FEDERAL RESERVE SYSTEM

12 CFR Part 250

[Miscellaneous Interpretations; Docket R–1015]

Applicability of Section 23A of the Federal Reserve Act to the Purchase of Securities From Certain Affiliates

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: Section 23A of the Federal Reserve Act restricts the ability of a member bank to fund its affiliates through asset purchases, loans, or certain other transactions (''covered transactions''). The Board is adopting an interpretation that would expand the types of asset purchases that are eligible for the exemption in section 23A(d)(6), which exempts the purchase from an affiliate of an asset that has a readily identifiable and publicly available market quotation. This interpretation would expand the ability of an insured depository institution to purchase securities from its registered broker-dealer affiliates, while ensuring that the transactions are conducted in a manner that is consistent with safe and sound banking practices.

EFFECTIVE DATE: June 11, 2001.

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SUPPLEMENTARY INFORMATION:

Background

The Board is adopting an interpretation of section 23A(d)(6) of the Federal Reserve Act to expand the types of securities that an insured depository institution (''depository institution'') can purchase on an exempt basis from a registered broker-dealer affiliate.[1] Section 23A of the Federal Reserve Act, originally enacted as part of the Banking Act of 1933, is designed to prevent the misuse of a member bank's resources through ''non-arm's length'' transactions with its affiliates. Section 23A limits covered transactions between a member bank and an affiliate to 10 percent of the bank's capital stock and surplus, and limits the aggregate amount of all transactions between a member bank and all of its affiliates to 20 percent of capital stock and surplus. The purchase of assets by a bank from its affiliates is included in the definition of covered transaction and is subject to the statute's quantitative limits.

Section 23A also contains several exemptions from the statute's quantitative limits and collateral requirements. One exemption is contained in section 23A(d)(6), which exempts from the statute's quantitative limits a purchase of an asset that has ''a readily identifiable and publicly available market quotation'' (''(d)(6) exemption'').[2] In the past, institutions have been advised that the (d)(6) exemption was available only for the purchase of assets, the price of which was recorded in a widely disseminated publication that was readily available to the general public. Such assets included obligations of the United States, securities traded on exchanges, foreign exchange, certain mutual fund shares, and precious metals. Other marketable assets could not meet this standard.

In 1997, the Board removed certain prohibitions on transactions between a bank and its section 20 affiliates (''section 20 firewalls''). Because of the changes to the section 20 firewalls, the Board received several requests from organizations (''Petitioners'') regarding the interpretation of the (d)(6) exemption as it related to the purchase of assets from section 20 affiliates. Several Petitioners stated that, although the removal of the firewall was welcomed, section 23A continued to limit certain transactions with section 20 affiliates. Petitioners argued that certain prohibited transactions do not raise significant safety and soundness issues and that the prohibition impeded the efficient operations of the insured depository institution and the section 20 affiliate. In particular, Petitioners were concerned about the ability of an insured depository institution to purchase securities under the (d)(6) exemption because of the Board's narrow reading of the exemption, which prevented the purchase of otherwise marketable assets.

Summary of Comments and Description of the Rule

Because of Petitioners' requests, the Board proposed to expand the ability of a bank to purchase from a registered broker-dealer affiliate securities that, although not so widely traded as to warrant the inclusion of their prices in publications of general circulation, are actively traded and whose prices can be verified by independent reliable sources (''1998 Proposal''). Under the 1998 Proposal, a purchase of securities by an insured depository institution from its broker-dealer affiliate would meet the (d)(6) exemption if the transaction met the following criteria:

(1) The broker-dealer from which the securities were purchased was registered with the Securities and Exchange Commission (''SEC'');

(2) The securities had a ''ready market,'' as defined by the SEC in its regulation codified at 17 CFR 240.15c3–1(c)(11)(i);

(3) The securities had received an investment grade rating from a nationally recognized statistical rating organization (''NRSRO''), and no NRSRO had stated that the rating was under review for a possible downgrade to below investment grade;

(4) The securities were not purchased during an underwriting or within 30 days of an underwriting if an affiliate was an underwriter of the security;

(5) The price paid for the securities could be verified by

(i) A widely disseminated news source;

(ii) An electronic service that provided indicative data from real-time financial networks; or

(iii) Two or more actual independent dealer quotes on the exact securities to be purchased, where the price paid was not higher than the average of the price quotes obtained from the unaffiliated broker-dealers; and

(6) The securities were not issued by an affiliate, unless the securities were obligations of the United States or fully guaranteed by the United States or its agencies as to principal and interest.

The Board received thirteen comments on the proposed interpretation: nine from banks and bank holding companies, three from trade associations and one from a clearing house. In addition, comments were received from eight Federal Reserve Banks. Commenters generally supported the Board's proposed interpretation. The commenters concurred with the Board that a broader interpretation of the (d)(6) exemption, as proposed, would promote operational efficiencies in a banking organization

[1] 12 U.S.C. 371c(d)(6). By its terms, section 23A only applies to member banks. The Federal Deposit Insurance Act extends the coverage of section 23A to all FDIC-insured nonmember banks. 12 U.S.C. 1828(j). The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 applies section 23A to FDIC—insured savings associations. 12 U.S.C. 1468.

[2] 12 U.S.C. 371c(d)(6). Although such asset purchases are exempt from the quantitative restrictions of section 23A, the (d)(6) exemption requires that the bank's purchase be consistent with safe and sound banking practices. 12 U.S.C. 371c(a)(4).

while still ensuring that transactions are conducted in a safe and sound manner.

Although the commenters uniformly supported the Board's proposal to expand its interpretation of the (d)(6) exemption, a number of commenters expressed concerns about the specific qualifying criteria proposed by the Board. The commenters' views regarding each of the criteria and the Board's response are discussed below.

(1) The Securities Must Be Purchased From a Broker-Dealer Registered With the SEC

In order for a purchase of securities to meet the expanded (d)(6) exemption, the Board proposed that the purchase of securities must be from a broker-dealer registered with the SEC.

One commenter specifically supported the Board's proposed requirement that the broker-dealer affiliate be registered with the SEC. Several other commenters, however, urged the Board to loosen the requirement. One commenter argued that the Board should allow depository institutions to buy securities under the exemption from broker-dealers registered with foreign authorities. Several other commenters argued that there is no reason to limit the exemption to broker-dealers. These commenters expressed the view that non-broker-dealers may hold securities that would qualify under the terms of the 1998 Proposal, and these commenters argued that there is no policy reason for prohibiting these non-broker-dealer affiliates from using the proposed interpretation.

Broker-dealers that are registered with the SEC are subject to supervision and examination by the SEC and are required by SEC regulations to keep and maintain detailed records concerning each securities transaction conducted by the broker-dealer. In addition, SEC-registered broker-dealers have experience in determining whether a security has a ''ready market'' under SEC regulations, as described below. The Board believes that these factors will help ensure that banks satisfy the requirements of the expanded exemption and will assist the Federal banking agencies in monitoring such compliance.

The Board does not believe it is appropriate at this time to expand the exemption to include securities purchases from foreign broker-dealers because such entities may be subject to different levels of supervision and regulation and because of the increased difficulties associated with monitoring compliance by foreign entities. An insured depository institution can, however, request that the Board exempt securities purchases from a foreign broker-dealer, and the Board would consider these requests on a case-by-case basis in light of all the facts and circumstances.

In addition, although the proposed expanded (d)(6) exemption is limited to purchases from registered broker-dealers, the Board notes that a purchase of securities or other assets from other types of affiliates would continue to be exempt under section 23A(d)(6) if the price of the asset is routinely quoted in a widely disseminated news source and the asset was purchased at or below its current market price. The Board, in any event, expects to evaluate the continued need for the requirement as insured depository institutions and the Board gain experience with this expanded exemption.

(2) The Securities Must Have a ''Ready Market'' as Defined by the SEC

The 1998 Proposal provided that, in order to meet the expanded (d)(6) exemption, the assets must have a ''ready market,'' as defined by the SEC.[3]

Based on public comments, the Board considered various alternative marketability definitions. Some commenters noted that the Office of the Comptroller of the Currency (''OCC'') defines ''marketable'' under its Investment Securities regulations to include those securities that can be sold with reasonable promptness at a price that corresponds reasonably to fair value.[4] The commenters submitted that banks would be comfortable with this alternative definition of ''ready market.''

One commenter argued that the SEC's ''ready market'' concept was not appropriate for the (d)(6) exemption. The commenter contended that the SEC's ''ready market'' concept is used in the context of determining the liquidity of a broker-dealer's portfolio, and the commenter argued that the concept of liquidity is not analogous to the question raised in the context of the (d)(6) exemption as to whether the security was purchased at a fair market price. The commenter argued that a more appropriate standard is set forth in the ''fair market price'' definition in National Association of Securities Dealers (''NASD'') Rule 2730. The commenter noted that the NASD's ''fair market price'' definition is one with which broker-dealers are already familiar.

In the proposed interpretation, the Board employed the ''ready market'' test because it believed that this definition would help ensure that a ready, competitive market exists for the securities that the bank purchases. Under the SEC's net capital rules, a registered broker-dealer must deduct 100 percent of the carrying value of securities and certain other assets if there is not a ''ready market'' for the assets. The purpose of the ''ready market'' test is to identify securities with a liquid market to ensure that a broker-dealer promptly can sell a security and receive its value. The types of securities that meet this definition include obligations of the United States and its agencies, as well as many asset-backed, corporate debt, and sovereign debt securities. It is a standard understood by SEC-registered broker-dealers and monitored by the SEC, and if the bank is unsure of the status of a security, it can determine the status by asking how the security is treated by the broker-dealer affiliate for its own capital purposes.

The Board believes that the ''ready market'' test provides the best standard that is well understood by the banking and securities industries. Because a broker-dealer must adjust its capital daily—and therefore must confirm daily that its assets meet the ''ready market'' definition—the liquidity of purchased securities is confirmed by an independent standard on a regular basis. The Board believes that the ''ready market'' standard provides more specific guidance to banks than either the OCC's ''marketable'' definition or NASD Rule 2730.

In addition, the Board does not believe that NASD Rule 2730 is appropriate for the exemption because the rule is concerned primarily with the price at which a security is bought. The Board disagrees with commenters who stated that only price, not liquidity, is critical under the (d)(6) exemption. The (d)(6) exemption, by its terms, applies only to assets with a ''market'' quotation. The Board believes that inherent in the concept of a market quotation is the idea that the asset can be bought and sold on a regular basis. Moreover, this proposal deals primarily with assets that are too thinly traded to warrant listing of their price in a widely disseminated publication, and this criterion helps support the validity of the market quote mechanism discussed below. In addition, section 23A requires

[3] 17 CFR 240.15c3–1(c)(11)(i). The SEC defines a ready market as including a recognized established securities market: (i) In which there exist independent *bona fide* offers to buy and sell so that a price reasonably related to the last sales price or current *bona fide* competitive bid and offer quotations can be determined for a particular security almost instantaneously; and (ii) where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom.

[4] 12 CFR 1.2(f)(4).

that all covered transactions, whether or not they meet an exemption, be on terms and conditions that are consistent with safe and sound banking practices. The Board believes that it would be inconsistent with safe and sound banking practices to allow a depository institution to purchase from an affiliate unlimited amounts of a security for which no ''ready market'' exists.

(3) The Securities Must Be Eligible for Purchase by a State Member Bank and Must Not Be Low-Quality Assets

In the 1998 Proposal, the Board proposed that a purchase of a security would be eligible for the expanded (d)(6) exemption only if the security were rated investment grade by a nationally recognized statistical rating organization (''NRSRO''). In light of comments received on the proposal, however, the Board now proposes replacing the investment-grade requirement with requirements that the security be eligible for direct purchase by a State member bank under section 9 of the Federal Reserve Act, as determined by the Board,[5] and that the security not be a low-quality asset (as defined in section 23A).

The Board received one comment supporting the Board's proposed requirement that the security being purchased under the expanded (d)(6) exemption have an investment grade rating from an NRSRO. The commenter argued that this requirement would help ensure bank safety and soundness. Approximately ten commenters, however, opposed or proposed modifications to this requirement. Several commenters argued that this condition is unnecessary and overly restrictive, especially in light of the protections afforded by the Board's other proposed criteria. One commenter noted that the focus of the (d)(6) exemption is liquidity and market information, and the commenter argued that a security can have substantial liquidity and be the subject of significant market information even if it is not investment grade. Several commenters also contended that section 23A separately addresses the question of depository institution purchases of low-quality assets from affiliates, and they contended that there is no statutory basis for importing the investment grade requirement into the (d)(6) exemption.

Other commenters proposed alternative standards. Some of them argued that non-rated securities could satisfy the Board's concerns, provided that the purchasing depository institution conducts an independent evaluation of the security. Another commenter noted that the OCC's regulations allow national banks to purchase securities that are rated investment grade or, if not rated, are the ''credit equivalent'' of a security rated investment grade. Two commenters also argued that the Board's proposed requirement of an investment grade rating is superfluous given the OCC's restrictions on what types of securities national banks can purchase. Several commenters also argued that, at a minimum, the investment grade rating requirement should be expanded to include high yield securities traded on the NASD's Fixed Income Pricing System (''FIPS''), because the NASD carefully reviews a security's volume and pricing, and the issuer's name recognition and research following, before approving a security for FIPS quotation.

The Board originally proposed that a security must be rated by an NRSRO because it believed that such a rating ensured the marketability of a security and that the security would not be the equivalent of a ''low-quality asset,'' the purchase of which is prohibited by section 23A. In light of the comments, however, the Board has decided to eliminate the requirement that a security receive an investment grade rating from an NRSRO. Instead, the security will be eligible for the expanded (d)(6) exemption if it is eligible for purchase by a State member bank under section 9 of the Federal Reserve Act and is not a low-quality asset, as defined by section 23A.[6]

Section 9 of the Federal Reserve Act permits a State member bank to purchase securities that a national bank may own pursuant to paragraph 7 of section 5136 of the Revised Statutes.[7] This provision permits the purchase of a variety of securities, including obligations of State and local governments and asset-backed and corporate debt securities, that may not be rated. State member banks can purchase unrated corporate debt securities and asset-backed securities, however, only if the securities generally are the credit equivalent of a security rated investment grade.[8] Moreover, a State member bank's purchases of corporate debt securities of any one obligor are limited to 10 percent of the bank's capital and surplus; and purchases of asset-backed securities, except certain highly rated mortgage-backed securities, are limited to 25 percent of capital and surplus.[9] Institutions using this exemption would be subject to the restrictions described above and all other terms and conditions that govern the investment activities of State member banks.

The Board believes that the statutory and other restrictions placed on a State member bank's ownership of securities also are appropriate limits on the securities eligible for this interpretation of the (d)(6) exemption. The Board further believes that the purchase must be recorded by the insured depository institution as a security purchased, and not as a loan, pursuant to the instructions of the Call Report.

The Board also proposes to restrict the availability of this interpretation of the (d)(6) exemption to purchases of assets that are not low-quality assets (as defined in section 23A). Because of the inherent volatility of low-quality assets and section 23A's special concern with respect to purchases of low-quality assets, it is inappropriate to allow banks to purchase an unlimited amount of low-quality assets from an affiliate pursuant to this interpretation.

These two replacement requirements should increase the types of securities eligible for purchase under the new (d)(6) exemption, as compared with the investment grade requirement, while ensuring that purchases are consistent with section 23A's injunction that covered transactions, even exempt covered transactions, must be consistent with safe and sound banking practices.

(4) No Purchases During an Underwriting Period and for Thirty Days Thereafter

The Board's proposed interpretation would disqualify from the expanded (d)(6) exemption an insured depository institution's purchase of a security from an affiliate during the underwriting period for the security and for 30 days thereafter. Approximately 11 commenters expressed opposition to this criterion. The commenters believed that a 30-day underwriting exclusion is unnecessary. The commenters believed that the proposed restriction was based on misperceptions on the part of the Board about pricing volatility and conflicts of interest in the underwriting of securities.

Several commenters also argued that the Board's concerns regarding potential conflicts of interest between

[5] 12 U.S.C. 335.

[6] 12 U.S.C. 335.

[7] 12 U.S.C. 24(7).

[8] *See* 12 CFR 1.1(e). State member banks also are permitted to invest up to 5 percent of their capital and surplus in securities that may not be the credit equivalent of investment-grade securities, but only if the bank concludes that the obligors will be able to satisfy their obligations under the securities and that the securities may be sold with reasonable promptness at a price that corresponds reasonably to their fair value. *See* 12 CFR 1.3(i).

[9] *See* 12 CFR 1.3.

underwriting affiliates and depository institutions were unfounded. Commenters argued that the Board had not identified any conflicts and could not demonstrate that conflicts were sufficiently serious to require the proposed 30-day underwriting exclusion.

A number of commenters argued that the Board's proposed limitation could not be supported by the language of section 23A, which does not contain any restriction on purchases of securities during an underwriting period. Commenters also noted that section 23B does contain a provision that prohibits a depository institution from purchasing securities during the existence of any underwriting or selling syndicate if a principal underwriter of the securities is an affiliate of the depository institution. The prohibition in section 23B, however, contains an exception if the purchase or acquisition of securities has been approved by a majority of the directors of a depository institution before such securities are initially offered for sale to the public. The commenters contended that, if the Board decides to adopt the proposed restriction, the Board also should add a similar exception for purchases receiving prior director approval.

A number of commenters argued that, at a minimum, the 30-day waiting period after the underwriting should not be required. Some commenters argued that the 30-day buffer should be deleted, if in no other circumstances, in those situations in which an affiliate has been able to sell all of its allotted securities to third parties during the underwriting. Commenters also urged the Board to eliminate the 30-day waiting period for investment-grade securities.

Two commenters noted that, in the preamble to the proposed exemption, the Board stated that the proposed 30-day underwriting exclusion applies to bank-ineligible securities. The commenters noted, however, that the text of the proposed rule would appear to cover all securities, eligible and ineligible. The commenters urged the Board to clarify that the restriction would apply only to bank-ineligible securities.

The Board proposes to maintain the 30-Day Restriction in its final rule with one exception, because of uncertain market values of securities during and shortly after an underwriting period and because of the conflicts of interest that may arise during and after an underwriting period, especially if an affiliate has difficulty selling its allotment.

The Board believes that the 30-Day Restriction should not apply to purchases of obligations of, or obligations fully guaranteed as to principal and interest by, the United States or its agencies. The markets for these instruments generally do not require substantial market stabilization by the underwriters, and therefore it is less likely that the risks of stabilization efforts could be transferred from the securities affiliate to the depository institution.

The Board also has reviewed the restriction imposed by section 23B and its relationship to the (d)(6) exemption. As noted above, the requirements of section 23B are in addition to the requirements of section 23A. Section 23B requires the approval of a majority of the insured depository institution's directors prior to the purchase of securities for which an affiliate is a principal underwriter. Even with the directors' vote, however, the insured depository institution's purchase would be subject to the quantitative limits of section 23A. If the securities are exempt under (d)(6), however, there is no quantitative limit imposed on the insured depository institution. The Board believes that given the expansion of the types of securities that insured depository institutions can purchase under this interpretation of the (d)(6) exemption, a vote of the directors is not sufficient protection to the insured depository institution if it is permitted to purchase unlimited amounts of a security before it has even been offered for sale to the public.

(5) Price Verification Methods

Several commenters concurred with the Board's requirement for the verification of the price of each security purchased by a depository institution from an affiliated broker-dealer. At least two commenters supported the Board's inclusion of three alternative price verification methods—(1) A widely disseminated news source; (2) an electronic service that provides indicative data from real-time financial networks; and (3) two independent dealer quotes on the exact security purchased. These commenters believed use of the two independent dealer quotes would ensure that the securities in question are readily marketable and have a price that is verifiable, which may not be the case if only one price quote were obtained.

Approximately ten commenters expressed concerns about the price verification methods proposed by the Board. One commenter suggested the Board eliminate the detailed requirements for price verification. The commenter suggested that these price verification conditions are redundant in light of the ''ready market'' condition discussed above.

Several commenters argued that, in addition to indicative data from real-time networks, the Board should permit the use of pricing matrices proposed by the bank or its affiliate, which the commenters claimed are widely used by dealers and institutional investors and relied upon in setting prices for actual trades. The commenters noted that matrices are updated daily and are based on actual trades and dealer marks-to-market involving securities having substantially similar characteristics. The commenters stated that, so long as a security meets the credit, liquidity, and other criteria of the proposed rule, a depository institution is as assured of obtaining the security at fair market value when using a matrix as the institution is when using any of the other pricing verification methods proposed by the Board.

A number of commenters suggested that, with respect to the third proposed method of verification (verification by two independent dealer bids on the same security), the Board also should permit verification by independent bids on closely *comparable* securities. The commenters argued that requiring quotes on the exact security purchased was needlessly burdensome. Several commenters also contended that permitting quotes on comparable securities would recognize that, as a practical matter, it is often difficult to get quotes on the particular security being purchased.

One commenter argued that there should be a mechanism that allows Board staff to evaluate the use of comparable securities on a case-by-case basis. Such a procedure, the commenter noted, would allow depository institutions to present the comparability question in the context of a specific security. Another commenter suggested that the Board adopt a method by which Board staff may consider the permissibility of new dependable pricing mechanisms as they become available. The commenter noted that rapid developments and enhancements of information systems may produce equally dependable price verification methods in the future, which, the commenter argued, should then be included in the scope of the interpretation.

The 1998 Proposal included a price verification test because of the statutory requirement that the asset have a ''readily identifiable and publicly available market quotation'' and the Board's belief that the proposed criteria would meet the statutory requirement. Prior to publication of the proposal, the

Board reviewed the use of matrices and the use of comparable securities and did not believe that those price verification methods would meet the statutory standard that the quotation be ''publicly available.'' In addition, the Board believed that the value of a security should be independently determined and not by a method that was subject to manipulation by the insured depository institution or its affiliated broker-dealer.

The Board has reviewed its position in light of the comments received on the 1998 Proposal and further analysis of the reliability of various pricing methodologies set forth in the 1998 Proposal. The Board continues to believe that the use of matrices and comparable securities to determine the price of a security may indicate a lack of liquidity in the market for that security, and the purchase of unlimited amounts of such a security from an affiliate raises safety and soundness concerns. Moreover, if a securities purchase could meet the (d)(6) exemption by the use of a matrix or comparable securities, the limitations Congress imposed in the (d)(6) exemption would be meaningless because an insured depository institution could always develop a price for a security using its own methodology. The Board believes that the use of third-party networks helps ensure that a market for the security exists and that the price the insured depository institution pays for the security is a fair market price.

Moreover, the Board has concluded that it would not be appropriate to use independent dealer quotations to establish a market price for a security under the expanded (d)(6) exemption. The Board also is concerned that a security that is not quoted routinely in a widely disseminated news source or a third-party electronic financial network may not trade in a sufficiently liquid market to justify allowing an insured depository institution to purchase unlimited amounts of such security from an affiliate.[10]

The exemption also provides that a depository institution that is taking advantage of the new (d)(6) exemption must pay a price for the relevant security that is no higher than the current market quotation for the security and must ensure that the size of the transaction executed by the depository institution does not cast material doubt on the appropriateness of relying on the current market quotation for the security.

The Board agrees with commenters that there should be procedures in place for the Board to review new dependable market pricing mechanisms as they become available. The Board will continue to assess the appropriateness of new methodologies.

(6) The Securities Must Not Be Issued by an Affiliate

Finally, the proposed interpretation provided that the exemption would not apply to securities issued by an affiliate unless those securities were backed by a guarantee of the U.S. government.

Several commenters specifically supported the Board's decision to exclude from the (d)(6) exemption those securities issued by an affiliate, including asset-backed securities issued by an affiliate and shares of a mutual fund advised by the depository institution or affiliate, unless such securities are guaranteed by the United States government. One commenter noted that inclusion of these securities within the interpretation could lead to potential self-dealing and could double capital exposure from the underwriting activity of the affiliate and the treatment of the security as an asset of the depository institution.

Two commenters argued that advised mutual funds should not be treated like other affiliates under section 23A. The commenters argued that, because a mutual fund's profits do not accrue to its advisor but to the fund's investors, there is little risk that a depository institution's purchase of shares of an advised mutual fund could contribute to the unlimited funding of the affiliated fund. The commenters noted that certain mutual fund shares are permissible investments for national banks under the OCC's regulations, mutual fund share prices are subject to comprehensive regulation under the Investment Company Act, and mutual fund share prices are published daily in *The Wall Street Journal*. The commenters contended that, in light of these facts, there is no justification for a blanket prohibition on depository institution purchases of affiliated mutual fund shares under the (d)(6) exemption.

Several commenters requested that the Board confirm that the sale of asset-backed securities, where the underlying assets were on the depository institution's books immediately prior to the securities offering, would be outside the scope of section 23A. The commenters argued that the Board's proposal should not be interpreted to extend section 23A limits to the investments of insured depository institutions in a securitization of their own loans or other assets merely because the securitization is underwritten or traded by their affiliated broker-dealer.

The proposed regulation prohibits the applicability of the (d)(6) exemption to most affiliate-issued securities because a contrary determination would permit a bank to acquire an unlimited credit exposure to an affiliate in contradiction to the purposes of section 23A. In addition, if a purchase of assets *from* an affiliate is also a purchase *of* affiliate-issued securities (if, for example, a bank purchases securities issued by one affiliate from the inventory of another affiliate), the bank has engaged in two types of covered transaction. Although the (d)(6) exemption may apply to the one-time asset purchase component of the transaction, it should not apply to exempt the ongoing investment in securities issued by an affiliate.

The Board continues to believe that safety and soundness requires restrictions on a bank's ability to purchase securities issued by an affiliate. Such restrictions help prevent a bank from acquiring an unlimited credit exposure to its affiliates, and are consistent with other provisions of section 23A, which limit the bank's ability to lend to an affiliate or accept the affiliate's securities as collateral.

In light of the comments, the Board will continue to review the appropriateness of making the purchase of affiliate-issued asset-backed securities and affiliate-advised mutual funds eligible for the (d)(6) exemption.

(7) Document Retention

Five commenters expressed concerns about the Board's proposed requirement that pricing information be retained in the insured depository institution's files for five years. One commenter requested that the Board change the requirement to allow documents to be retained only for two years. The commenter noted that depository institutions are examined every one or two years and, accordingly, it does not make sense to require retention of documents beyond an examination cycle.

Another commenter requested that Board staff consult and work with market participants regarding what information can be made available without imposing an undue administrative burden. Other commenters requested that the Board clarify that the requirement applies to documentation concerning the actual price paid; the commenters believed that a simple notation of the price paid and source of price verification should

[10] The final (d)(6) interpretation also does not include the ''widely disseminated news source'' pricing option because the old (d)(6) exemption remains as a separate, stand-alone exemption.

be sufficient. The commenters argued that otherwise this requirement would be overly burdensome for depository institutions, especially in light of the fact that historical pricing data are available from other sources.

The Board proposed a five-year standard because it believed that it would provide examiners a basis to review how the exemption was applied over time by insured depository institutions. The Board has determined to shorten the period of time necessary for the insured depository institution to retain the price verification information to two years. The Board concurs with the commenters that this period of time is consistent with the exam schedules of the institutions in question and that further information retention is not necessary in order to ensure compliance with the law. The Board does not believe that the documentation requirements are substantial, and insured depository institutions should contact their primary regulators to determine what documentation is required. At a minimum, however, the Board believes that an institution's records should clearly show the security purchased, the seller, price and date of purchase, and evidence of the method used to determine the price.

(8) Other Issues

Failure to meet the conditions for availability of this interpretation of the (d)(6) exemption does not prevent an insured depository institution from purchasing securities or other assets. A depository institution, of course, can continue to buy securities and other assets from an affiliate subject to the quantitative limits of section 23A and can buy such securities and other assets from unaffiliated parties without any section 23A limit, so long as the purchase is otherwise authorized by law. In addition, this interpretation of the (d)(6) exemption does not interfere with the ability of a depository institution to purchase securities and other assets from affiliates pursuant to the (d)(6) exemption so long as the prices of such assets are recorded in a widely disseminated publication that is readily available to the general public.

Regulatory Flexibility Act

The Board certifies that adoption of this final rule is not expected to have a significant economic impact on a substantial number of small business entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) because most small bank holding companies and insured depository institutions do not have registered broker-dealer affiliates. For this reason, most small bank holding companies would not be affected by this final rule. In addition, the rule would expand the types of transactions that an insured depository institution may engage in with its broker-dealer affiliates. Accordingly, the rule does not impose more burdensome requirements on depository institutions, their holding companies, or their affiliates than are currently applicable.

Administrative Procedure Act

Subject to certain exceptions, 12 U.S.C. 4801(b)(1) provides that new regulations and amendments to regulations prescribed by a Federal banking agency that impose additional reporting, disclosure, or other new requirements on an insured depository institution must take effect on the first day of a calendar quarter that begins on or after the date on which the regulations are published in final form. This rule is not subject to this delayed effective date requirement because the rule imposes no new requirements on existing operations of depository institutions. The rule only exempts transactions that were previously subject to the restrictions of section 23A.

Paperwork Reduction Act

The Board has determined that the final rule does not involve the collection of information pursuant to the provisions of the Paperwork Reduction Act of 1995, 44 U.S.C. 3501 *et seq.*

List of Subjects in 12 CFR Part 250

Banks, banking, Federal Reserve System.

For the reasons set forth in the preamble, the Board amends 12 CFR part 250 as follows:

PART 250—MISCELLANEOUS INTERPRETATIONS

1. The authority citation for part 250 continues to read as follows:

Authority: 12 U.S.C. 78, 248(i) and 371c(f).

2. Section 250.246 is added to read as follows:

§ 250.246 Applicability of section 23A of the Federal Reserve Act to the purchase of a security by an insured depository institution from an affiliate.

(a) The purchase of a security by an insured depository institution from an affiliate that is a broker-dealer registered with the Securities and Exchange Commission is exempt from section 23A of the Federal Reserve Act (12 U.S.C. 371c) under paragraph (d)(6) of that statute if:

(1) The security has a ''ready market,'' as defined in 17 CFR 240.15c3–1(c)(11)(i);

(2) The security is eligible for a State member bank to purchase directly, subject to the same terms and conditions that govern the investment activities of a State member bank, and the institution records the transaction as a purchase of securities for purposes of the bank Call report, consistent with the requirements for a State member bank;

(3) The security is not a low-quality asset;

(4) The security is not purchased during an underwriting, or within 30 days of an underwriting, if an affiliate is an underwriter of the security, unless the security is purchased as part of an issue of obligations of, or obligations fully guaranteed as to principal and interest by, the United States or its agencies;

(5) The security's price is quoted routinely on an unaffiliated electronic service that provides indicative data from real-time financial networks, provided that:

(i) The price paid by the insured depository institution is at or below the current market quotation for the security; and

(ii) The size of the transaction executed by the insured depository institution does not cast material doubt on the appropriateness of relying on the current market quotation for the security; and

(6) The security is not issued by an affiliate, unless the security is an obligation fully guaranteed by the United States or its agencies as to principal and interest.

(b) The purchase of the security must comply with paragraph (a)(4) of section 23A, which requires that any covered transactions between an insured depository institution and an affiliate be on terms and conditions that are consistent with safe and sound banking practices.

By order of the Board of Governors of the Federal Reserve System, May 3, 2001.

Jennifer J. Johnson,

Secretary of the Board.

[FR Doc. 01–11609 Filed 5–10–01; 8:45 am]

BILLING CODE 6210–01–P

FEDERAL RESERVE SYSTEM

12 CFR Part 250

[Miscellaneous Interpretations; Docket R–1016]

Applicability of Section 23A of the Federal Reserve Act to Loans and Extensions of Credit Made by a Member Bank to a Third Party

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: Section 23A of the Federal Reserve Act restricts the ability of a member bank to fund its affiliates through investments, loans, asset acquisitions, or certain other transactions (''covered transactions''). Section 23A deems transactions between a member bank and a nonaffiliated third party as covered transactions between the bank and its affiliate to the extent that proceeds of the transactions are used for the benefit of or transferred to the affiliate. The Board is adopting an interpretation and exemptions from section 23A for certain loans made by an insured depository institution (''depository institution'') to customers who use the loan proceeds to purchase a security or other asset through an affiliate of the depository institution acting exclusively as a broker or riskless principal in the transaction.

First, the Board is adopting an interpretation confirming that section 23A does not apply to extensions of credit by an insured depository institution to customers that use the loan proceeds to purchase a security or other asset through an affiliate of the depository institution, so long as the affiliate is acting exclusively as a broker in the transaction, and the affiliate retains no portion of the loan proceeds. The Board also is exempting from section 23A that portion of a loan to a third party that an affiliate retains as a market-rate brokerage commission or agency fee.

In addition, the Board is adopting an exemption from section 23A for extensions of credit by an insured depository institution to customers that use the loan proceeds to purchase a security issued by third parties through a broker-dealer affiliate of the institution that is acting as riskless principal in the securities transaction. Finally, the Board is adopting an exemption for extensions of credit by an insured depository institution to customers that use the credit to purchase securities from a broker-dealer affiliate of the institution when that extension of credit was made pursuant to a preexisting line of credit not entered into in contemplation of the purchase of securities from an affiliate of the depository institution.

EFFECTIVE DATE: June 11, 2001.

FOR FURTHER INFORMATION CONTACT: Pamela G. Nardolilli, Senior Counsel (202/452–3289), or Mark E. Van Der Weide, Counsel (202/452–2263), Legal Division; or Molly S. Wassom, Associate Director (202/452–2305), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20051.

SUPPLEMENTARY INFORMATION:

Background

Section 23A of the Federal Reserve Act, originally enacted as part of the Banking Act of 1933, is designed to prevent the misuse of a member bank's resources through ''non-arm's length'' transactions with its affiliates.[1] To achieve this purpose, section 23A establishes both quantitative limits and qualitative restrictions on transactions by a member bank with its affiliates. The statute limits ''covered transactions'' between a member bank and any single affiliate to no more than 10 percent of the bank's capital and surplus and limits aggregate covered transactions with all affiliates to no more than 20 percent of the bank's capital and surplus.[2] Covered transactions include extensions of credit, investments, and certain other transactions that expose the member bank to the credit risk of an affiliate. Section 23A also requires that credit exposures to an affiliate be secured by collateral, the amount of which is statutorily defined.[3]

In addition to regulating direct transactions between a bank and its affiliates, section 23A deems any transaction by a member bank with any person to be a transaction with an affiliate to the extent that the proceeds of the transaction are ''used for the benefit of, or transferred to,'' that affiliate.[4] This provision of the statute, commonly referred to as the ''attribution rule,'' is designed to prevent an evasion of the quantitative limits and collateral requirements of section 23A through the use of a third party that serves as a conduit for the flow of funds from the bank to its affiliates.[5] The Board and its staff have taken the position that section 23A applies to loans made by a bank to a third party, where the proceeds of the loans are used to purchase various types of assets from the bank's affiliate.[6]

Section 23A also gives the Board authority to grant exemptions from the statute's restrictions. Specifically, the statute permits the Board to exempt transactions or relationships, by regulation or by order, if such exemptions are ''in the public interest and consistent with the purposes of this section.'' [7]

In August 1997, the Board adopted Operating Standards governing the activities of section 20 subsidiaries.[8] Operating Standard #6 allows a bank to extend credit to a customer to purchase securities from a section 20 affiliate during the underwriting period for the securities, pursuant to a preexisting line of credit not entered into in contemplation of the purchase of affiliate-underwritten securities. In adopting Operating Standard #6, the Board stated that it would consider whether an exemption from section 23A for transactions permitted under the Operating Standard would be appropriate.

Proposal

On June 10, 1998, the Board proposed two exemptions from the quantitative limitations and collateral restrictions of section 23A for loans made by an insured depository institution, the proceeds of which are used to buy securities from a registered broker-dealer affiliate of the depository institution.[9] The first exemption proposed by the Board applied to loans made by a depository institution to its customers for the purpose of purchasing third-party securities through a registered broker-dealer affiliate of the institution that is acting as broker or riskless principal [10] in the securities

[1] 12 U.S.C. 371c. Although section 23A originally applied only to member banks, Congress has since applied the section to insured nonmember banks and insured savings associations in the same manner as it applies to member banks. *See* 12 U.S.C. 1828(j); 12 U.S.C. 1468.

[2] ''Capital and surplus'' has been defined by the Board as tier 1 and tier 2 capital plus the balance of an institution's allowance for loan and lease losses not included in tier 2 capital. 12 CFR 250.242.

[3] 12 U.S.C. 371c(c).

[4] 12 U.S.C. 371c(a)(2). Section 23A defines an affiliate to include, among other things, ''any company that controls the member bank and any other company that is controlled by the company that controls the member bank.'' 12 U.S.C. 371c(b)(1).

[5] *See* A Discussion of Amendments to Section 23A of the Federal Reserve Act Proposed by the Board of Governors of the Federal Reserve System 36 n.1 (September 1981).

[6] *See, e.g.*, Letter from General Counsel of the Board to Ms. Charla Jackson (August 26, 1996) (crop-production loan to farmer who leases farm land from a bank's affiliate is covered by section 23A).

[7] 12 U.S.C. 371c(f)(2).

[8] 12 CFR 225.200.

[9] 63 FR 32,766 (1998).

[10] ''Riskless principal'' is the term used in the securities business to refer to a transaction in which

transaction (''Broker/Riskless Principal Exemption''). As proposed, the exemption was applicable even if the broker-dealer affiliate of the depository institution retained part of the loan proceeds as a brokerage commission or, in the case of a riskless principal transaction, a mark-up for effecting the securities transaction.

The second proposed exemption applied to extensions of credit by a depository institution to a customer made pursuant to a preexisting line of credit, the proceeds of which were used to purchase securities underwritten or sold as principal by a registered broker-dealer affiliate of the institution (''Preexisting Line of Credit Exemption''). The proposal also required that the line of credit not have been entered into in contemplation of the purchase of securities from an affiliate and that either the line of credit be unrestricted or the extension of credit be clearly consistent with any restrictions imposed under the line.[11]

Summary of Comments and Final Rule

The Board received approximately 14 comments on the proposed exemptions. The commenters included ten banks or bank holding companies, and four trade associations that represent the banking industry. The Board also received seven comments from the Federal Reserve Banks. The commenters overwhelmingly supported the goals of the Board's proposals, which they believed would provide benefits to both consumers and depository institutions without raising the types of concerns that section 23A was intended to address, but many commenters argued that the Board should achieve its goals through alternative means.

Broker/Riskless Principal Exemption

Commenters generally agreed with the position taken in the Board's proposal that loans by an insured depository institution to a third party to purchase securities through a broker-dealer affiliate of the depository institution that is acting exclusively in a brokerage or riskless principal capacity should not be within the ambit of section 23A. Many commenters, however, argued that the Board should not adopt an exemption to section 23A that applies only to broker-dealers and securities. These commenters contended that a better course of action would be for the Board to issue an *interpretation* broader in scope than the proposed exemption. The interpretation suggested by the commenters would confirm that in no case is a loan from a depository institution to a third party subject to section 23A when the third party purchases assets through a bank affiliate acting exclusively as broker or agent for the third party (regardless of the affiliate's retention of brokerage or agency fees).

The commenters argued that adoption of a specific exemption for securities brokerage transactions involving broker-dealer affiliates implies that, absent a grant of exemption, the Board considers brokerage or agency transactions involving other types of affiliates and assets to be covered by section 23A. The commenters contended that, if an affiliate is acting only as broker or agent in a transaction, the affiliate does not receive a ''benefit'' from the transaction, and the transaction cannot be viewed as fitting within section 23A. One commenter, however, found support for the Board's decision to issue an exemption for riskless principal transactions, noting that there could be disagreement as to whether riskless principal transactions should be viewed as within the scope of section 23A.

The exemption from section 23A proposed by the Board would have applied when an insured depository institution lends to its customers for the purpose of purchasing third-party securities through a registered broker-dealer affiliate acting solely as broker or riskless principal in a securities transaction with the customer. The Board believed that the exemption would be consistent with the purposes of section 23A because of the negligible risk that loans made pursuant to the exemption would be used as a source of funding from an insured depository institution to its broker-dealer affiliate. As proposed, the exemption only would have been available when the securities being sold were not in the inventory of the broker-dealer. Accordingly, the loan proceeds, although initially transferred to the affiliate to purchase the securities, would be transferred in turn (minus a brokerage fee or riskless principal mark-up) to the seller of the securities, which would not be an affiliate of the depository institution.

The Board concurs with the commenters that extensions of credit by a depository institution to customers to purchase third-party securities and assets through an affiliate of the depository institution that is acting exclusively in a brokerage or agency capacity fall outside of the reach of section 23A to the extent that the affiliate retains no part of the loan proceeds. Accordingly, rather than issuing the proposed exemption from section 23A to cover certain types of brokerage transactions, the Board is issuing a broader *interpretation*, as requested by the commenters. The interpretation confirms that section 23A does not apply when a depository institution's borrower uses loan proceeds to enter into agency transactions with an affiliate of the depository institution so long as the securities or other assets being purchased by the borrower are not issued by, or sold from the inventory of, any affiliate of the depository institution and to the extent that no affiliate retains any portion of the loan proceeds.

A somewhat different analysis under section 23A is required, however, when an affiliate retains a portion of a depository institution's loan to a third party as a brokerage commission or agency fee. The portion of the loan used by the borrower to pay the affiliate's commission or fee would be subject to section 23A because that transaction fee represents the proceeds of a loan retained and used for the benefit of an affiliate under the attribution rule.

In accordance with its original proposal, the Board has determined to *exempt* from section 23A that portion of a loan from a depository institution to an unaffiliated customer that is retained by an affiliate of the institution as a market-rate brokerage fee or agency commission; that is, a fee or commission no greater than that prevailing at the same time for comparable agency transactions entered into by the affiliate with persons who are neither affiliates nor borrowers from an affiliated depository institution, as required by section 23B of the Federal Reserve Act (12 U.S.C. 371c–1). The Board expects that such transaction fees will be nominal amounts and will represent a small percentage of the overall agency transaction and, accordingly, believes that these fees present little opportunity for a depository institution to benefit its broker-dealer affiliate.

Finally, a loan from a depository institution to a customer who engages in a riskless principal trade through a broker-dealer affiliate of the depository institution would be covered transactions under section 23A. Riskless principal trades—although the functional equivalent of securities brokerage transactions—involve the purchase of a security by the depository institution's broker-dealer affiliate.

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a broker-dealer, after receiving an order to buy (or sell) a security for a customer, purchases (or sells) the security for its own account to offset a contemporaneous sale to (or purchase from) the customer. *See, e.g.*, 12 CFR 225.28(b)(7)(ii); *The Bank of New York Company, Inc.*, 82 Federal Reserve Bulletin 748 (1996).

[11] For example, if the customer had a preexisting line of credit limited to purchases of rated securities, then the bank would continue to be prohibited from lending to purchase unrated securities underwritten by an affiliate.

Accordingly, the broker-dealer retains the loan proceeds at least for some moment in time.[12] As noted in the proposing release, there is negligible risk that loans made by a depository institution to borrowers to engage in riskless principal trades through a broker-dealer affiliate of the depository institution would be used to fund the broker-dealer. For this reason, the Board believes that it is appropriate to adopt the proposed *exemption* from section 23A to cover riskless principal securities transactions engaged in by depository institution borrowers through broker-dealer affiliates of the depository institution.[13] This grant of exemption is applicable even if the broker-dealer retains a portion of the loan proceeds as a market-rate mark-up for executing the riskless principal securities trade.

Preexisting Line of Credit Exemption

Approximately a dozen commenters offered specific comments on the proposed preexisting line of credit exemption. A majority of these commenters supported the Board's proposed exemption and concurred with the Board's view that exempting an extension of credit pursuant to a preexisting credit line from section 23A would not raise safety and soundness concerns.

Several commenters expressed concern about the requirement that the credit line be ''preexisting.'' The commenters urged the Board to adopt other safeguards in lieu of the ''preexisting'' requirement. For example, one commenter argued that the Board should only require that banks conduct independent credit analyses before granting credit. Other commenters offered alternative standards.

The Board is adopting the exemption for preexisting lines of credit substantially as proposed. As noted above, the exemption applies to extensions of credit by a depository institution made pursuant to a preexisting line of credit, the proceeds of which are used to buy securities underwritten or held as principal by a registered broker-dealer affiliate of the depository institution. Under the exemption, extensions of credit must be made by a depository institution pursuant to a preexisting line of credit that was not entered into in contemplation of the purchase of securities by the borrower from an affiliate of the institution, and the extension of credit must be consistent with any restrictions imposed by the line. The Board believes that the ''preexisting'' and other requirements for such lines of credit are important safeguards to ensure that the credit was not extended by the depository institution for the purpose of inducing a borrower to purchase securities from or issued by an affiliate.

Several of the commenters that opposed the requirement that the line of credit be ''preexisting'' argued that, if, despite their objections, the Board decided to use a ''preexisting'' requirement as part of this exemption, the Board should adopt a safe harbor. These commenters urged the adoption of a five-day safe harbor, in which the credit line would meet the ''preexisting'' requirement if the line were established at least five days prior to the customer's securities transaction with the bank's broker-dealer affiliate.

The Board does not regard as necessary or appropriate a five-day safe harbor for determining whether a line of credit is truly ''preexisting.'' The Board intends that this exemption be used in good faith by depository institutions. As noted in the proposing release, in determining whether the exemption is being used in good faith, examiners will consider the timing of the line of credit. In addition, examiners will consider the conditions imposed on the credit line and whether the line of credit has been used for purposes other than the purchase of securities from an affiliate. The Board will issue additional examiner guidance regarding the ''preexisting'' requirement should such guidance prove necessary.

Some commenters objected that the proposed Preexisting Line of Credit Exemption was not necessary to cover a borrower's purchases of bank-eligible securities from an affiliate, which the commenters apparently believed fall outside the purview of section 23A. The attribution rule of section 23A does not, however, distinguish between bank-eligible and bank-ineligible securities: A loan from a depository institution, the proceeds of which are used by the borrower to buy securities underwritten or held as principal by an affiliate of the depository institution, would be covered by section 23A regardless of whether the securities purchased are bank-eligible or bank-ineligible. To avoid having the loan covered by the quantitative limits of section 23A, the loan would need to qualify for an exemption under the statute—either the Preexisting Line of Credit Exemption being adopted by the Board today or some other exemption (*e.g.*, the exemption in section 23A(d)(4) for obligations fully secured by deposit accounts or U.S. government obligations).

At the request of one commenter, the Board also is clarifying that the Preexisting Line of Credit Exemption may not be used in circumstances in which the line has been merely pre-approved. Accordingly, for an extension of credit to qualify for this exemption, the credit line must be, in fact, ''preexisting'' and not merely ''preapproved.''

Regulatory Flexibility Act

The Board certifies that adoption of these rules is not expected to have a significant economic impact on a substantial number of small business entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) because the Board's action creates exemptions and clarifies certain interpretations under section 23A of the Federal Reserve Act. Accordingly, the Board's action does not impose more burdensome requirements on depository institutions, their holding companies, or their affiliates than are currently applicable.

Administrative Procedure Act

Subject to certain exceptions, 12 U.S.C. 4801(b)(1) provides that new regulations and amendments to regulations prescribed by a Federal banking agency that impose additional reporting, disclosure, or other new requirements on an insured depository institution must take effect on the first day of a calendar quarter that begins on or after the date on which the regulations are published in final form. These rules are not subject to this delayed effective date requirement because the rules impose no new requirements on existing operations of depository institutions. The rules only exempt transactions that were previously subject to the restrictions of section 23A.

Paperwork Reduction Act

The Board has determined that the rules do not involve the collection of information pursuant to the provisions

[12] For this reason, riskless principal trades involve risks that are different from securities brokerage transactions. *See, e.g.*, Exchange Act Rel. No. 33,743, *reprinted in* [1993–1994] Fed. Sec. L. Rep. (CCH) 85,326 (March 9, 1984).

[13] As in the proposed rule, the final rule would make clear that the exemption for riskless principal transactions would not apply if the broker-dealer affiliate sold securities to the third-party borrower out of its own inventory or out of the inventory of another affiliate of the depository institution. This condition is not intended to make the exemption unavailable when the broker-dealer affiliate sells as principal to the third-party borrower a security that it purchased immediately prior to the sale in order to effect the riskless principal transaction requested by the borrower, so long as the broker-dealer affiliate did not purchase the security from another affiliate of the depository institution.

of the Paperwork Reduction Act of 1995, 44 U.S.C. 3501 *et seq.*

List of Subjects in 12 CFR Part 250

Banks, banking, Federal Reserve System.

For the reasons set forth in the preamble, the Board amends 12 CFR part 250 as follows:

PART 50—MISCELLANEOUS INTERPRETATIONS

1. The authority citation for part 250 continues to read as follows:

Authority: 12 U.S.C. 78, 248(i) and 371c(f).

2. Section 250.243 is added to read as follows:

§ 250.243 Applicability of section 23A of the Federal Reserve Act to loans and extensions of credit by an insured depository institution to a nonaffiliate to enable the nonaffiliate to purchase an asset through an affiliate of the institution that is acting exclusively in an agency or brokerage capacity in the transaction.

(a) The attribution rule of section 23A of the Federal Reserve Act (12 U.S.C. 371c) provides that ''a transaction by a member bank with any person shall be deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate.'' [1] The Board has considered the question of whether a loan or extension of credit by an insured depository institution (''depository institution'') to an unaffiliated borrower who uses the proceeds of the transaction to purchase an asset through an affiliate of the institution that is acting exclusively as an agent or broker in the transaction should be subject to the attribution rule because of the limited benefit that the affiliate receives when it acts only as an agent or broker in the transaction. The Board believes that a loan by a depository institution to an unaffiliated borrower who uses the proceeds of the loan to purchase an asset through an affiliate of the institution that is acting exclusively in an agency or brokerage capacity is not covered by section 23A if the affiliate retains no portion of the loan proceeds as a fee or commission for its services.

(b) A somewhat different analysis is required when the affiliate acting as agent or broker in the transaction retains a portion of the loan proceeds as a fee or commission. In such a case, the portion of the loan not retained by the affiliate as a fee or commission still would be outside the coverage of section 23A. On the other hand, the portion of the loan retained by the affiliate as a fee or commission would be subject to section 23A because it represents proceeds of a loan by a depository institution to a third party that are transferred to, and used for the benefit of, an affiliate of the institution. The Board hereby grants an exemption from section 23A for such fees and commissions.

(c) The Board notes that this interpretation would not apply if the securities or other assets purchased by the third-party borrower through the affiliate of the depository institution were issued or underwritten by, or sold out of the inventory of, another affiliate of the depository institution. In such a case, proceeds of the loan from the depository institution would be transferred to, and used for the benefit of, the affiliate that issued, underwrote, or sold the asset on a principal basis to the third party.

(d) The Board also notes that the transactions described above (including the loan to the third-party borrower and any fee or commission paid to the affiliate of the depository institution out of the loan proceeds) would be subject to the market terms requirement of section 23B, which applies to ''any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or any other person.'' [2]

3. Section 250.244 is added to read as follows:

§ 250.244 Exemption from section 23A of the Federal Reserve Act for certain loans and extensions of credit by an insured depository institution to a nonaffiliate to enable the nonaffiliate to purchase securities through a registered broker-dealer affiliate of the institution that is acting exclusively as riskless principal in the securities transaction.

(a) A loan or extension of credit by an insured depository institution (''depository institution'') to any person other than an affiliate of such depository institution is exempted from section 23A of the Federal Reserve Act (12 U.S.C. 371c) if—

(1) The loan or extension of credit is on terms that are consistent with safe and sound banking practices; and

(2) The proceeds of the loan or extension of credit are used to purchase a security through an affiliate of the depository institution that is a broker-dealer registered with the Securities and Exchange Commission, where

(i) The affiliate is acting exclusively as a riskless principal in the securities transaction; and

(ii) The security is not issued or underwritten by, or sold out of the inventory of, any affiliate of the depository institution.

(b) This grant of exemption is applicable to a loan or extension of credit covered by paragraph (a) of this section even if a portion of the proceeds of the loan or extension of credit is used by the borrower to pay a riskless principal mark-up to the affiliate, provided that the mark-up is substantially the same as, or lower than, those prevailing at the same time for comparable transactions with or involving other nonaffiliated companies, in accordance with section 23B of the Federal Reserve Act (12 U.S.C. 371c–1).

4. Section 250.245 is added to read as follows:

§ 250.245 Exemption from section 23A of the Federal Reserve Act for certain loans and extensions of credit by an insured depository institution to a nonaffiliate made pursuant to a preexisting line of credit.

Section 23A of the Federal Reserve Act (12 U.S.C. 371c) shall not apply to an extension of credit by an insured depository institution (''depository institution'') to any person other than an affiliate of such depository institution if—

(a) The proceeds of the loan or extension of credit are used to purchase a security from or through an affiliate of the depository institution that is a broker-dealer registered with the Securities and Exchange Commission; and

(b) The loan or extension of credit is made pursuant to, and consistent with any conditions imposed in, a preexisting line of credit that was not established in contemplation of the purchase of securities from or through an affiliate of the depository institution.

By order of the Board of Governors of the Federal Reserve System, May 3, 2001.

Jennifer J. Johnson,

Secretary of the Board.

[FR Doc. 01–11607 Filed 5–10–01; 8:45 am]

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[1] 12 U.S.C. 371c(a)(2).

[2] 12 U.S.C. 371c–1(a)(2)(D).

FEDERAL RESERVE SYSTEM

12 CFR Part 250

[Miscellaneous Interpretations; Docket No. R–1104]

Application of Sections 23A and 23B of the Federal Reserve Act to Derivative Transactions With Affiliates and Intraday Extensions of Credit to Affiliates

AGENCY: Board of Governors of the Federal Reserve System.