

the obligor's revenues from a particular source are not general obligations." In order to be eligible for underwriting by member banks, the issuer must possess the power of general property taxation and the securities must be supported by that power, as a part of the "full faith and credit" of the issuer.

(d) The bonds in question are issued pursuant to Washington Laws of 1961, Ex Sess., Chapters 3 and 23. These statutes provide that the bonds "shall not be a general obligation of the state of Washington but shall be payable * * * from the proceeds of retail sales taxes * * *." The statutes also provide that "the state undertakes to continue to levy the taxes referred to herein and to fix and maintain said taxes in such amounts as will provide sufficient funds to pay said bonds and interest thereon until all such obligations have been paid in full."

(e) The statutory provisions that the bonds in question "shall not be a general obligation of the State of Washington" and "shall be payable * * * from the proceeds of retail sales taxes" appear to indicate that the bonds will not be supported by the full faith and credit of the State, including its power of general property taxation. If this is correct it follows on the principles previously stated, that these bonds would not be "general obligations" of the State within the meaning of R.S. 5136 and would not be eligible to be underwritten by member banks. The undertaking to levy retail sales taxes that will provide sufficient funds to pay the bonds in full reflects the intent of the State that the bonds (and interest thereon) shall be paid, but it does not negate the plain statement in the Washington statute that the bonds shall be payable from a particular source—namely, the proceeds of retail sales taxes—and are not general obligations.

(f) This conclusion does not conflict with the decision of the Supreme Court of Washington in *State of Washington v. Martin*, decided August 7, 1963. It was there held that bonds of this nature are "issued upon the credit of the state and are in truth debts of the state." However, the Court made it quite clear that such bonds are not supported by the full faith and credit of

the State and its plenary taxing power. Under the State constitutional and statutory provisions dealt with in that decision, bonds of the State of Washington that are payable from a particular source of revenue constitute a debt of that State but are not general obligations thereof.

(g) For these reasons, the Board concludes that the bonds in question are not "general obligations" within the purview of section 5136 of the Revised Statutes and consequently are not eligible for underwriting by State banks that are members of the Federal Reserve System.

(12 U.S.C. 24, 335)

§ 250.121 Application of investment securities regulation to member State banks.

(a) *General.* A revision of the Investment Securities Regulation (Part 1 of this title) was issued recently by the Comptroller of the Currency. Under section 9 of the Federal Reserve Act (12 U.S.C. 335) the regulation is applicable to member State banks as well as to national banks, insofar as it conforms to paragraph Seventh of section 5136 of the Revised Statutes (R.S. 5136; 12 U.S.C. 24).

(b) *Provisions of regulation with respect to "exempt securities".* (1) Paragraph Seventh refers to two areas of securities transactions by a bank: (i) Underwriting and dealing, which are grouped as "underwriting" herein, and (ii) investing (called "purchasing for its own account" in the statute).

(2) The statute contains a general prohibition against a member bank (i) underwriting securities or (ii) investing more than 10 percent of its capital and surplus in the securities of any one obligor. In addition to this 10 percent limitation, the power of national banks and member State banks to purchase securities for investment is subject to "such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe". The term *investment securities* is defined in paragraph Seventh and is subject to "such further definition * * * as may by regulation be prescribed by the Comptroller".

(3) The statute also provides, however, that “The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for [the bank’s] own account, investment securities shall not apply to obligations of the United States or general obligations of any State or of any political subdivision thereof,” or certain other securities. In other words, national banks and member State banks are legally free (i) to underwrite such “exempt securities” and (ii) to invest therein without regard to the 10 percent limitation mentioned in this section.

(4) The authority of the Comptroller of the Currency to issue investment regulations pursuant to R.S. 5136 does not include authority to exempt additional kinds of securities from the prohibition against underwriting or the prohibition against investing more than 10 percent of capital and surplus in securities of any one obligor. Despite this, §1.3 of this title, the Comptroller’s recent revision of the Investment Securities Regulation, contains a definition of *public security* and §1.4 of this title states that “A bank may deal in, underwrite, purchase and sell for its own account a public security subject only to the exercise of prudent banking judgment.” The term *public security* is so defined that, in effect, the regulation purports to authorize national banks and member State banks to underwrite, and to purchase without limitation on amount, securities that are not exempted by law from the statutory prohibition against underwriting and against investing in excess of the 10 percent limitation. For example, the terms of the regulation would authorize such banks to underwrite some securities of public corporations that are payable solely out of revenues derived from the operation of a tunnel, turnpike, bridge, or the like, despite the fact that the applicable statute does not exempt such securities from the general prohibition against underwriting by banks.

(5) Since the Comptroller is not authorized by law to expand the category of exempt securities established and described in paragraph Seventh of R.S. 5136, the current regulation does not have the force and effect of law insofar

as it attempts to do this. Accordingly, member State banks are informed that, in the opinion of the Board of Governors, the only securities that are exempt from the limitations and restrictions of paragraph Seventh are those specified in R.S. 5136. Unless a particular issue of securities is exempt by virtue of that provision of law, member State banks may not underwrite the issue, and the 10 percent limit is applicable to investments therein. Since so-called *revenue obligations* of the kinds mentioned above, as well as other revenue obligations, are not exempt from the limitations and restrictions of R.S. 5136, it would be unlawful for a member State bank to underwrite such securities or to invest in them in excess of the 10 percent limit.

(c) *Convertible securities.* (1) From time to time corporations issue debentures or similar securities that constitute an obligation to pay a specified dollar amount of principal (as well as interest) and in addition give the holder an option to convert the security into a specified number of shares of the corporation’s stock. When the market value of the stock into which such a debenture is convertible is substantially less than the face value of the debenture, the debenture ordinarily will sell at a price that reflects principally its value as a corporate obligation, without regard to the conversion option. However, the market value of the stock sometimes increases to such an extent that the shares into which a debenture is convertible have a market value that is much greater than the face value of the debenture. For example, a number of convertible debentures traded on the New York Stock Exchange sell at prices of \$2,000, \$3,000, or more, for securities with a face value of \$1,000. These prices approximate very closely the current market value of the shares of stock for which the convertible may be exchanged at the holder’s option.

(2) A question has arisen as to the circumstances in which a member State bank may purchase convertible debentures for its investment portfolio under the provisions of the Investment Securities Regulation of the Comptroller of the Currency, as recently revised.

(3) Section 1.3(b) of this title defines *investment security* to exclude securities “which are predominantly speculative in nature”, so that, under R.S. 5136 and the regulation, the purchase of *predominantly speculative* securities is not permissible. When the market price of a convertible debenture is far in excess of its face value because of the conversion feature, and its price fluctuations parallel the fluctuations in the price of the stock into which it is convertible, the debenture is necessarily speculative. Market conditions may induce price fluctuations that may have no relationship to the quality of the debenture or even of the particular stock into which it can be converted.

(4) Accordingly, it would appear that a bank is prohibited from purchasing convertible debentures in the circumstances described. However, uncertainty as to this matter could arise from the terms of §1.10 of this title (Comptroller’s Revised Regulation), which might be read as indicating that a bank may purchase convertible securities generally, provided that the cost of such a security is written down promptly “to an amount which represents the investment value of the security considered independently of the conversion feature”.

(5) Quite apart from questions of interpretation of the revised regulation, however, it is to be noted that the law itself (paragraph Seventh of R.S. 5136) in effect forbids national banks and member State banks to purchase “any shares of stock of any corporation”. When the market price of a convertible security reaches 200 percent or 300 percent of its face value due to a rise in the price of the related stock, purchase of the convertible security is, for practical purposes, equivalent to the purchase of the stock it represents.

(6) In the light of these statutory and regulatory provisions, it is the position of the Board of Governors that a member State bank may not lawfully invest in a convertible security whose price exceeds, by more than an insignificant amount, the investment value of the obligation, considered independently of the conversion feature. Adherence to this principle will avoid violations of the statute and regulation that would occur if a bank were to purchase con-

vertible securities in such circumstances that the security necessarily would be “predominantly speculative in nature”, for the reasons described, and the transaction would be tantamount to a purchase of corporate stock.

(12 U.S.C. 24, 335)

§250.122 Underwriting of public Authority bonds payable from rents under lease with governmental entity having general taxing powers.

(a) The Board of Governors has been asked whether securities of a public Authority that are to be paid from rents payable under a lease of the Authority’s facilities to a governmental entity that possesses general powers of taxation, including property taxation, constitute “general obligations” within the meaning of section 5136 of the U.S. Revised Statutes (12 U.S.C. 24). In cases where this question can be answered in the affirmative, member State banks of the Federal Reserve System may lawfully underwrite and deal in such securities, and invest therein without limitation on amount, as far as Federal banking law is concerned.

(b) The Board understands that the issuing Authorities usually have no taxing powers and that their obligations are not, under pertinent State constitutional and statutory provisions as interpreted by the courts, “debt” of the lessee—that is, the governmental entity with general powers of taxation. However, whether a security constitutes a *debt* for purposes of State law is not determinative as to whether it is a *general obligation* within the meaning of section 5136, a Federal statute. (See §250.120.)

(c) During recent Hearings before the Committee on Banking and Currency of the House of Representatives, published under the title “Increased Flexibility for Financial Institutions—1963”, the Board expressed its understanding of the meaning of the phrase “general obligations of any State or of any political subdivision thereof” as used in section 5136.

(d) As the House Committee was informed, the Board understands that phrase to include “only obligations that are supported by an unconditional