

**DRAFT**

September 17, 2008

TO: Vice Chairman Kohn                      SUBJECT: Authority of a Reserve  
Bank to take warrants in connection  
FROM: Legal Division                      with an extension of credit under  
(Messrs. Alvarez,                      section 13(3)  
Ashton & Van Der Weide)

**ISSUE:** In connection with a credit extension to an individual, partnership, or corporation (IPC) under section 13(3) of the Federal Reserve Act, does the Federal Reserve have the authority to condition the granting of the credit on the issuance to the Federal Reserve of warrants to purchase equity securities of the borrower.

**SUMMARY:** There is a reasonable argument that accepting warrants to purchase equity securities of a section 13(3) borrower is incidental to the extension of the credit and therefore authorized by the Federal Reserve Act.

**DISCUSSION:** Section 13(3) of the Federal Reserve Act authorizes the Federal Reserve Banks to extend credit to IPCs in unusual and exigent circumstances and secured to the satisfaction of the Federal Reserve Bank, if the Reserve Bank obtains evidence that the borrower is unable to secure adequate credit accommodations from other banking institutions.<sup>1</sup> Any such extensions of credit by a Reserve Bank are subject to “such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.” The Federal Reserve Act also provides that each Reserve Bank has the authority to 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

<sup>1</sup> 12 USC 343.



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prescribed by this Act.”<sup>2</sup> The Board has long read the incidental powers clause as authorizing powers that are “reasonably necessary” to effectuate a power specifically granted by the Act.<sup>3</sup>

The question has arisen whether a Federal Reserve Bank has authority to take warrants in connection with a section 13(3) extension of credit to an IPC. In answering this question, it is important to note that the Federal Reserve Banks are not obligated to lend to any IPC – even if the Board makes a determination that unusual and exigent circumstances prevail and even if the Reserve Bank finds that an IPC is unable to secure adequate credit accommodations from other banking institutions. Moreover, the Federal Reserve Act does not contain any limits on what conditions a Reserve Bank might impose on a section 13(3) borrower. As such, a Reserve Bank should be viewed as having implicit power to condition any section 13(3) extension of credit as it deems appropriate to justify the decision to extend credit (including to help ensure that the credit is secured to the satisfaction of the Reserve Bank).

Moreover, we understand that it is common practice in the banking industry for lenders to take a warrant issued by the borrower in connection with a loan. Thus, it would not be unreasonable to find that accepting warrants is incidental to the power to extend credit as authorized by section 13(3) of the Federal Reserve Act.

The question of whether the Reserve Bank would be authorized to exercise any warrants that it has received in connection with a section 13(3) loan and thus to acquire, hold, and vote the equity securities it obtains

<sup>2</sup> 12 USC 341(7<sup>b</sup>).

<sup>3</sup> See Memorandum to the FOMC from Mr. Hackley, General Counsel, regarding the legality of a plan for lending government securities by Federal Reserve Banks, dated July 10, 1968.

pursuant to the warrants does not need to be addressed at this time. It has been proposed that in connection with the AIG transaction, the New York Reserve Bank would either transfer any warrants relating to AIG shares it may acquire in the transaction to the Treasury Department before the warrants are exercised or would exercise the warrants and immediately sell the equity securities purchased.