal Reserve Act (12 U.S.C. 341) provides in part that a Federal Reserve Bank shall have power -

> "Seventh. To exercise by its board of directors, or duly authorized officers or agents, all powers specifically granted by the provisions of this Act and such incidental powers as shall be necessary to carry on the business of banking within the limitations prescribed by this Act."

In 1925, the Attorney General of the United States held that a Federal Reserve Bank had incidental power "to purchase and own real estate for the purpose of supplying suitable banking quarters." (34 Op. Atty. Gen. 527) The correctness of this holding is obvious. It represents a classic example of incidental powers, but it affords no help in determining the much more difficult question here at issue.

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Only two court decisions have specifically dealt with the statutory provision regarding the incidental powers of the Reserve Banks, both growing out of the same factual situation. In Lucas v. Federal Reserve Bank of Richmond, 59 F. 2d 617 (1936), it was held that the Reserve Bank had "incidental" power to take paper ineligible for discount under the Federal Reserve Act as additional security for an extension of credit to a member bank. The Court stated:

> "It [the Federal Reserve Bank] is given power by the act (12 USCA § 341, seventh) to exercise, not only the powers expressly granted therein, but also such incidental powers as shall be necessary to carry on the business of banking within the limitations prescribed; and that the power to require and accept additional security, either for existing indebtedness or for eligible paper discounted, is a power necessary to carry on properly the business of banking within the limitations of the act, seems too clear to admit of argument. The fact that the paper taken as additional security is ineligible for discount, ought not and does not preclude its being taken as collateral." (59 F. 2d 620)

In support of its conclusion, the Court noted that the provision of the Federal Reserve Act granting incidental powers to the Reserve Banks was "practically the same" as the provision granting incidental powers to national banks, and that it was "well settled that, under these incidental powers, a national banking association may take, as security for a loan, collateral of a character in which it is precluded from investing its funds."

In Federal Reserve Bank of Richmond v. Duffy, 210 N.C. 598, 188 S.E. 82 (1936), it was held that the obligor on the "ineligible" paper in the same situation as that giving rise to the Lucas case could not raise the question of lack of authority on the part of the Reserve

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Bank in support of the contention that the Reserve Bank was not a holder in due course.

The holdings in these two cases that a Reserve Bank has incidental power to take additional security to protect itself against loss again are so clear that they provide no help in resolving the present question.

One case decided by the United States Supreme Court, while not specifically directed at the incidental powers clause in section 4 of the Federal Reserve Act, is particularly significant in the present connection. In <u>Federal Reserve Bank of Richmond</u> v. <u>Malloy</u>, 264 U.S. 160 (1924), the Supreme Court held that, since the Federal Reserve Board's Regulation J did not expressly authorize a Reserve Bank to accept from a drawee bank anything other than money in payment for a check drawn on such bank, the Reserve Bank did not have "incidental" power to accept a draft in payment. The Court recognized that the Regulation might be amended to authorize the acceptance of drafts in payment (as the Regulation was later amended), but the Court then went on to say:

> "But to justify an extension by implication of the terms of the regulation, it must be made to appear, at least, that the addition sought to be annexed is a necessary means to carry into effect the authority expressly given by the regulation. See <u>First National Bank</u> v. <u>Missouri</u>, 263 U.S. 640. It follows from this limitation upon the extent and purpose of implied powers, that a distinct and independent power cannot be brought into existence by implication from the grant of another distinct power. In other words, authority to do a specific thing carries with it by implication the power to do whatever is necessary to effectuate the thing authorized--not to do another and separate thing, since that would be, not to carry the authority granted into effect, but to add an authority beyond the terms of the grant. The authority expressed by the regulation is 'to send

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> checks for collection to banks on which checks were drawn;' the authority now sought to be annexed by implication is 'to accept exchange drafts in payment,' instead of money, as required by law. That neither is a necessary means of carrying the other into effect, is clear . . . ."

Lending of securities by the Reserve Banks would appear to be somewhat less "necessary" to effectuate their specifically granted powers than power to accept drafts in payment for checks.

It may be argued that this case was concerned, not with the scope of the incidental powers clause in section 4 of the Federal Reserve Act, but with the terms of a collections contract as partly reflected in the Board's Regulation J, and that the criteria applicable in determining implied powers under a contract are not applicable in determining the incidental powers of a corporation. In my opinion, the criteria are generally the same; in both cases, the basic question is one of intent - by the parties in the case of a contract and by the Congress in the case of a statute. Moreover, it is clear that the Supreme Court in the Malloy case made no such distinction. In support of its statement above quoted, it cited First National Bank v. Missouri, an earlier Supreme Court case directly involving the incidental powers of national banks under the National Bank Act.

Comparison of Incidental Powers of Reserve Banks and National Banks

As has just been noted, the Malloy case cited a case involving the incidental powers of national banks. The Lucas and Duffy cases previously mentioned both observed that the section of the Federal

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Reserve Act granting incidental powers to the Federal Reserve Banks is "practically the same" as the section of the National Bank Act granting incidental powers to national banks. It might be assumed, therefore, that court decisions construing the incidental powers provision of the National Bank Act are relevant to a construction of the comparable provision of the Federal Reserve Act.

With respect to incidental powers of national banks, section 5136 of the Revised Statutes (12 U.S.C. 24) provides in part that a national bank shall have power -

> "Seventh. To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this title . . . ."

Obviously, this provision must have been in the minds of the drafters of the provision of the Federal Reserve Act relating to the incidental powers of the Federal Reserve Banks. It is not clear, however, whether the Federal Reserve Act provision was intended to be applied in the same manner as the National Bank Act provision.

It has been suggested that the Federal Reserve Act provision should be construed <u>more liberally</u> than the National Bank Act provision, first, because of textual differences and, second, because of institutional differences.

Thus, it may be argued that the Federal Reserve Act provision broadly authorizes the Reserve Banks to exercise all such incidental

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powers as shall be necessary to carry on the business of banking within the limitations prescribed by the Federal Reserve Act, in other words, to exercise any incidental power that is not expressly or impliedly prohibited by the Act; but that the National Bank Act provision literally authorizes a national bank to exercise incidental powers only by exercising the specifically named banking functions, i.e., discounting and negotiating promissory notes, drafts, and bills of exchange, receiving deposits, buying and selling exchange, loaning money, and issuing circulating notes. On its face, such a literal reading of the National Bank Act provision cannot be supported; it would mean, for example, that national banks could not borrow money, provide travel services, and engage in many other activities that are commonly recognized as falling within their incidental powers.

It may also be argued that, because the Federal Reserve Banks are required to perform statutory functions to accomplish public purposes, their incidental powers should be more liberally construed than the incidental powers of national banks that are operated for profit and engage in private functions. In support of this argument, it might be pointed out that, although the Supreme Court in 1934 had held that a national bank did not have incidental power to pledge assets to secure a private deposit, that Court in 1940 ruled that a national bank did have incidental power to pledge assets to secure deposits of funds made by certain governmental corporations, even though those funds were not "public money" within the scope of section 45 of the National Bank Act

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(12 U.S.C. 90), which provides for the giving of security by national banks for deposits of public money. Inland Waterways Corporation v. Young, 309 U.S. 517. In distinguishing the Court's earlier ruling regarding the power to pledge assets to secure private deposits, the Supreme Court in this case stated:

> ". . . What may be inimical to the private aspects of the national banking system, and therefore ultra vires, has no such relevance to the public aspect of national banks, and to the enforcement of the public interest by those charged with primary responsibility for its guardianship."

Actually, it appears that the Court's conclusion in the Inland Waterways case was based primarily upon consideration of a long practice of requiring security for deposits of public funds in banks and the fact that the giving of security for such deposits was a "long continued practice pursued with the knowledge of the Comptroller of the Currency".

There is a reasonable basis for the position that the incidental powers of the Federal Reserve Banks should be construed more strictly, instead of more liberally, than the incidental powers of national banks, again on the basis of both textual and institutional differences. Thus, the incidental powers clause in the Federal Reserve Act begins and ends with language not contained in the incidental powers clause in the National Bank Act. By stating that a Federal Reserve Bank may exercise "all powers specifically granted by the provisions of this Act" and such incidental powers as shall be necessary to carry on the business of banking "within the limitations prescribed by this Act", the Federal Reserve Act provision suggests a scope more restricted than the comparable National Bank Act provision.

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Moreover, it may be persuasively argued that a broad construction of the "incidental powers" of a private corporation is not likely to have any substantial effect on the public interest, but that particular care should be taken to avoid enlargement of the important governmental powers of a governmental corporation in a manner beyond the intent of Congress. When Congress has intended that the powers of a governmental corporation should be freely and flexibly exercised, it has made that intent clear, with an implicit recognition that ordinarily the powers of public corporations are not so broadly construed. For example, when the Tennessee Valley Authority was established, the Statement of the Managers for the House of Representatives, appended to the Conference Committee Report, stated:

> ". . . We have sought to set up a legislative framework, but not to encase it [TVA] in a legislative strait-jacket. We intend that the corporation shall have much of the essential freedom and elasticity of a private business corporation." (H.R. Rep. No. 130, 73d Cong. (1933), p. 19)

In recommending the TVA legislation, the President's message referred to TVA as "a corporation clothed with the powers of the government but possessed of the flexibility and initiative of a private enterprise". (H.R. Doc. No. 15, 73d Cong., 1st Sess. (1933))

Judicial Construction of Incidental Powers of National Banks

Granting, for purposes of argument, that the incidental powers of Federal Reserve Banks should be construed at least as liberally as the incidental powers of national banks, it is by no means clear that court decisions relating to the incidental powers of national banks lend support to the argument that a Federal Reserve Bank has incidental power to lend securities.

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Perhaps the leading case regarding the incidental powers of national banks is First National Bank v. National Exchange Bank, 92 U.S. 122, decided in 1875. It was there held that a national bank has incidental power to acquire stock in connection with a bona fide compromise of a contested claim against the bank. This clear example of an incidental power is analogous to the incidental power of a Federal Reserve Bank to take ineligible paper as additional security for an extension of credit to a member bank that was upheld in the Lucas case previously mentioned. Indeed, the Lucas case in 1936 relied partly upon the 1875 First National Bank case.

The Supreme Court, in the First National Bank case, made the following general statement regarding incidental powers of national banks:

> "Authority is thus given to transact such a banking business as is specified, and all incidental powers necessary to carry it on are granted. These powers are such as are required to meet all the legitimate demands of the authorized business, and to enable a bank to conduct its affairs, within the general scope of its charter, safely and prudently." (92 U.S. at 127)

A careful reading of this statement suggests that a national bank has only such incidental powers as are "necessary" to carry on the banking business and that these powers must be such as are required to meet legitimate demands of the bank's authorized business or as are required to enable the bank to conduct its affairs safely and prudently within the general scope of its charter. The Court does not say that a power is properly "incidental" if it is simply safe and prudent; it said

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explicitly that the power must be one that is required to enable the bank to conduct its affairs safely and prudently. Applying this principle to the question whether a Reserve Bank has incidental power to lend securities, it is questionable whether, even though such a practice may be clearly safe and prudent, it is a practice that is required to enable the Reserve Bank to meet the legitimate demands of its "authorized" business and to conduct its affairs safely and prudently.

In the First National Bank case, the Supreme Court also made the following statement:

> "Dealing in stocks is not expressly prohibited; but such a prohibition is implied from the failure to grant the power." (92 U.S. at 128)

The literal application of this statement obviously goes too far, since it could be regarded as meaning that a bank has no incidental powers at all. Certainly that was not the intent of the Court. However, the statement does suggest a narrow approach to the delineation of implied powers of national banks.

The same statement to the effect that the absence of a power is implied from failure to grant the power was made in California Bank v. Kennedy, 167 U.S. 362, 367 (1897). In that case, the Supreme Court held that a national bank did not have incidental power to acquire the stock of a savings bank. In this connection, the Court again used language suggesting a narrow construction of the incidental powers of national banks. Thus, the Court said:

> "It is settled that the United States statutes relating to national banks constitute the measure of the authority of such corporations, and that they cannot rightfully exercise

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> any powers except those expressly granted, or which are incidental to carrying on the business for which they are established." (167 U.S. at 366)

Following the same line, the Supreme Court two years later held that a national bank could not acquire the stock of another national bank. Concord First National Bank v. Hawkins, 174 U.S. 364 (1899) Here the Court found that such an investment was "plainly against the meaning and policy of the statutes from which they [national banks] derive their powers, and evil consequences would be certain to ensue if such a course of conduct were countenanced as lawful."

Again basing its decision upon the "meaning and policy" of the national bank laws, the Supreme Court in 1924 held that national banks did not have incidental power to establish branches. First National Bank v. Missouri, 263 U.S. 640 (1924) (National bank branching was not authorized until 1927.) In reaching this conclusion, the Court noted that Federal law required that the organization certificate of a national bank should specify the place at which it would operate, that the law also required that a national bank's business must be transacted at the place so specified, and that administrative construction was opposed to authority for the operation of branches. In its opinion, the Court paraphrased the statement with respect to incidental powers made in the California Bank case, above quoted, but, significantly, it added the word "necessary". It said:

> "The extent of the powers of national banks is to be measured by the terms of the federal statutes relating to such associations, and they can rightfully exercise only such as are expressly granted or such incidental powers as are necessary to carry on the business for which they are established." (263 U.S. at 656) (Emphasis added.)

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A similar statement was made in Kimen v. Atlas Exchange National Bank, 92 F. 2d 615 (CCA 7, 1937), holding that a national bank had no power to agree to repurchase at par certain bonds sold by it. There the Court said:

> "National banks may rightfully exercise only such powers as are expressly granted and such as are necessarily incidental to the effectuation of their chartered purposes. Incidental powers can avail neither to create powers which expressly or by reasonable implications are withheld nor to enlarge the powers granted. They are inferred and exist only to carry into effect such powers as are granted." (92 F. 2d at 617) (Emphasis added.)

Here again, the use of the word "necessarily" is significant.

In Texas & Pacific Railway Co. v. Pottorff, 291 U.S. 245 (1934), the United States Supreme Court held that national banks do not have incidental power to pledge their assets as security for private deposits. Echoing the statement made in the California Bank case, the Supreme Court stated, with respect to national banks, that -

> ". . . The measure of their powers is the statutory grant; and powers not conferred by Congress are denied." (291 U.S. at 253)

The Court found that there was no basis for the claim that pledges of assets as security for such deposits were "necessary" to carry on the banking business. In a footnote, the Court said:

> "A practice is not within the incidental powers of a corporation merely because it is convenient in the performance of an express power." (291 U.S. at 255)

By the same reasoning, lending of securities by a Reserve Bank is not justified merely because it is "convenient" in the effectuation of open market operations.

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In Colorado National Bank v. Bedford, 310 U.S. 41 (1940), the Supreme Court held that a national bank has incidental power to carry on a safe-deposit business. This case proves little, since the Court's opinion recognized that language contained in the National Bank Act, as amended (12 U.S.C. 24), clearly sanctions the carrying on of such business by national banks. Referring to that language, the Court said:

> ". . . The language of the proviso of § 24, just quoted, is the language suitable to impose restrictions on a recognized power, not the language that would be used in creating a new power." (310 U.S. at 49)

If there were a comparable provision in the Federal Reserve Act impliedly recognizing the power of Federal Reserve Banks to lend securities, there would be no question as to the existence of such a power.

In summary, court decisions relating to the incidental powers of national banks seem to say that such powers exist only if they are necessary or required to enable such banks to perform their authorized functions, and that, in deciding whether this is the case, the general intent of the statutes under which they operate, as well as long continued administrative practice, may properly be considered.

In recent years, the Office of the Comptroller of the Currency has issued rulings that have given a liberal construction to the incidental powers of national banks, such as the authority of such banks to establish "operations subsidiaries". These rulings have not been tested in the courts. Even if they should be upheld, they would not have any conclusive relevance to the scope of the incidental powers of

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the Federal Reserve Banks. The extent of those powers, in the last analysis, must be considered in the light of the "general intent" of the provisions of the Federal Reserve Act.

"General Intent" of the Federal Reserve Act

The Federal Reserve Banks, unlike national banks, are operated solely for public purposes. Whether or not the Reserve Banks have implied power to lend securities in aid of open market operations must be determined in the context of relevant provisions of the Federal Reserve Act.

In seeking to resolve this question, however, the various general pronouncements made by the Supreme Court with respect to the incidental powers of national banks should be borne in mind, particularly the statement in First National Bank v. National Exchange Bank that incidental powers are "such as are required to meet all the legitimate demands of the authorized business, and to enable a bank to conduct its affairs, within the general scope of its charter, safely and prudently." (Emphasis added.) Particularly relevant also is the following statement made in First National Bank v. Missouri:

> ". . . Certainly an incidental power can avail neither to create powers which, expressly or by reasonable implication, are withheld nor to enlarge powers given; but only to carry into effect those which are granted." (263 U.S. at 659)

And finally, with specific reference to Federal Reserve Banks, it is important to bear in mind the statement in the Malloy case that "a distinct and independent power cannot be brought into existence by implication from the grant of another distinct power."

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Section 13 of the Federal Reserve Act expressly authorizes the Reserve Banks to discount certain types of paper, e.g., paper drawn for commercial or agricultural purposes, sight drafts of specified kinds, and bankers' acceptances that meet specified requirements. The same section expressly authorizes advances to member banks on specified types of security, such as "eligible" paper and U. S. Government obligations, and advances to any individual, partnership, or corporation on direct U. S. obligations.

Section 14 of the Act expressly authorizes the Reserve Banks to buy and sell in the open market specified types of obligations, such as obligations issued or fully guaranteed by the United States, obligations issued or guaranteed by Federal agencies, and State and local tax anticipation warrants. In addition, the Reserve Banks are specifically authorized to buy and sell directly from or to the United States direct or fully guaranteed U. S. obligations, but only for a temporary period and only up to a specified aggregate amount.

These specific provisions authorizing loans by the Reserve Banks (through discounts and advances) and purchases and sales of certain obligations by the Reserve Banks are not accompanied by any express authority to lend securities. The law contains no provision expressly prohibiting the Reserve Banks from lending U. S. Government securities. However, the particularity with which the Reserve Banks are authorized to make loans and to buy and sell securities seems to suggest that they were not intended to be granted power to lend securities. It is difficult

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to accept the view that the express power to buy and sell securities was intended to grant incidental power to lend securities. In other words, it would seem that incidental power to lend securities has been withheld, in the words of the Supreme Court, by "reasonable implication".

The fact that national banks have apparently followed the practice of lending Government securities for many years (a practice that has not been passed upon by the courts) is not conclusive as to the authority of the Federal Reserve Banks to lend such securities. Whether the Reserve Banks have similar incidental authority must be determined in the light of the nature of the Reserve Banks and the provisions of the Federal Reserve Act; and the particularity of those provisions with respect to the powers of the Reserve Banks, as heretofore indicated, suggests that such incidental authority was impliedly withheld. Moreover, the existence of such authority in the case of the Reserve Banks cannot be legally supported, as in the case of national banks, by "long continued" administrative practice.

The argument that the Reserve Banks have incidental power to lend securities because that power is not prohibited obviously proves too much. Thus, the law does not expressly prohibit the Reserve Banks from buying and selling "agency issues". Nevertheless, the Board recommended, and Congress in 1966 concurred in, a specific amendment to the law authorizing the purchase and sale of agency issues. Such an amendment would not have been necessary if the purchase and sale of such issues had been regarded as "incidental" to the effectuation of open market operations.

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The accomplishment of the major objectives of open market operations might be aided by many actions that are not expressly authorized by the Federal Reserve Act. For example, there might be times when such objectives would be promoted by the purchase and sale of municipal and corporate securities or by loans to particular segments of the economy. Stated differently, if the Reserve Banks have incidental power to lend Government securities to dealers on the ground that this action would "aid" in effectuating open market operations, it would seem to follow that the Reserve Banks could engage in <u>any</u> activity (including dealings in corporate stocks) that they, or the Open Market Committee, might regard as conducive to effective open market operations. On this basis, for example, it could be argued that the New York Reserve Bank could invest balances held with foreign banks in securities of foreign governments in order to facilitate foreign currency operations; yet the Board has considered it necessary to recommend legislation that would specifically grant this authority.

Carrying the argument further, if the Reserve Banks have incidental authority to engage in any activity that is not expressly prohibited and is not clearly unsafe or unsound, as an "aid" to the accomplishment of System objectives, it could easily be argued that the Reserve Banks could engage in many activities that were not within the contemplation of Congress.

If it could be demonstrated that the lending of Government securities is <u>necessary</u> or <u>required</u> in order to enable the Reserve

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Banks to carry out their "authorized" functions with respect to open market operations, the situation would, of course, be entirely different. In the absence of such a demonstration, it is my opinion that the Reserve Banks have no incidental authority to lend Government securities as proposed in the policy paper of July 11, 1967.

Attachment

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AUTHORITY OF FEDERAL RESERVE BANKS
TO "LEND" GOVERNMENT SECURITIES

It has been proposed that Federal Reserve Banks lend* government securities to participants in the existing securities clearance arrangement operated by Federal Reserve Bank of New York and to government securities dealers to enable the dealers to make deliveries in cases where they have sold securities purchased from a customer who has failed to deliver the securities to the dealer. The loans would be made in aid of open market operations.

The purpose of this memorandum is to consider whether Federal Reserve Banks have authority so to lend government securities. The conclusion reached is that Federal Reserve Banks are authorized to lend securities in aid of open market operations.

There is no express statutory authority for Federal Reserve Banks to make loans of securities. Accordingly, if Federal Reserve Banks are authorized to lend securities, the authorization must come into existence by virtue of the seventh paragraph of Section 4 of the Federal Reserve Act, which authorizes a Federal Reserve Bank

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* A "loan" of securities in the sense in which that term is used in the securities market contemplates transfer of title to securities from A to B and a promise by B to return securities of the same amount and issue to A after a specified time, or on demand, and to pay a fee for the use of the securities, the performance of B's promise being ordinarily secured by cash or other collateral.

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> "To exercise by its board of directors, or duly authorized officers or agents, all powers specifically granted by the provisions of this Act and such incidental powers as shall be necessary to carry on the business of banking within the limitations prescribed by this Act."

I. There are no judicial decisions construing paragraph seventh of Section 4 that are helpful in determining the scope of the incidental powers of the Federal Reserve Banks.

It has been suggested that the case of Federal Reserve Bank of Richmond v. Malloy, 264 U. S. 160 (1923), sheds light on the scope of the incidental powers granted to Federal Reserve Banks. However, the Malloy case had nothing to do with the corporate powers, incidental or otherwise, of Federal Reserve Banks. In that case, the Federal Reserve Bank of Richmond argued, in effect, that the terms of Regulation J required its sending bank, as principal, to authorize the Federal Reserve Bank, as agent, to receive drafts in payment of checks, and, in addition, that the taking of drafts in payment of checks was justified by banking custom binding upon Malloy Brothers. The Supreme Court found that "it is settled law that a collecting agent is without authority to accept for the debt of his principal anything but . . . money . . .". The court also pointed out that Regulation J did not expressly permit the taking of drafts in payment of checks, and stated as follows:

> ". . . This regulation, while it contemplates the sending of checks for collection to the drawee banks, does not expressly permit the acceptance of payment other than in money. It is insisted, however, that the authority to send checks to the drawee bank carries with it, by necessary implication, authority to accept a draft in payment from the drawee. We

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> assume, for the purposes of the argument, that the obligation which the law imposes to collect only in money may be varied by a regulation, clearly and positively so providing, although, in terms, it relates only to the banks inter se, upon the ground that the owner of the check is bound by the knowledge and consent of his subagent. But to justify an extension by implication of the terms of the regulation, it must be made to appear, at least, that the addition sought to be annexed is a necessary means to carry into effect the authority expressly given by the regulation. See First National Bank v. Missouri, 263 U. S. 640. It follows from this limitation upon the extent and purpose of implied powers, that a distinct and independent power cannot be brought into existence by implication from the grant of another distinct power. In other words, authority to do a specific thing carries with it by implication the power to do whatever is necessary to effectuate the thing authorized--not to do another and separate thing, since that would be, not to carry the authority granted into effect, but to add an authority beyond the terms of the grant. The authority expressed by the regulation is 'to send checks for collection to banks on which checks were drawn;' the authority now sought to be annexed by implication is 'to accept exchange drafts in payment,' instead of money, as required by law. That neither is a necessary means of carrying the other into effect, is clear. . . ." (Emphasis added.)

It is also clear that the above language has nothing to do with the scope of the incidental corporate powers of a Federal Reserve Bank; the question that the court was addressing itself to was whether it would be proper to imply, in a regulation promulgated by the Federal Reserve Board (which, by hypothesis, became part of the contract between Federal Reserve Bank of Richmond and the Malloy Brothers), a requirement that sending banks, as principals, authorize Federal Reserve Banks, as agents, to accept drafts in payment of checks. The court held that it would not be proper to do so

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and affirmed the judgment for the Malloy Brothers, basing its decision on the fact that the Federal Reserve Bank had accepted payment ". . . in a medium which the contract [including the relevant provisions of Regulation J] read in the light of the law forbids". (Emphasis and material in brackets added.) The distinction between implying authority in a contract between a principal and agent in the circumstances of the Malloy case, and construing the incidental powers of a corporation, is clear and significant. The criteria applicable to the former are not, in law or in logic, applicable to the latter.

II. In the absence of judicial decisions construing the incidental powers provision of the Federal Reserve Act, it is appropriate to look to decisions construing the incidental powers provision of the National Bank Act on which the relevant provision of the Federal Reserve Act was modeled.

The incidental powers provision of the Federal Reserve Act was clearly modeled on the incidental powers provision of the National Bank Act.

As stated in Lucas v. Federal Reserve Bank of Richmond, 59 Fed. 2d 617,

> "The section of the Federal Reserve Act granting incidental powers to the Federal Reserve Banks is practically the same as the section granting incidental powers to national banking associations (12 U.S.C.A. § 24, 7th); and with respect to the incidental powers granted the latter, Mr. Chief Justice Waite, in the case of First National Bank v. National Exchange Bank, 92 U. S. 122, 127, 23 L. Ed. 679, said: 'authority is thus given to transact such a banking business as is specified, and all incidental powers necessary to carry it on are granted. These powers are such as are required to meet all the legitimate demands of the authorized business,

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and to enable a bank to conduct its affairs, within the general scope of its charter, safely and prudently.' . . ." (See also Federal Reserve Bank of Richmond v. Duffy, 210 N. Carolina 598.)

It has been argued that the incidental powers of Federal Reserve Banks should be subject to a narrower construction than the incidental powers of national banks. This argument is based on two propositions; (a) that the text of the relevant statutory provisions support a narrower construction with respect to Federal Reserve Banks, and (b) the fact that Federal Reserve Banks partake of a "public" nature, whereas national banks do not. The first proposition is erroneous and the second does not support the argument.

Considering the first of the propositions, a textual comparison of the two relevant statutory provisions* supports the view that the incidental powers of Federal Reserve Banks should be more liberally construed than the incidental powers of national banks. Viz.: national banks are authorized, in effect, to exercise

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* Seventh. To exercise by its board of directors, or duly authorized officers or agents, all powers specifically granted by the provisions of this Act and such incidental powers as shall be necessary to carry on the business of banking within the limitations prescribed by this Act (Federal Reserve Act, Section 4, par. 4).

Seventh. To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this title (Section 5136 Rev. Stat.).

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"such incidental powers as shall be necessary to carry on the business of banking" by exercising specifically named banking functions, e.g., by discounting promissory notes; Federal Reserve Banks are authorized to exercise "such incidental powers as shall be necessary to carry on the business of banking within the limitations prescribed by this Act". (Emphasis added.) Thus, Federal Reserve Banks are authorized (1) to exercise all powers specifically granted, and (2) through the exercise of incidental powers to carry on the business of banking within the limitations of the Federal Reserve Act. A limitation, used in this context, is obviously some[illegible] that limits; a "restriction of power" or a "qualification" [illegible] Webster's Unabridged Dictionary, Second Edition). It may w[illegible] that the correct reading of the incidental powers provision of the Federal Reserve Act is that the authority to carry on the business of banking, through the exercise of incidental powers, is subject only to the express limitations and qualifications of the Federal Reserve Act. Under this reading of the incidental powers provision, the only relevant inquiries would be (1) whether the function sought to be exercised is part of the business of banking, and (2) if so, whether the exercise of the function is restricted or qualified by any express provision of the Act. However, it is not necessary to go that far in the instant case. It is enough to conclude that the authority of Federal Reserve Banks to carry on the business of banking, through the exercise of incidental powers, is

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subject only to those restrictions or qualifications which are expressly set forth in the Act, or which can be properly implied from the other provisions of the Act.

Proceeding to the second proposition, assuming arguendo that Federal Reserve Banks are public corporations and that national banks are not, it does not follow that the incidental powers of Federal Reserve Banks must be more strictly construed than the incidental powers of national banks. It must be remembered in this connection that, during the period when the law with respect to incidental powers of national banks was developing in the courts, national banks played a role with respect to national monetary policy analogous to that now played by Federal Reserve Banks; and that, when the Federal Reserve Banks were created, they assumed, in large part, the functions and responsibilities earlier conferred on national banks (First Agricultural National Bank of Berkshire County v. State Tax Commission, 32 Washington Financial Reports T-1, August 14, 1967). As stated by the Supreme Court of Massachusetts in the Berkshire County case, supra:

> ". . . The functions conferred upon the national banks [at the time of the enactment of the National Bank Act] were not unlike those granted to their earlier predecessors, the United States Bank and the Second United States Bank. During the next half century the national banks played an important role in the establishment and supervision of national monetary policy." (Emphasis and material in brackets added.)

The court goes on to state that:

> ". . . In effect, the Federal Reserve System assumed in large part the functions and responsibilities

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> conferred in earlier years on the first two Banks of the United States and successor national banks." (Emphasis added.)

The legislative history of the Federal Reserve Act similarly suggests an analogy between Federal Reserve Banks and national banks. The Report on H.R. 7837 (one of the three bills which were the source of the original Federal Reserve Act), submitted by Mr. Glass in 1913, states in part that:

> "Indeed, with one or two minor modifications of existing law they [Federal Reserve Banks] could be so organized under the present National Bank Act. It is to be noted that some national banks now organized and doing business in the larger cities perform in a measure very much the same functions for smaller banks which do business with them that it is now proposed to have the Reserve Banks to be organized under this Act do for the banks that are to be their constituent stockholders. The existing banks which perform this function do it for profit, and when opportunity offers make exorbitant returns for themselves on the transactions they enter into. The proposed Reserve Banks are to be cooperative institutions, rendering their service for the good of all the banks that are stockholders in them, as well as for that of the public, while the Government is to get the excess profits of the institution." (Material in brackets added.)

As indicated in Mr. Glass' statement, national banks are operated for profit. Federal Reserve Banks are not operated for profit; they are operated to carry out the responsibilities imposed on them by law as parts of the Federal Reserve System. Not only does it not follow from this that the powers of Federal Reserve Banks should be subject to a more narrow construction than those of national banks; it would appear to follow that powers of Federal Reserve Banks to be exercised in furtherance of carrying out duties to the public imposed on the banks by law should be more liberally

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construed than the powers of national banks exercised merely to make a profit. The Supreme Court has recognized a distinction between the public and private functions of national banks and indicated that their incidental powers should be more broadly construed with respect to public functions. In Texas and Pacific Railway Co. v. Pottorff, 291 U. S. 245 (1934), the court held that a national bank did not have the incidental power to pledge assets to secure a private deposit. (See page 9, infra.) In Inland Waterways Corp. v. Young, 309 U. S. 517 (1940), the court held that a national bank had the incidental power to pledge assets to secure deposits of funds made by government agencies. (See page 19, infra.) In the Inland Waterways case, Justice Frankfurter, in distinguishing Pottorff, stated as follows:

> ". . . What may be inimical to the private aspects of the national banking system, and therefore ultra vires, has no such relevance to the public aspect of national banks, and to the enforcement of the public interest by those charged with primary responsibility for its guardianship."

Accordingly, the Supreme Court has construed incidental powers relating to public aspects of national banks more broadly than those relating to private aspects. Thus, it is logical to conclude that the incidental powers of a Federal Reserve Bank relating to what is clearly a public function, i.e., the carrying on of open market operations, should be more liberally construed than the incidental powers of national banks and other corporations relating to their private functions.

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III. Under the judicial decisions construing the incidental powers of national banks, the test applied by the courts as to the existence of an incidental power is not the mechanical test of whether a power is necessary to the exercise of one of the express powers; the test applied is whether the incidental power may be properly implied from the entire statute in the light of the general intent of the statute.

In Texas and Pacific Railway Co. v. Pottorff, 291 U. S. 245 (1934), the main question for decision was whether a national bank had power to pledge a part of its assets to secure a private deposit. The Supreme Court held, in an opinion by Mr. Justice Brandeis, that national banks lack power to pledge their assets to secure a private deposit. The court reasoned that (1) since the practice of pledging assets to secure deposits was practically unknown among national banks, that the practice could not be said to be "necessary" to the business of banking, and (2) that "to permit the pledge would be inconsistent with many provisions of the National Bank Act, which are designed to ensure, in case of disaster, uniformity in the treatment of depositors and a ratable distribution of assets."

The court, in Pottorff, looked to the entire statute and to banking custom; it did not apply the test whether the power is necessary to the exercise of an express power.

The teaching of Pottorff is that the incidental powers clause cannot be construed as conferring corporate power to do an act, the doing of which would be (i) inconsistent with the purposes of other provisions of the corporate charter, and (ii) not sanctioned by custom and, indeed, "deemed contrary to good banking practice." Neither of these factors is present with respect to

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the lending of securities: The practice is not inconsistent with the purposes of any provision of the National Bank Act or of the Federal Reserve Act; and I am informed that the practice of lending government securities has prevailed, and continues to prevail, on the part of national banks and other banks with connections to the government securities market for as long as the market has been in existence.*

In First National Bank v. National Exchange Bank, 92 U. S. 122, the Supreme Court of the United States held that a national bank had the incidental power to acquire stock as part of a settlement of a contested obligation resting upon the national bank. The court stated that the incidental powers granted to national banks are

> ". . . such as are required to meet all the legitimate demands of the authorized business, and to enable a bank to conduct its affairs, within the general scope of its charter, safely and prudently".

It has been suggested that First National Bank v. National Exchange Bank supports a narrow construction of the incidental powers

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* Justice Brandeis stated, in a footnote in Pottorff, that "A practice is not within the incidental powers of a corporation merely because it is convenient in the performance of an express power." (Emphasis added.) This dicta is a truism. It is not the position taken in this memorandum that a practice is within the incidental powers of a corporation merely because it is convenient in the performance of an express power. A practice can be convenient in the exercise of an express power, but, as was the case in Pottorff, inconsistent with the purposes of other provisions of the applicable statute.

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of national banks, and, therefore, of Federal Reserve Banks. However, the holding of the court does not support such a conclusion, since the court held that national banks do have the power to acquire stock under the circumstances of that case; and it seems clear that the court's dicta, quoted above, with its reference to "legitimate demands", "authorized business" and "general scope of its charter" does not point in the direction of a mechanical test, such as whether the power is necessary to the exercise of an express power; it points in the direction of consideration of the entire statute to determine the "authorized business" of the bank and the "general scope" of its charter. It is also important to note that the court imports the tests of safety and prudence as relevant factors in determining the existence of a claimed incidental power.

California Bank v. Kennedy, 167 U. S. 362 (1896) held, inter alios, that a national bank does not have the power to deal in stocks. The court disposed of this issue summarily:

> "It is clear, however, that a national bank does not possess the power to deal in stocks. The prohibition is implied from the failure to grant the power."

The conclusion of the court was clearly correct. However, the reason assigned by the Supreme Court for its conclusion is less than satisfactory. Obviously, a "prohibition" is not implied with respect to all powers not expressly granted--otherwise no incidental powers could exist. And the court does not indicate why it implied a prohibition with respect to the particular power at issue,

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viz., the power to deal in stocks. However, dealing in stocks with borrowed money, or money received on deposit, is, of course, a risky business. Prohibitions against it were inserted in all bank charters granted in the State of New York from 1791 to 1836; and banks in New York were prohibited from dealing in stocks under the New York Banking Act of 1838 (Talmage v. Pell (7 N. Y. 328)), which was the model for the incidental powers provision of the National Bank Act. Thus, there were considerations of safety and prudence, banking custom and prior interpretation of the statute on which the National Banking Act was based, as solid underpinnings for the Supreme Court's decision.

None of these factors are present with respect to the lending of securities.

In First National Bank v. Missouri (263 U. S. 640, 1923), the Supreme Court held that national banks do not have the incidental power to establish branches. The test enunciated by the court in that case was as follows:

> "The extent of the powers of national banks is to be measured by the terms of the Federal statutes relating to such associations and they can rightfully exercise only such as are expressly granted or such incidental powers as are necessary to carry on the business for which they are established. Bullard v. Bank, 18 Wall. 589, 593; Logan County National Bank v. Townsend, 139 U. S. 67, 73; California Bank v. Kennedy, 167 U. S. 362, 366." (Emphasis added.)

The court, in applying the test it enunciated, looked to several provisions of the National Bank Act, which appeared to be patently

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inconsistent with the establishment of branches by national banks, and concluded that the provisions of the national banking laws were "persuasively to the contrary" to the existence of the power to establish branches. Again, the court looked to the entire statute to discern the intent of Congress.

It is also of particular interest in this case that the court referred to the construction of the National Bank Act by the "executive officers charged with the administration of the law". The court stated, in this connection, that:

> "The construction of the executive officers charged with the administration of the law has been, with substantial uniformity, to the same effect, and in this view the Department of Justice, in a well considered opinion, rendered May 11, 1911, concurred. . . .
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> "This interpretation of the statute . . . by the executive officers of the government would go far to remove doubt as to its meaning if any existed."

The court cited as support for this proposition United States v. Hermanos y Compañia, 209 U. S. 337 (1907). In that case, which involved a question of the construction of the tariff laws, the court stated that:

> "Counsel for the Government also points out that the provisions of the tariff act of 1875 and subsequent acts were substantially similar to paragraph 296, and that the Treasury decisions thereunder were in accordance with the interpretation for which the Government now contends. The first of these decisions was made in 1879. . . . The ruling was repeated in 1893. . . . And again in 1899. . . .

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> "We have said that when the meaning of a statute is doubtful great weight should be given to the construction placed upon it by the department charged with its execution. . . ."

In Concord First National Bank v. Hawkins, 174 U. S. 364 (1899), the Supreme Court held that a national bank may not lawfully acquire and hold the stock of another national bank as an investment. The court alluded to decisions holding that a national bank may not purchase stock of another corporation, and concluded that the rationale underlying those decisions was equally applicable to the purchase by a national bank of the stock of another national bank. The court found that such purchase was plainly against the "meaning and policy of the statutes" from which national banks derive their powers, and determined that "evil consequences" would ensue if the National Bank Act were construed as permitting the purchase by a national bank of the stock of another national bank:

> ". . . The investment by national banks of their surplus funds in other national banks, situated, perhaps, in distant States, as in the present case, is plainly against the meaning and policy of the statutes from which they derive their powers, and evil consequences would be certain to ensue if such a course of conduct were countenanced as lawful. Thus, it is enacted, in section 5146, that 'every director must, during his whole term of service, be a citizen of the United States, and at least three fourths of the directors must have resided in the State, Territory or district in which the association is located for at least one year immediately preceding their election, and must be residents therein during their continuance in office.'

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> "One of the evident purposes of this enactment is to confine the management of each bank to persons who live in the neighborhood, and who may, for that reason, be supposed to know the trustworthiness of those who are to be appointed officers of the bank, and the character and financial ability of those who may seek to borrow its money. But if the funds of a bank in New Hampshire, instead of being retained in the custody and management of its directors, are invested in the stock of a bank in Indiana, the policy of this wholesome provision of the statute would be frustrated. The property of the local stockholders, so far as thus invested, would not be managed by directors of their own selection, but by distant and unknown persons. Another evil that might result, if large and wealthy banks were permitted to buy and hold the capital stock of other banks, would be that, in that way, the banking capital of a community might be concentrated in one concern, and business men be deprived of the advantages that attend competition between banks. Such accumulation of capital would be in disregard of the policy of the national banking law, as seen in its numerous provisions regulating the amount of the capital stock and the methods to be pursued in increasing or reducing it. The smaller banks, in such a case, would be in fact, though not in form, branches of the larger one."

The inquiry of the court in Concord is expressly directed to the "meaning and policy of the statutes from which they [national banks] derive their powers" (material in brackets added) and to the "evil consequences" which would ensue if the sought for power were found to exist. The inquiry is emphatically not in the direction of determining whether the sought for incidental power could be "matched up" with an express power.

In Kimen v. Atlas Exchange National Bank of Chicago, 92 F. 2d 615 (1937), the Circuit Court of Appeals for the Seventh

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Circuit held that an agreement that the national bank would, at any time, repurchase at par certain bonds sold to the appellee, was beyond the power of a national banking corporation. The reasoning of the court follows the usual pattern. The starting place is the evil results that would follow if the power sought to be exercised were held to exist; on the basis of these evil results, the court deduces, quite correctly, that Congress could not have intended to grant the power:

> "The contract relied upon was an agreement by the president of the bank at the time he sold to appellant real estate bonds that the bank would at any time repurchase them at par. This was in effect a guarantee. Obviously the extended practice of such contracts would permit a national bank to guarantee bonds without limitation as to number, amount or date. The evident constant temptation to a bank to deal in large quantities of securities for the commissions easily earned by selling to its customers tends to produce an ever increasing number of guarantees contingent upon the desire of the purchasers. There is no certainty that the buyers will ever require the bank to repurchase, and the bank cannot know whether it will be expected to comply with demands. Such contingent liabilities, in order to comply with the law, must be carried upon the bank's records. Their amount cannot be ascertained, thus endangering the solvency of the banking institution." (At page 617; emphasis added.)
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> "Arguments that agreements of the character here involved are a part of the general banking business do not appeal to us, for banks of deposits, having custody of the funds of their depositors, are intended by all banking statutes, to be conducted in such manner as reasonably to protect the depositors. Periodic statements of conditions must be made; examinations by the

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> officers of the government are had, all with the idea of procuring safety to deposits. Surely it was not intended by Congress that there should come into existence contingent liabilities by way of guarantees or suretyship which cannot be measured or determined in amount or time except by sifting the market values of the particular securities guaranteed from day to day. Such liabilities cannot be reported accurately to the statutory officials, and no bank can ascertain its liability before it knows whether there will be any demand. <u>There is a risk of complete destruction of the banking institution</u>, if the instances be multiplied and depressed values come into existence. We believe that the contract was beyond the power of a national banking corporation." (At page 618; emphasis added.)

The transaction condemned in Kimen was, in effect, a guarantee by the bank that the purchaser would suffer no loss arising out of a drop in the value of the bonds sold to him by the bank; a type of agreement that could expose the funds of depositors, other creditors and stockholders of a national bank to great risk if permitted. The lending of securities could not, of course, endanger the solvency of a Federal Reserve Bank and would not expose its funds to any appreciable risk.

In Colorado Bank v. Bedford, 310 U. S. 41 (1940), the Supreme Court held that national banks were authorized by the incidental powers clause of the National Bank Act to conduct a safe deposit business. The court based its decision, in large part, on its finding that the safe deposit business was part of the business of banking. It found that national banks, for many years, had carried on a safe deposit business and that State banks quite usually were given the power to conduct a safe deposit business:

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> "The obvious fact, known to all, is that national banks do and for many years have carried on a safe deposit business. State banks, quite usually are given the power to conduct a safe deposit business. We agree with the appellant bank that such a generally adopted method of safeguarding valuables must be considered a banking function authorized by Congress."

In Inland Waterways Corp. v. Young, 309 U. S. 517 (1940), the Supreme Court held that a national bank was authorized by the incidental powers provision of the National Bank Act to pledge assets to secure deposits of funds made by governmental agencies even though the funds were not "public money" within the scope of Section 45 of the National Banking Act. Again, the Supreme Court looked to the "history and purposes of the statute". In the light of the history and purposes of the statute, the court refused to draw a negative inference from the fact that Section 45 of the Act specifically ordered the Secretary of the Treasury to exact security for "public moneys" deposited by him in national banks.

> "Placing § 45 in the setting of its history, we do not think it should be read in a niggardly spirit, as though it expressed a gingerly departure from public policy." (At page 522.)

The court also placed heavy reliance on the fact that the practice in question had long been pursued with the knowledge of the Comptroller of the Currency without objection on his part:

> "The policy underlying Congressional legislation and reflected in the history of governmental deposits is confirmed by the explicit recognition of that official in whom is centered oversight of the administration of the National Banking Act. . . . The Comptroller of the Currency, to be sure, must himself move within the orbit of the National Banking

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> Act. Illegality cannot attain legitimacy through practice. But when legality itself is in dispute - when Congress had spoken at best with ambiguous silence - a long continued practice pursued with the knowledge of the Comptroller of the Currency is more persuasive than considerations of abstract conflict between such a practice and purposes attributed to Congress. . . . This practice had the approval of the Comptroller because he believed it within the scope of the National Banking Act. . . . When dealing with such necessarily argumentative concepts as those of which the law of ultra vires is so largely composed, the responsible and pervasive practice of public officers bent on safeguarding the public interests ought to carry the day even were the issue more in doubt than we believe it to be." (Emphasis added.)

In Heinz v. National Bank of Commerce in St. Louis, 237 Fed. 942, the Circuit Court of Appeals for the Eighth Circuit held that the establishment of a pension fund was within the incidental powers of a national bank, and said in part:

> "The tests in regard to all such matters [incidental powers] are: Is the act or transaction prohibited by the charter or other law? Is the act or transaction reasonably suitable and necessary for the carrying on of the business for which the corporation was created and organized? Is the act or transaction performed in good faith, or as a mere cloak to some illegal or fraudulent act?" (Material in brackets added.)

In Wyman v. Wallace, 201 U. S. 230 (1905), one of the issues was whether a national bank had the incidental power to borrow money. The Supreme Court held that it did, and stated as follows:

> "The question, therefore, is, whether a national bank finding itself embarrassed, with a large amount of assets, much in excess of its obligations, yet without the cash to make payment of those which are due and urgent, can borrow to meet those pressing demands.

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> A very natural answer is, why not? It is not borrowing money to engage in new business. It simply exchanges one creditor for others. There may be wisdom in consolidating all its debts into the hands of one person. At least such a consolidation cannot be pronounced beyond its powers. When time is obtained by the new indebtedness (in this case a year) it gives the borrowing bank and its officers and stockholders time to consider and determine the wisdom of attempting a further prosecution of business. In the case of an individual it would be a legitimate and often a wise transaction. It is not in terms prohibited by the National Banking Act." (Emphasis added.)

In Bank of California v. City of Portland, 69 Pacific 2d, 274, the issue before the court was whether the business of operating a safe deposit vault was an integral part of the banking business for a national bank. The court held that it was. The reasoning of the court is of interest. The court first referred to Morse on Banks and Banking and stated as follows:

> ". . . In section 47 of that volume, we read, in substance, that the business powers of a bank are either express or implied, and are conveniently divided into, first, primary or principal, or banking powers, for the exercise of which it is created, and, second, incidental powers, or such as are necessary or usual and convenient for the attainment of the purposes of its creation. It is necessary to confer in distinct terms in the charter or act of incorporation only those powers which the company could not otherwise exercise, or those concerning which there might be some doubt. Various powers have been at different times declared by the courts to be inherent, and to be properly enjoyed by banking associations simply by virtue of their creation and existence as such, and for the designated end of conducting the banking business. But powers of this nature, being based only upon a legal implication, must be used only in a manner and for purposes strictly consistent with such restrictions, and in furtherance of such duties as are specifically prescribed by law. To ascertain what is legitimately within the scope of the business of banking, it is

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> proper to refer to the history of banking and the definitions of lexicographers. As the business of bankers is part of the law merchant, courts judicially notice the universal custom of bankers. The heart of the law of banking is that a bank has such powers as are requisite for the safe and convenient attainment of the purposes of its incorporation."

The court then reviews the history of safe deposit vaults and states as follows:

> "The uncontradicted testimony in this case shows that plaintiffs' safe deposit departments and facilities are necessary and integral services for their customers and the public generally, and that similar facilities are in operation throughout the entire national banking system of the country, carrying the unquestioned approval of legality by the Comptroller of the Currency, their supervisory authority, . . ."

* * *

> "Defendants contend that the powers specifically enumerated constitute the full measure of the incidental powers granted to national banks. They contend that as Congress is the only source from which national banks can acquire authority to engage in certain practices, these practices must clearly appear in the enabling statutes, if they are to be carried on. If strictly adhered to, this view is too narrow and would curtail the privilege of national banks to borrow money, when necessary, or operate a collection department or escrow department.

> "Time was, perhaps, when the safe deposit vault business would not be considered an integral part of the banking business, but in this day and age, as the testimony shows, the modern bank is not complete without safe deposit facilities, just as in earlier times the business of banking would have failed in one of its most important phases if the practice of receiving valuables for safekeeping had been eliminated."

It is of interest to note that the unquestioned power of Federal Reserve Banks to conduct a very large, important and expensive safekeeping operation for their member banks arises out

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of the incidental powers of Federal Reserve Banks and would be supported by the same reasoning used by the courts in Bank of California v. City of Portland, supra, and Colorado Bank v. Bedford, supra.

The foregoing cases establish, quite clearly, that when faced with the question of whether a national bank possesses a certain power under the grant of incidental powers, the courts have not applied any mechanical test, but have attempted to deduce the unexpressed intent of Congress from the entire statute in the light of the general purpose of the statute; that is, the "meaning and policy" or the "history and purposes" of the statute (Texas and Pacific Railway Co. v. Pottorff, supra; First National Bank v. Missouri, supra; Kimen v. Atlas Exchange National Bank of Chicago, supra). The courts have made inquiry into whether the activity sought to be performed was generally performed by banks (Texas and Pacific Railway Co. v. Pottorff, supra; Colorado Bank v. Bedford, supra; Inland Waterways Corp. v. Young, supra); whether the activity was one which would work against the interests of depositors and other creditors (Texas and Pacific Railway Co. v. Pottorff, supra), or of the community in which the bank is situated (Concord First National Bank v. Hawkins, supra); whether the exercise of the power would conflict with the purpose to be served by other express provisions of the statute (Texas and Pacific Railway Co. v. Pottorff,

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supra; Inland Waterways Corp. v. Young, supra)*; and whether the exercise of the power in question has been approved by the Comptroller of the Currency (Inland Waterways Corp. v. Young, supra; First National Bank v. Missouri, supra; see also United States v. Hermanos y Compañia, supra).

It should also be noted that a review of the cases shows that there is no basis for the conclusion that "incidental powers" imports power of an "ancillary" rather than those of a substantive nature. On the contrary, it is clear that important substantive

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* It should be emphasized that the courts have not, in applying this test, drawn any inference from the fact that the sought for incidental power is not expressly granted, while other powers of a generally similar nature have been expressly granted. The inquiry has been whether the exercise of the sought for power would conflict with the purpose to be served by other express provisions of the statute. The argument that, by granting certain express powers, Congress indicated an intent that other substantive powers not expressly granted should not be exercised -- in essence, an argument based on the maxim expressio unius est exclusio alterius -- has not been accepted by the courts. Thus, in Inland Waterways Corp. (supra), the Supreme Court rejected the argument that since Congress had "By a series of specific statutory commands . . . recognized the power of national banks to give security for deposits of a governmental nature . . ." (at page 523), Congress had thereby evidenced an intent that national banks should not have the power to give security for deposits of governmental funds which were not public money. Clearly, the "expressio unius" argument would attribute to Congress a prescience that no legislative body could possess. As stated by a Pennsylvania court:

> "Charters of incorporation [of banks] are constitutions, not codes. They furnish outlines, which those who are to execute their faculties are at liberty to fill up, but always in harmony with the main design." (Bank of Kentucky v. Schuylkill Bank, 1 Parsons Select Cases 180, 235.)

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powers are within the scope of the incidental powers clause, viz., the powers of a national bank to borrow money, to conduct a safe deposit business, to create a pension fund and to pledge assets to secure deposits of government agencies are certainly powers of a substantive nature and they derive from the incidental powers clause.

IV. Applying the tests that would be applicable in the case of a national bank to the question whether Federal Reserve Banks are authorized under the incidental powers clause of the Federal Reserve Act to lend securities, it is clear that the courts would hold that the Federal Reserve Banks have such power, particularly if the Board of Governors and the Federal Open Market Committee approve of the practice.

Applying the tests that would be applicable in the case of a national bank to the question whether Federal Reserve Banks are authorized to lend securities, it is necessary, under the cases, to inquire (i) whether the practice would be safe and prudent, (ii) whether the practice is generally engaged in by banks who conduct an active business in the government securities market, (iii) whether the exercise of the power would conflict with other express provisions of the statute, and (iv) whether the practice would be consistent with the purpose to be served by the Federal Reserve Act and related statutes.

(i) Whether the Practice Would Be Safe and Prudent

Since loans would be secured by other government securities having a market value in excess of the securities loaned, the practice would be all but riskless; and it would be entirely riskless with respect to principal, since obligations of the United States will be paid at par at maturity.

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(ii) Whether the Practice is Generally Engaged in by Banks Who Conduct an Active Business in the Government Securities Market

I am advised that State banks and national banks that are government securities dealers, and other banks as well, have, for many years, engaged in the practice of lending government securities and continue to do so at the present time, and that the lending of securities by such banks is considered to be a normal banking function. So far as I know, neither state banking authorities nor the Comptroller of the Currency has raised any objection to the practice.

(iii) Whether the Exercise of the Power Would Conflict With Other Express Provisions of the Federal Reserve Act or the Purpose to be Served Thereby

There are no express provisions of the Federal Reserve Act with which the lending of securities would conflict. It may be argued that, since Congress has expressly authorized Federal Reserve Banks to lend money to specified borrowers under specified conditions, the inference should be drawn that Federal Reserve Banks are not authorized to lend securities. This argument has in its favor simplicity and ease of application. However, it is not valid. Otherwise, the Supreme Court in Inland Waterways Corp. v. Young (supra) would have held that the express statutory recognition of the power of national banks to pledge assets to secure one specific class of deposits justified an inference that no incidental power existed to pledge assets to secure another class. The court, of

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course, rejected this argument. Similarly, in Wyman v. Wallace, supra, the Supreme Court could have reasoned, but did not, that, since Congress had expressly empowered national banks to receive deposits, the absence of express power to borrow money indicated a Congressional intent not to authorize national banks to borrow.

In short, the courts approach the question of incidental powers of national banks with the common-sense attitude that it is completely unrealistic to assume that Congress would have in mind and express all of the functions it would have national banks perform.

Obviously, the argument that the granting of an express power raises an inference against the existence of a specific incidental power can be persuasive in cases where Congress has conferred detailed express powers relating to a specific practice. In such cases, the application of the test, which this memorandum concludes is the correct test, viz., whether the sought for incidental power may be properly implied from the entire statute in the light of the general intent of the statute, would, in the absence of countervailing evidence in the remainder of the statute, lead to the conclusion that Congress did not intend to grant substantive incidental powers relating to the same practice. For example, Federal Reserve Banks are expressly authorized to buy and sell government securities and certain other types of paper. The inference to be drawn from this is that Congress had given its

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attention to the classes of securities that Federal Reserve Banks may buy and sell and had intended to exclude all classes, except those set forth in the statute. Also, the provisions of the Federal Reserve Act authorizing the Federal Reserve Banks to make loans and advances of money are drawn with great particularity and a similar inference might be drawn. However, the lending of securities is a qualitatively different function than the extension of central bank credit, and, accordingly, the provisions of the Federal Reserve Act relating to loans and advances of money do not support the inference that Congress did not intend to permit Federal Reserve Banks to lend securities.

(iv) Whether the Practice Would be Consistent With the Purposes to be Served by the Federal Reserve Act and Related Statutes

The functional basis for the proposal that Federal Reserve Banks lend government securities is that such loans would tend to improve the System's ability to effect through open market operations the purposes of Section 12A of the Federal Reserve Act and of the Employment Act of 1946. Open market operations in government securities are, of course, carried out in the government securities market. Federal Reserve and Treasury government securities market experts advise that the lending of securities would, by improving the functioning of the government securities market, significantly aid the System in performing a duty imposed on it by the Congress, i.e., the carrying out of open market

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operations to effect the purposes of Section 12A of the Federal Reserve Act and of the Employment Act of 1946.

Accordingly, it seems necessary to conclude that the lending of securities would be consistent with the purposes of the Federal Reserve Act and related statutes.*

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* It should be noted that even if the incorrect mechanical test as to the existence of an incidental power -- that is, whether the incidental power is necessary to the exercise of an express power -- is applied to the lending of securities by Federal Reserve Banks, the conclusion would appear to be that the lending of securities _is_ "necessary" to carry out the express power to buy and sell government securities in such a way that the ends contemplated by Section 12A and the Employment Act of 1946 are served -- not "necessary" in the sense of indispensable (so far as I know, the courts have not used the word "necessary" in this sense in connection with incidental banking powers), but "necessary" in the sense of being reasonably calculated to produce the desired end.

> ". . . The word 'necessary' when used in reference to implied powers, does not mean indispensable, and is not to be given a narrow restricted meaning . . ." (_Heinz_ v. _National Bank of Commerce in St. Louis_, _supra_.)

> "If reference be had to its [the word 'necessary'] use, in the common affairs of the world, or in approved authors, we find that it frequently imports no more than that one thing is convenient, or useful, or essential to another. To employ the means necessary to an end, is generally understood as employing any means calculated to produce the end and not as being confined to those single means without which the end would be entirely unattainable." (Justice Marshall in _McCulloch_ v. _Maryland_, 17 Wheat. 314, 318.)

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The Federal Reserve System is a central banking system. It goes without saying that the powers of such a system, especially those to be exercised in markets where practices are dynamic rather than static, ought not to be narrowly construed unless the law requires such a construction. The lending of securities is sanctioned by banking custom; it carries with it no appreciable risk; it conflicts with no provision of the Federal Reserve Act, and it would clearly serve the purposes intended by Congress. It is submitted that, under these circumstances, the law is clear that Federal Reserve Banks have the incidental power to lend securities. The words of Mr. Justice Holmes in Johnson v. U. S., 163 Fed. 30, 32, are pertinent with respect to the attitude that should underly the interpretation of the statutes which govern the operations of the Federal Reserve System:

> ". . . A statute may indicate or require as its justification a change in the policy of the law, although it expresses that change only in the specific cases most likely to occur to the mind. The Legislature has the power to decide what the policy of the law shall be, and if it has intimated its will, however indirectly, that will should be recognized and obeyed. The major premise of the conclusion expressed in a statute, the change of policy that induces the enactment, may not be set out in terms, but it is not an adequate discharge of duty for courts to say: We see what you are driving at, but you have not said it, and therefore we shall go on as before."

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As indicated supra, the Supreme Court, in a number of cases, has placed substantial weight on whether the supervisory authority involved has construed the statute as permitting the exercise of the incidental power. Accordingly, the approval of the Board of Governors and of the Federal Open Market Committee (which as a practical matter would be necessary if the Federal Reserve Banks are to lend securities) would add further weight to the conclusion that the Reserve Banks are authorized to lend securities.