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July 11, 1986

TO: Federal Open Market Committee

FROM: Messrs. Bradfield, Oltman and Ashton

SUBJECT: Melcher litigation -- consideration of scope of possible remedy

The FOMC's reply brief in the Melcher litigation is due to be filed today, Friday, July 11. Oral argument before Judge Greene is scheduled for Wednesday, July 16. In this connection, we are considering what position to take on the issue of the appropriate relief should Senator Melcher prevail on his claim that the provisions of the Act relating to Reserve Bank members' service on the FOMC are inconsistent with the Appointments Clause. Senator Melcher claims that the alleged constitutional infirmity can be remedied by having the Court prohibit the Reserve Bank members from voting at FOMC meetings, but allowing them to attend in a purely advisory capacity. The issues involved in resolving this question are discussed below.

The courts have ruled that in general the test for determining whether particular invalid provisions can be severed from existing statutory framework is whether Congress, had it been aware that the invalid provisions could not be included, would have decided to discard the entire statutory framework. Thus, unless it is clear that Congress would have preferred no statute at all in lieu of the statute with invalid provisions excised, courts generally will leave intact the

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remaining valid portion of the statute. On the other hand, what remains after severance should be "fully operative" and constitute "workable administrative machinery."

In order to apply these principles to this case, it is necessary to examine the components of the statutory framework created by Congress to govern the FOMC. Under section 14 of the original Federal Reserve Act, the Reserve Banks are authorized to buy and sell United States securities in accordance with regulations of the Board. In 1933, when Congress made the FOMC a statutory body, the FOMC retained the basic character of its predecessors: the committee was composed solely of Reserve Bank representatives and, while its recommendations had to be approved by the Board, each Reserve Bank could decline to follow these directives if it wished. In 1935 Congress created the basic structure governing the FOMC today: the FOMC's directives were made mandatory on the Reserve Banks but the Reserve Banks were given minority representation on the decision-making body.

Given that there are two essential aspects to the FOMC statutory framework, i.e., (1) the power to direct Reserve Bank open market operations and (2) the presence of both the Board members and Reserve Bank representatives on the Committee, there are three principal options that the court might take if it found that Reserve Bank members' service on the Committee is unconstitutional:

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(1) finding that Congress would not have given the FOMC mandatory authority over Reserve Bank operations without at least minority representation by the Reserve Banks on the Committee, the court may invalidate all of the provisions relating to the FOMC in section 12A of the Act. In such a case, each Reserve Bank presumably would continue to be authorized to conduct its own open market operations under section 14 of the original Act subject to regulation by the Board.

(2) finding that Congress would have wanted control over open market operations by a centralized authority, regardless of its composition, the court could prohibit Reserve Bank members from exercising a vote on the Committee, or

(3) the court may leave the composition of the FOMC intact but prohibit it from exercising any mandatory functions, _i.e._, from issuing directives to the Reserve Banks.

The legislative history of the 1935 legislation suggests that the House of Representatives would have supported the second option -- prohibiting Reserve Banks members' voting. The House-passed version of the legislation gave the Board alone mandatory authority over Reserve Bank open market operations.

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While the history of the Senate's consideration of the bill is not so clear, the Senate found the House version unacceptable. Senator Glass, Chairman of the Senate Banking Committee, stated that some senators were opposed to any alteration of the then existing (i.e., non-mandatory) arrangements and that other senators wanted Reserve Bank representatives to control the FOMC. Senator Glass described the composition of seven Board members and five Reserve Bank members as the result of a compromise undertaken "to reconcile bitter differences." The Senate (and thus Congress as a whole) would apparently not have adopted an FOMC with mandatory authority that did not have Reserve Bank members, and thus would have preferred invalidation of all FOMC provisions.

Another consideration is whether, after excision of invalid provisions, a workable administrative framework remains. If all provisions relating to the FOMC are invalidated (option (1)) or if the FOMC's authority to issue mandatory directives is invalidated (option (3)), then there would be no centralized authority to conduct monetary policy through open market transactions. The Board has authority under section 14 to issue regulations governing Reserve Bank open market operations. There are a number of ways this authority could be exercised, with varying degrees of Board control over the specifics of open market operations. Depending on the machinery selected, it is possible that under

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this scenario a new lawsuit would be brought against the Reserve Banks making the same allegations advanced here against the FOMC.

If Judge Greene finds that the statute is invalid, however, it is very likely that whatever remedy he imposes will be stayed pending appeal to the Supreme Court. In the Supreme Court, the issue of severability can be explicitly addressed. Moreover, even if the Supreme Court agrees that the statute is unconstitutional, any remedy ordered by the Supreme Court will undoubtedly be stayed for a period of time to allow Congress to address the situation. The stay could last from 60 days (as in the Gramm-Rudman case) to one year or more (as in the case of the bankruptcy judges).